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

Second, the MDTE has created behavioral rules prohibiting favoritism or discrimination in transactions between regulated parent utilities and their unregulated affiliates. As discussed in Section V, the MDTE may wish to add a "market-like" institution to govern transactions between parent utilities and their affiliates, so that a regulated utility's purchases from unregulated affiliates would be limited to contracts won through an objective bidding process in which a third party evaluates the bids. This arrangement is likely to allow an affiliate to participate in unregulated 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.

Third, the MDTE rules permit 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 MDTE may wish to conduct consumer testing to assure itself that such a disclaimer is sufficient to avoid consumer deception. It may be difficult to establish an effective disclaimer.

Fourth, the MDTE's explanatory statement accompanying its rules relies, in part, on enforcement of the Federal antitrust laws to remedy existing market power. The Federal antitrust laws were developed to prevent increases in market power through mergers or unfair forms of competition. The analysis of horizontal mergers under the guidelines developed by the U.S. Department of Justice and the Federal Trade Commission(6) does not focus on detecting or measuring market power that either may exist in the market or is not being protected or enhanced by unfair methods of competition. As we discuss in Section VII, the MDTE may wish to reexamine whether to address

projected economies are realized.(14) At that time, it may be appropriate for the MDTE to review the experience of other jurisdictions that have prescribed different kinds of affiliate rules.(15) The MDTE may wish to move to a divestiture policy after its subsequent policy review if (1) the existing rules prove inadequate to prevent discriminatory conduct or cross-subsidization by affiliates or parent utilities (or are too costly to enforce), and (2) the benefits of preventing such conduct outweigh the costs of forgone economies of vertical integration.

V. Limits on Transactions Between Utilities and Their Affiliates

The MDTE has established certain behavioral rules to discourage discrimination in transactions between regulated utilities and their unregulated affiliates. As discussed above, we have significant reservations about the effectiveness of relying exclusively on behavioral rules. If the scale, scope, or vertical integration economies of affiliation are substantial and can be realized even in the presence of functional unbundling, the MDTE may wish to strengthen its approach by requiring the affiliates to operate independently, on a bid-based, arm's-length basis. For example, the MDTE 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.

unwilling to incur the costs of mak(ef)2(f)2(612 470.88e,) [(t4)119(ng p)05 T6cTd [(l)-1()2(i)-elest be per1 Pot m, (h)13ecotire(bj)-1(el)1

(1) Potential Deception: Massachusetts is concerned about the effects on consumers and competition of unrestricted use by unregulated affiliates of the logo of the regulated distribution firm. Harm to consumers and competition may occur if elements of the reputation of the regulated firm are not applicable to the unregulated affiliate, but consumers believe that they are applicable when the unregulated affiliate uses the parent utility's logo.(23) For example, an element of a parent firm's reputation might be the credibility of its pledges of high-quality service that are backed by the parent's financial stability as a government-franchised monopoly. If a consumer imputed this same credibility to an affiliate's promises of high-quality service because of its use of the parent's logo, when in fact the affiliate did not have access to the revenues of the monopoly franchise, the consumer could be injured if the affiliate was unable to fulfill its promises in the way the consumer expected.(24) Under such circumstances, the use of the logo by the unregulated affiliate could harm consumers and competition in much the same way as deceptive advertising.

Deceptive advertising is prohibited under Section 5 of the Federal Trade Commission Act.(25) The FTC generally considers advertising deceptive if at least a substantial minority of consumers acting reasonably takes a particular message from an advertisement, and if that message is likely to mislead consumers to their detriment.(26)

Thus, when considering the effect of an affiliate's use of the parent utility's logo, the FTC would consider consumers' impressions about the relationship between the utility and the affiliate and whether those impressions would be likely to affect purchase decisions. If use of the utility's logo implies to consumers that the relationship between the utility and the affiliate is different from what it really is -- an attribute that consumers care about -- such use of the logo could be considered deceptive.

We suggest that the MDTE evaluate the alternatives related to this issue by focusing on the impression that consumers are likely to have under a particular policy alternative, and whether that impression would be accurate. For example, it may be difficult to develop disclaimers as proposed by the MDTE that are simultaneously sufficient to avoid deception and succinct enough not to make impractical the unregulated affiliates' use of the regulated parent utility's logo. Consumer research designed to investigate the effects of several alternative policies on consumers may be the most effective approach.(27) If research reveals that consumers are harmed by this deception, the MDTE may wish to restrict further an affiliate's use of the parent's logo.

(2) Potential Cross-subsidization and the Use of the Parent Utility's Logo: Although some forms of cross-subsidization may be effectively addressed by transfer pricing rules,(28) other forms may be more difficult to assess. Cross-subsidization could take the form of cost-shifting among inputs used for both regulated and unregulated products, such as the use of a corporate logo in marketing the affiliate's products and services as well as the regulated parent utility's products and services. Costs of shared inputs could be assigned in a biased manner (i.e., with additional costs assigned to the regulated side of the business) so that the regulated entity can justify higher rates. This biased assignment of costs, which is often difficult for regulators to detect and remedy, distorts competition and produces inefficiencies in the unregulated business as well.

