significant costs associated with regulating this behavior effectively, especially in time-sensitive electric power markets. On the other hand, a public utility may benefit from efficiencies of vertical integration that can be passed along to consumers in the forms of lower prices and broader service offerings.

In these comments, the FTC staff has started with the general proposition that potential cross-subsidization and other forms of vertical discrimination by regulated firms in favor of their unregulated affiliates, plus the costs of regulation, are significant enough that structural vertical separation is likely to be a preferable remedy, unless economies of vertical integration are substantial.(5) Thus, it is critical to have a framework to assess the economics of vertical integration.

This comment elaborates on an analytical framework that both the FTC and the Antitrust Division of the U.S. Department of Justice use in evaluating mergers and that could be applied here as well to consider the economics of vertical integration. In antitrust analysis, only those verifiable efficiencies flowing directly from a proposed transaction are cognizable to offset an increased threat to competition stemming from the transaction. Thus, in assessing efficiency benefits from proposed vertical integration, New Mexico may wish to consider only those efficiencies that reverse the threat to competition arising from the close operating relationship between a public utility and its unregulated affiliates. This analytical framework could be used in preliminarily assessing whether to separate vertically the regulated and unregulated activities of a public utility, as well as in specifically gauging the efficiency benefits of a particular joint activity between a public utility and its unregulated affiliate(s).

In addition to assessing the efficiency benefits of proposed transactions between regulated utilities and their unregulated affiliates, the NMPRC may wish to augment Section 10.1 of the draft code of conduct to more fully treat connection rules for distributed generation (DG) in New Mexico. Such a step may contribute significantly to the development of competition in providing electric power services to New Mexico's citizens and businesses. DG technologies are developing rapidly and may provide unique reliability and cost advantages to electricity users, provided that rules for interconnecting DG to transmission and distribution lines are in place to help provide a fair market test for this new technology.(6)

II. Cost/Benefit Analysis Is an Appropriate Framework for Codes of Conduct

Many of the public policy issues surrounding the appropriate elements in codes of conduct are the same as those involved in preventing discrimination in access to transmission.(7) The basic policy dilemma is how to balance the expected benefits and costs of separating regulated utilities from their unregulated affiliates. As the Public Utility Commission of Texas has noted, an analysis of this trade-off should recognize 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.(8)

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.

In the merger context, the federal antitrust agencies have adopted Horizontal Merger Guidelines that explain how the agencies analyze efficiencies potentially arising from a merger.(11) In particular, the agencies recognize only those merger-specific efficiencies that offset competitive concerns, termed "cognizable efficiencies." Although the following excerpt from the Horizontal Merger Guidelines discusses horizontal mergers, the same analysis is appropriate to evaluate efficiency claims when examining the competitive effects of vertical transactions, because significant competitive problems can arise in either context:

The Agency will consider only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects. These are termed merger-specific efficiencies. Only alternatives that are practical in the business situation faced by the merging firms will be considered in making this determination; the Agency will not insist upon a less restrictive alternative that is merely theoretical.

Efficiencies are difficult to verify and quantify, in part because much of the information relating to efficiencies is uniquely in the possession of the merging firms. Moreover, efficiencies projected reasonably and in good faith by merging firms may not be realized. Therefore, the merging firms must substantiate efficiency claims so that the Agency can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific. Efficiency claims will not be considered if they are vague or speculative or otherwise cannot be verified by reasonable means.

Cognizable efficiencies are merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service. Cognizable efficiencies are assessed net of costs produced by the merger or incurred in achieving those efficiencies.

The Agency will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market. To make the requisite determination, the Agency considers whether cognizable efficiencies likely would be sufficient to reverse the merger's potential to harm consumers in the relevant market, e.g., by preventing price increases in that market.(12)

The NMPRC may wish to use this analytical framework in making the preliminary assessment of whether to require vertical separation between a public utility and its unregulated affiliates.

In addition, the framework may be applicable in assessing the efficiency benefits of a particular joint activity between the public utility and its unregulated affiliate(s).(13) Given widespread evidence of continued vertical discrimination concerns in the operation of the transmission grid(14) and regulated utilities' similar incentives to favor their unregulated affiliates in other aspects of their operations, the NMPRC may wish to take into account the strong likelihood that certain joint activities or substantial transactions(15) between a regulated utility and one of its unregulated affiliates, other than an arm's-length purchase in an open market, represent a potential threat to competition. In this regard, the NMPRC may wish to consider requiring that the regulated utility demonstrate cognizable efficiencies sufficient to offset potential anticompetitive effects before the utility may engage in a particular joint activity or consummate a substantial transaction with one of its unregulated affiliates.(16)

III. Conclusion

In developing an affiliate code of conduct, a cost/benefit framework contrasting likely threats to competition with likely efficiency gains is useful. An important insight from application of the antitrust laws, which also use this framework, is that not all efficiencies are relevant. Only efficiencies that are verifiable and specific to the particular utility/affiliate relationship are relevant. The NMPRC may wish to incorporate this principle in its affiliate code of conduct to help provide a basis for evaluating proposed substantial transactions between regulated utilities and their unregulated affiliates. This will help assure that the NMPRC's affiliate code of conduct protects competition.

Respectfully submitted,

____

Jeremy I. Bulow, Director

John C. Hilke, Electricity Project Coordinator
Bureau of Economics
Federal Trade Commission
600 Pennsylvania Ave., N.W.
Washington, D.C. 20580

December 6, 1999

Endnotes:

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. The staff of the FTC has commented to FERC on electric power regulation in Docket No. RM99-2-000 (Aug. 16, 1999) (regional transmission organizations); Docket EL99-57-000 (May 27, 1999) (Entergy transco proposal); Docket RM98-4-000 (Sept. 11, 1998); Docket No. PL98-5-000 (May 1, 1998) (merger filing guidelines); Docket Nos. ER97-237-000 and ER97-1079-000 (Feb. 6, 1998) (New England ISO); Docket No. RM96-6-000 (May 7, 1996) (merger policy); Docket Nos. RM95-8-000 and RM94-7-001 (Aug. 7, 1995) (open access). The staff of the FTC also has submitted comments to various state agencies, including the Public Utilities Commission of the State of California, Docket No. R.98-12-015 (distributed generation) (Mar. 17, 1999) (California Distributed Generation Comment);