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

Before the

Public Utilities Commission of Texas
Austin, Texas

Chapter 25. Substantive Rules
Applicable to Elect ric Service Providers

Project Number 17549

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

June 19, 1998

I. Introduction and Summary

The FTC is an independent administrative agency responsible for maintaining competition and safeguarding the interests of consumers. The staff of the FTC often analyzes regulatory or legislative proposals that may affect competition or the efficiency of the economy. In the course of this work, as well as in antitrust research, investigation, and litigation, the staff applies established principles and recent developments in economic theory and empirical analysis to competition issues.

The staff of the FTC has a longstanding interest in regulation and competition in energy markets, including proposals to reform regulation of the natural gas and electric power industries. The staff has submitted numerous comments concerning these issues at both the federal and state levels.(3) Moreover, the FTC regularly reviews proposed mergers involving e

Second, creating “market-like” institutions to govern the types of transactions between utilities and their affiliates may be a viable system for preventing discrimination. These institutions will allow affiliates to participate in unregulated markets and preserve any significant vertical economies. In addition, experience in other settings suggests that bidding arrangements that mimic these institutions can work if there is confidence in the objectivity of the bid evaluation process.

Third, when unregulated affiliates are allowed to use a regulated parent utility’s name or logo, the parent utility may have incentives to overinvest in building its reputation (as a provider of high-quality services, for example) in ways that are difficult for regulators to detect and prevent. This may result in harm both to competition because the affiliate does not have to expend resources to build its reputation, and to consumers because these expenditures inflate the utility’s rate base. Accordingly, the PUCT may wish to investigate the likely effects on consumers of the use of a utility’s name and logos by unregulated affiliates.

Fourth, the comment observes that the proposed competitive bidding process does not specify whether the PUCT will disclose publicly the price and other terms of the winning contracts between utilities and their respective affiliates. To avoid facilitating collusion among bidders, the PUCT may wish to keep such information confidential, particularly in situations where the bidding process will be repeated.

II. Separation of a Utility from Its Affiliates

The PUCT observes that “. . . there is a clear trade-off between the degree of structural separation between utilities and their affiliates versus the amount of regulatory oversight that is required . . .(4) We agree with the PUCT’s assessment that

there is a strong likelihood that a utility will favor its affiliates where these affiliates are providing services in competition with other, non-affiliated entities. . . Further . . . 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.(5)

As a general proposition, we have found that structural remedies, 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 lies in the fact that they directly alter incentives. Behavioral remedies, in contrast, leave incentives for discriminatory behavior in place and impose a substantial burden on government agencies to monitor subsequent conduct.

On the other hand, divestiture also may be costly in terms of transaction costs and in terms of irreversibility. In two comments to FERC, we discussed this type of trade-off and recommended alternative structural approaches that appear less costly than divestiture. Each approach sought to capture the benefits of structural remedies while retaining economies of vertical integration and allowing additional firms (the affiliates) to participate in unregulated markets. In 1987, when the relevant industry was natural gas pipelines, we suggested that FERC prohibit marketing firms from using their affiliated natural gas pipelines, but we did not recommend vertical divestiture or rate regulations.(6) In 1995, with regard to competition in electric generation and transmission, we suggested that FERC promote independent system operators (ISOs) to control the regional electric transmission grids, as an alternative to ordering divestiture of transmission lines or relying solely on open access rules to promote competition in electric generation markets.(7) Both of these comments are attached.

Similarly, we believe that the PUCT’s approach of allowing utilities to own affiliates, but requiring them to operate independently, on an arm’s-length basis, may be a reasonable initial step. Before adopting its current proposals, the PUCT may wish to assure itself that there are significant existing or prospective economies of vertical integration and that such economies remain when affiliates are operated independently. If there are no economies of vertical

integration, divestiture may be more appropriate now, at the outset of regulatory reform. If arm's-length rules would prevent substantial economies of vertical integration, the PUCT may wish to consider carefully whether operational separation of a utility from its affiliates yields net benefits.

