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Before the
Public Utilities Commission of Nevada
Carson City, Nevada

Regulations Governing Conditions Under Which

Affiliates of Distribution Companies May Offer Potentially 5034

Components of Electric or Natural Gas Service

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

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Regulations Governing Conditions

Under Which Affiliates of Distribution

The staff of the Bureau of Economics of the Federal Trade Commission (FTC) appreciates this opportunity to present

affiliates. The Public Utility Commission of Texas has noted that this tradeoff 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.

IV. Benefits and Costs of Potential Remedies for Market Power

As a general proposition, we have found that structural remedies to address market power, such as divestiture in merger cases, are the most effective and require the least amount of subsequent monitoring by government agencies. The effectiveness of structural remedies stems from the fact that they directly alter incentives. Divestiture, however, may be costly in terms of both transaction costs and irreversibility.

Behavioral remedies, in contrast, leave incentives for discriminatory behavior in place. They also are likely to impose a substantial burden on government agencies to monitor subsequent conduct. Because behavioral rules leave incentives to discriminate in place, active monitoring and enforcement of such rules is essential if the rules are to appreciably curtail discrimination.(9)

In two comments to the Federal Energy Regulatory Commission (FERC), we discussed this type of trade-off and recommended alternative approaches that appeared less costly than divestiture. Each approach sought to capture the benefits of structural remedies while retaining economies of vertical integration and allowing additional firms8o,t onie appraden /TT1

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 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;(25) and (3) discouragement of potential entry that likely would have occurred absent the cross-subsidization, including entry involving innovative products and production processes.

In Section 23 of its proposed rules, the PUCN generally [illegible] the use of the regulated distribution firm's logo by its

The PUCN has established a set of rules designed to strike a balance between preventing discriminatory conduct by utilities and their affiliates and preserving possible economies of vertical integration. The proposed rules appear to constitute a reasonable initial approach if there are both (1) significant economies of vertical integration between regulated utilities and their affiliates operating in unregulated markets, and (2) net benefits to be gained from separating regulated utilities and their unregulated affiliates. These rules may be strengthened by including bidding systems for transactions between regulated utilities and their unregulated affiliates and by extending these rules beyond energy-related affiliates, primarily because of concerns about potential cross-subsidization. The PUCN may wish to set a future date to reevaluate the adequacy of these rules with a view to moving to full divestiture if the rules have not prevented discrimination and cross-subsidization, or have proven too costly to enforce.

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.

6. Public Utility Commission of Texas, 23 Tex. Reg. 5294 (May 22, 1998).

7. Economies of vertical integration occur when a single firm's performance of activities at two or more stages of production yields lower average costs. Economies of scale are present if, when all inputs are adjusted optimally, average costs decline as output increases within a firm. Economies of scope are present if average costs decline when two or more products are produced by the same firm. See Jean Tirole, The Theory of Industrial Organization 16-21, 288 (1989).

8. See John E. Kwoka, Jr., Power Structure: Ownership, Integration, and Competition in the U.S. Electricity Industry (1996).

18. 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.

19. Consumers could view use of the parent utility's logo as a guarantee that the affiliate firm is not a fraudulent operator.

20. We use the term "logo" here to include the logo, name, and other elements used to identify the regulated utility.

21. 15 U.S.C. § 45.

22. 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).

23. Harm to consumers or competition could arise if, for example, the affiliate failed to provide the anticipated level of service reliability, forcing consumers to incur costs of obtaining access to alternative sources of supply.

24. Transfer pricing rules typically forbid transactions between an unregulated affiliate and its regulated parent utility