UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Before the
Louisiana Public Service Commission
Baton Rouge, Louisiana 70821

Affiliate Relationships

Docket Number U-21453

Comment of the Staff of the
Bureau of Economics
of the Federal Trade Commission (1)

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I. Introduction and Summary

markets yet preserve any significant vertical economies with the parent utility. Experience in other settings suggests that this bidding arrangement can work if there is confidence in the objectivity of the bid evaluation process.

If the LPSC considers adopting rules permitting an affiliate to use the corporate name or logo of the regulated parent firm with the proviso that such use be accompanied by a disclaimer, Section VI notes that the LPSC may wish to conduct consumer testing to assure itself that such a disclaimer is sufficient to avoid consumer deception. However, it may be difficult to establish an effective disclaimer.

II. Benefits and Costs of Separating a Utility from Its Affiliates

The LPSC is justifiably concerned about effects on consumers and competition of potential discrimination and cross-subsidization in transactions between regulated distribution utilities and their unregulated affiliates providing retail electric and gas services.(5) These concerns are increasing as states implement regulatory reform in the electric industry by requiring vertically integrated monopolies to unbundle various services. The basic policy issue concerns how to balance the expected benefits and costs of separating regulated utilities from their unregulated affiliates. The Public Utility Commission of Texas has noted that this trade-off should be analyzed with a recognition of utilities' continuing incentives:

[T]here is a strong likelihood that a utility will favor its affiliates where these affiliates are providing services in competition with other, non-affiliated entities. . . . [In addition,] there is a strong incentive for regulated utilities or their holding companies to subsidize their competitive activity with revenues or intangible benefits derived from their regulated monopoly businesses. . . . Finally, . . . current regulations . . . are not adequate to prevent or discourage [this] anticompetitive behavior. . . . However, the Commission is aware that efficient competition is fostered by encouraging the participation of many qualified participants, including unregulated affiliates.(6)

The potential benefits to consumers from preventing discriminatory transactions and cross-subsidization between regulated distribution utilities and their unregulated affiliates can take several forms. First, discrimination and cross-subsidization may artificially increase the costs of the regulated utility as costs incurred for the benefit of the affiliate are shifted to the regulated firm. Under a rate-of-return regulatory regime, higher costs will result in increased prices in the regulated market. Second, such conduct may increase costs in unregulated markets by displacing innovative, lower-cost suppliers and entrants with a higher-cost affiliate of the local regulated distribution utility. Third, this displacement also may eliminate or reduce the process and product innovations that the displaced firms would have provided to consumers.

On the other hand, unbundling can impose costs on consumers in the form of lost economies of vertical integration and forgone economies of scale or scope.(7) These lost economies translate into higher costs and higher prices in either the regulated or unregulated markets. In addition, participation by affiliates may in itself increase competition in relevant markets.

In weighing the trade-offs between preventing discrimination and fostering economies of vertical integration, it is important to keep in mind that these questions arise in a broader context of introducing competition into a very large industry with widespread effects on local economies as well as the national economy. For competition to take hold quickly and effectively in these formerly regulated markets, it may be particularly important to dispel potential entrants' perceptions that the incumbent distribution firms will manipulate rules and mislead regulators to the disadvantage of new competitors.

This perception issue gains urgency to the extent that entry may be less costly when competition is being introduced initially in t

perception of potential discrimination and cross-

length basis. For example, the LPSC may wish to require that the bulk of regulated utility purchases from unregulated affiliates be restricted to contracts won through an objective bidding process in which a third party evaluates the bids.

A critical element of workable bidding systems is the perceived and actual objectivity of the bid evaluation process. The system must be perceived as objective in order to attract bidders. Potential bidders, other than affiliates, may be unwilling to incur the costs of making a bid if the system is perceived as biased in favor of affiliates. The system must also be objective in fact in order to avoid raising costs for customers of the regulated utility. The use of third-party evaluations of the bids is one technique for achieving such objectivity.(13)

A question addressed by some state regulators is whether non-energy affiliates would be covered by

alternative policy of requiring that the affiliate (and any other firms granted the right to use the logo) pay the parent for the right to use the logo.(26) Because the logo is an asset, use of the logo by other firms, including affiliates, represents an asset transfer from the parent firm, and the LPSC may wish to treat it like other asset transfers.(27) In order to avoid cross-subsidization in such a transaction, the use of the parent logo must be fairly evaluated.(28)

anticompetitive practices of pipeline marketing affiliates (1987) (Pipeline Comment); and Docket No. RM85-1-000 (pipeline regulation after partial wellhead decontrol) (1985).

3. LPSC Staff Report and Public Interest Determination, Docket No. U-21453 at 28 (Dec. 17, 1998).

4. Behavioral unbundling rules proscribe specific behavior between a parent and its affiliate, but do not remove the parent's profit incentives to engage in such behavior.

5. Under fully implemented retail competition, it is expected that both generation and final sales to end users (such as residential consumers, businesses, schools, etc.) will operate competitively with no price regulation. Meanwhile, distribution and transmission services are likely to remain regulated, given current technology. The formerly regulated local monopoly suppliers generally will be required to unbundle their services when retail competition is initiated. (An exception may occur if the state designates the traditional vertically integrated utility as the "supplier of last resort" to serve customers who do not select a competitive supplier.) To accomplish this unbundling, a traditional utility that is allowed by law or regulation to retain ownership of all its previous assets could, for example, elect to establish separate affiliates that would compete in (1) generating electricity (competing with other generators) and (2) selling electricity to consumers (competing with power marketers, independent power producers, utilities from nearby geographic areas, or the electricity supply pool associated with an Independent System Operator (ISO)). The utility also could establish unregulated affiliates in other industries or in other geographic markets in the electric industry.

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14. See e.g., Massachusetts Department of Telecommunications and Energy, Order on Standards of Conduct (DTE 97-96), Section 12.C (May 29, 1998).

15. Edison Electric Institute, 4 Retail Wheeling & Restructuring Report 65 (March 1998).

16. The incremental (marginal) cost of marketing to additional customers is likely to be lower if consumers are already familiar with the logo employed in the marketing effort, since little effort will be required to establish familiarity.

17. If the competing firms do not respond with lower prices, the affiliate likely will gain market share. If so, the average price in the market will be lower, even if competitors do not reduce their prices when the affiliate lowers prices, because of its lower marginal costs.

18. Consumers could view use of the paren