One advantage of the PUCT's proposed approach is that it will probably be less costly to revise than a policy of either ignoring potential discrimination or requiring full divestiture of affiliates. If the PUCT determines that its proposed rules can preserve significant economies of vertical integration, the PUCT may wish to add a provision to review its affiliate rules at a specified future date to ensure that these economies are realized. The PUCT may wish to move to a vertical divestiture policy after its subsequent policy review if (1) the proposals actually prove inadequate to prevent discriminatory conduct by affiliates or parent utilities (or prove very costly to enforce), and (2) the benefits of preventing such conduct outweigh the costs of foregone economies of vertical integration.

III. Li mits on the Types of Transactions Between Utilities and Their Affiliates

The PUCT proposes to limit the types of transactions between regulated utilities and their unregulated affiliates so as to make discrimination less likely. For the bulk of potential transactions, the PUCT proposes that utility purchases from affiliates be restricted to contracts won through an objective bidding process in which a third party evaluates the bids.

A critical element in making bid systems workable 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 bidding 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.(8)

The provisions on affiliate transactions proposed by the PUCT appear to focus primarily on making transactions between utilities and their affiliates more objective. Although this is a desirable outcome, these provisions do not appear to address another potential concern raised by vertical integration -- cross-subsidization by the parent utility of affiliates that are competing in unregulated markets. This cross-subsidization could take the form of cost-shifting among inputs used for both regulated and unregulated products. Costs of shared inputs, which in the electric power industry might include scheduling and general overhead, 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 cost-based 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. If the PUCT finds this concern to be important, it may wish to recognize that rules requiring arm's-length transactions may not address all of the significant forms of impermissible cross- subsidization, and to give additional consideration to ordering the divestiture of affiliates.

IV. Affiliate Use of the Parent Utility's Corporate Name or Logo

The PUCT proposes to require use of a disclaimer when an affiliate uses the parent utility's name or logo. This proposal attempts to address the concern that an unregulated affiliate's use of its regulated parent utility's name or logo is a particularly difficult form of cross-subsidization to police. This concern is most likely warranted if three conditions are present. First, the reputation of the regulated parent utility must be effectively embodied or represented by its name or logo. Second, the regulated parent utility must be able to improve its reputation by investing in equipme scn .S13(c)-3(t(1(i1.004 Tc -0.o 9 -0 0 9Tc 0 . t)2(o r)4(e)13(qui)-1(ro.002 Tw d62(o r)4(e)4(ei)-1(o)13(pr)17(1(icn 70.56 2211

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integration between regulated utilities and their affiliates operating in unregulated markets and (2) net benefits to be gained from the separation between the utilities and their affiliates. If this is the case, the PUCT may wish to set a date to reevaluate the adequacy of the rules it has adopted, with a view to moving to full divestiture if the rules have not prevented discrimination or have proven very costly to enforce. In the area of consumer protection, the PUCT may wish to adopt rules on advertising by affiliates that are consistent with FTC law on deceptive advertising. Finally, in receiving commercially sensitive information on winning bids, it would be prudent for the PUCT to maintain the confidentiality of such information in order to avoid aiding coordinated interaction among competitors.

Respectfully submitted,

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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. Inquiries regarding thi Iomdent19(i)-(I)a 15(r)(oue d(I)2(nqu)13(i4(oj)-1(e)13(ce1(oi)-6(T)15oi)-88 Tm [(J)-3(ohn)13(C)6(.)2(H)6(i)-1(l)15oi)-(3(i3

10. Arguably, injury could occur even if the affiliate did not renege on its promises, because the actual expected value of the promise is less than the consumer perceived it to be due to the affiliate's use of the parent utility's name or logo.

11. 15 U.S.C. § 45.

12. 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 (October 14, 1983), appended to Cliffdale Associates, 103 F.T.C. 110 (1984). The FTC's Policy Statement on Deception is attached.

13. It may be difficult to develop disclaimers as proposed by the PUCT that are simultaneously sufficient to avoid deception and succinct enough not to make use of the regulated parent utility's name or logo impractical for unregulated affiliates, given the proposed rules separating the management and financial condition of regulated parent utilities from their unregulated affiliates.

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