The risk of failing to detect anticompetitive cross-subsidization is heightened if (1) the reputation of the regulated parent utility is effectively embodied or represented by its logo; (2) the regulated parent firm can improve its reputation by incurring costs of the type that regulators would traditionally include in the rate base of the regulated firm; and (3) the unregulated affiliate can enhance its own reputation among consumers by using the logo of the regulated parent firm, even if elements of the regulated firm's reputation do not apply to the affiliate. When these factors are present, a regulated incumbent will have a heightened incentive to overinvest in reputation-building because it can expect to incorporate a greater share of these investments into its rate base than if the assets were not shared with the affiliate. Moreover, the affiliate would realize additional profits from its increased sales in the unregulated market. The principal obstacle to deterring this conduct is that it may be extraordinarily difficult to distinguish competitive from anticompetitive levels of investment in reputation-building. Harm to competition and to consumers may result from such overinvestment and subsequent cross-subsidization.

Harm to competition may occur because the unregulated affiliate's access to the logo of its regulated parent gives it a cost advantage that otherwise equally efficient competitors cannot match. The anticompetitive results may include (1)

higher-than-necessary average operating (i.e., non-logo-related) costs for the industry and higher prices for consumers due to the continued operation of the affiliate, which can survive with higher-than-necessary costs due to the cross-subsidization; (2) greater market concentration and less competition than would occur absent the cross-subsidization;(29) and (3) discouragement of potential entry that likely would have occurred absent the cross-subsidization, including entry involving innovative products and production processes. If the MDTE finds this concern to be important, it may wish to recognize that transfer pricing rules may not address all of the significant forms of cross-subsidization, and thus may wish to consider ordering the divestiture of unregulated affiliates.

If the MDTE determines upon more detailed study that substantial economies of vertical integration cannot be realized without allowing affiliates to use the logos of their regulated parent utilities, the MDTE may wish to consider an 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.(30) 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 MDTE may wish to treat it like other asset transfers.(31) In order to avoid cross-subsidization in such a transaction, the use of the parent logo must be fairly evaluated. As discussed in Section V, a bid-based, arm's-length approach may be an effective method of reaching a fair valuation.

VII. Reach of the Federal Antitrust Laws

In some instances, the MDTE implies that antitrust enforcement can be relied upon to address issues of existing market power.(32) Although the DOJ/FTC Merger Guidelines provide a firm foundation for analyzing changes in prospective market power resulting from a proposed merger, the analysis does not focus on detecting or measuring market power that may already exist in the market. Further, antitrust enforcement is focused on anticompetitive mergers and unfair methods of competition. From an antitrust perspective, a firm that lawfully acquired market power does not commit an antitrust offense merely by exercising that power unless, for example, it engages in unfair methods of competition to protect that power. Consequently, antitrust enforcement may not be able to remedy such market power as a market moves from locally regulated monopolies to competition. The MDTE may wish to examine these instances to assess whether its rules are adequate in light of the limited reach of the Federal antitrust laws.

VIII. Conclusion

The MDTE has established a set of rules designed to strike a balance between preventing discriminatory conduct by utilities and their affiliates and preserving poss15(es1)15(h)13(t4 470.-0 0 9 ul)13(es)-3( )13(des)11(i)-0 9 ules d**es**s omethods470.88n.

1. This comment represents the views of the staff of the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Federal Trade Commission or any individual Commissioner.

2. This comment represents the views of the staff of the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Federal Trade Commission or any individual Commissioner. Inquiries regarding this comment should be directed to John C. Hilke (303-844-3565).

3. The staff of the FTC has submitted comments to various state agencies, including the Public Utilities Commission of Nevada, LCB File No. R087-98, PUCN Docket No. 97-5034 (affiliate rules) (Sept. 22, 1998); Louisiana Public Service Commission, Docket No. U-21453 (stranded costs) (Aug. 7, 1998); Michigan Public Service Commission, Case No. U-11290 (electric restructuring) (Aug. 7, 1998); West Virginia Public Service Commission, Case No. 98-0452-E-GI (electric restructuring) (July 15, 1998); Commonwealth of Virginia, Joint Subcommittee Studying Electric Industry Restructuring, SJR-91 (July 9, 1998); Public Utility Commission of Texas, Project Number 17549 (affiliate transactions) (June 19, 1998); Maine Department of the Attorney General and Public Utilities Commission, "Interim Report on Market Power in Electricity" (May 29, 1998); Louisiana Public Service Commission, Docket No. U-21453 (market power) (May 15, 1998); California Public Utilities Commission, Docket Nos. R.94-04-031 and I.94-04-032

26. See Federal Trade Commission's Policy Statement on Deception, letter to Hon. John D. Dingell, Chairman, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, U.S. House of Representatives (Oct. 14, 1983), appended to Cliffdale Associates, 103 F.T.C. 110 (1984).

27. Private parties may submit such evidence from privately funded research. The MDTE, however, may wish to be wary of testing performed on behalf of special interests, and may wish to take steps to ensure that the results represent useful indications of likely consumer impressions and behavior.

28. Transfer pricing rules typically forbid transactions between an unregulated affiliate and its regulated parent utility at prices that fall outside of specified limits. Commonly used boundaries include market prices, embedded costs, and book value.

29. If entry is difficult or delayed, market share gained through cross-subsidization also may have persistent market power effects even after the cross-subsidization has been discontinued.

30. Payments to the regulated distribution firm for use of its logo could reduce prices for distribution services by substituting for revenues that the firm otherwise would be authorized by the MDTE to collect through distribution charges.

31. In some situations, firms may sell the right to use a logo to independent entities, contingent upon conditions and restrictions placed on use of the logo.

32. Section III.B. refers to antitrust essential facilities cases as the source of an adequate remedy if a regulated utility or its unregulated affiliates hold essential facilities in an unregulated market. Section III.D. refers to Federal antitrust law for redress of existing market power of affiliates in non-regulated markets.