



**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

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ROUNDTABLE ON ENERGY SECURITY AND COMPETITION POLICY

-- Note by the US Department of Justice and the US Federal Trade Commission --

This note is jointly submitted by the Delegation of the US Department of Justice and the US Federal Trade Commission to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 21-22 February 2007.

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1. Introduction

1. The Competition Committee is sponsoring a roundtable on the links between energy security and competition policy with a focus on natural gas. A central topic of the discussion is the appropriate roles for markets and governments in attaining energy security. The United States' experience is that competitive markets, supported by sound enforcement of antitrust laws, play an important role in achieving energy security.

2. There is more than one definition of "energy security." For purposes of this paper, the United States antitrust agencies define energy security as ensuring a reliable and plentiful supply of energy provided in an efficient manner. A robust and competitive market – with prices that signal appropriate levels of demand, supply, and innovation, and thus with only moderate volatility – is important and necessary in efficiently achieving this result. In general, fuel supplies, like other commodities, are most efficiently produced and allocated through competitive markets. In the absence of an identified market failure, United States economic policy favors competition over government intervention. Fluctuations in the conditions of supply and price volatility alone do not generally warrant government intervention, as competitive forces are particularly well suited to respond quickly and efficiently to these occurrences.¹

3. The United States' own historical natural gas supply situation and resulting natural gas security situation have differed significantly from those of many other OECD members. The United States has long been "natural gas independent," aside from relatively small imports from Canada and minimal liquefied natural gas ("LNG") imports. In 2002, only one percent of United States natural gas consumption was from imported sources. Furthermore, North American natural gas production comes from geographically dispersed producing basins, providing additional protection against supply disruption.

4. To date, the United States has not had the experience of an external natural gas supply disruption, as it has been mostly self-sufficient in its supply of natural gas. Nevertheless, the United States is not a stranger to energy supply shocks more generally, and it has participated in international efforts to limit the effects of shocks on the world petroleum market. First prompted by the Arab oil embargo of 1973, industrialized petroleum-consuming nations, through the International Energy Agency ("IEA"), have built an elaborate system designed to mitigate the effects of energy shocks on their economies.²

¹ The United States recognizes that a serious external disruption to the energy supply can threaten a nation's security and, in that case, market forces alone may not be sufficient to assure energy security. National security is an example of a "pure public good." A "pure public good" is technically defined as a good that is "non-rival" and "non-excludable." "Non-rival" goods are goods with the characteristic that consumption of a unit of the good by one consumer does not affect the amount available to other consumers. "Non-excludable" goods are goods for which it is not feasible to exclude any consumer or group of consumers from receiving the benefits. Government intervention may be necessary for optimal output of such goods, since private markets usually do not provide sufficient incentives. Not every potential disruption to supply raises national security concerns, however, and it is important narrowly and carefully to define those that do before abandoning market solutions. As antitrust agencies, it is not our function to analyze threats to national security. We will, therefore, focus on the aspect of energy security within our expertise – the role of competition policy in energy security.

² In 1974 the members of the IEA enacted the Agreement on an International Energy Program. Specifically designed to apply to crude oil and refined petroleum products, the current system is coordinated through the IEA. Within the individual member nations of the IEA, national policies also promote energy security on a countrywide basis. *See* International Energy Agency, *Energy Policies of IEA countries - 2006 Review*. For an example of United States response to a supply disruption following Hurricane Katrina, *see* John H. Seesel, Associate General Counsel for Energy, *Market Forces, Competitive Dynamics, and Gasoline Prices: FTC Initiatives to Protect Competitive Markets, Testimony Before the Committee on*

2. Competition and Energy Security

5. In some nations, government ownership or control of petroleum infrastructure is seen as the best means to ensure energy security. The United States takes a different view. In the United States, the petroleum industry is almost entirely privately owned and operated and is subject to vigorous enforcement of the United States antitrust laws. That is, private ownership of the means of production and distribution – and prices determined by the interplay of supply and demand in a free market – are relied upon to encourage, among other things, efficient investment decisions in energy-producing capacity and in the infrastructure necessary to distribute energy efficiently to users. Antitrust laws, in turn, promote strong competition among petroleum companies and a diversified, robust industry that can be expected to react quickly to internal or external shocks.

6. The United States' experience shows that a private industry organized around competitive market principles, and complemented by sound and well-administered antitrust laws, is compatible with – and indeed is a necessary element of – efficiently achieving energy security. Competitive markets can provide for efficient supply routes and the price signals to attract capital to the industry to meet both current and expected future demand.

7. The United States generally relies on market-based competition, with limited exceptions, as the means of organizing the production and delivery of goods and services to consumers. Antitrust laws support this goal. Our experience has shown that competitive markets enhance consumer welfare by encouraging sellers to provide goods and services that are attractive to consumers. Competition also promotes the efficient allocation of society's scarce resources and encourages higher rates of innovation. Information provided by competitive markets is also likely to result in efficient long-term investment decisions.

8. Challenges to competitive markets can arise, however, when significant externalities – that is, spillover effects arising from the production or consumption of a good or service for which no compensation is paid – result in too much or too little of a good or service. For example, because purchasers and sellers of electricity do not fully incorporate the costs of pollution emitted by the plant, free markets can result in the over-provision of electricity generated by power plants burning high-sulfur coal. Free markets similarly can lead to under-provision of elements of common infrastructure, such as public parks, that create public benefits and are subject to a free-rider problem. Nevertheless, even when such failings occur in competitive markets, addressing them with the creative use of market-based mechanisms usually leads to more efficient solutions than relying on direct government regulation.³

9. Some sectors of the United States economy are currently regulated in whole or in part. The energy sector in particular has had substantial regulation during much of its history. Nevertheless, because of new technology, changing market conditions, and new economic thinking, there has been a re-examination during the past 30 years of whether the energy sector and other industries require continuing

Commerce, Science and Transportation, United States Senate, at 2-3 (Sept. 21, 2005), *available at* <http://www.ftc.gov/os/testimony/050921gaspricestest2.pdf>; Federal Trade Commission Report, "Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases" (Spring 2006), *available at* <http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf>.

³ For instance, the U.S. Environmental Protection Agency's Acid Rain Program creates a market for the trading of sulfur dioxide emissions credits. The information and incentives generated by the market for tradable emissions credits provides for much more efficient distribution of the costs of restricting emissions than traditional regulatory mandates could achieve.

comprehensive regulation.⁴ Specifically, policymakers in the United States have identified emerging opportunities to introduce competition into at least some aspects of once extensively regulated industries. Where those opportunities have appeared, competitive alternatives have been sought through deregulation and industry restructuring. The United States energy sector, including natural gas, has undergone substantial deregulation. As a consequence, the United States relies today much more on competition, safeguarded by its antitrust laws, to satisfy the demand of its consumers for energy.

10. Energy security as it relates to natural gas should encompass not only physical security but also economic security and the ability to recover quickly from disruptions. Competitive markets do just that. Competitive markets react to a rapid increase in demand without extended shortages that could necessitate non-price rationing. They can provide a mechanism for replacing, in an orderly fashion, a supply source that shifts to a different buyer. Competitive markets are flexible and allow market participants to react nimbly to unforeseen events without waiting for a central decision-maker.⁵ They also send accurate and timely price signals to capital markets in order to give rise to incentives for appropriate investment decisions in new plant and equipment as well as infrastructure.⁶ Another positive feature of competitive natural gas markets is transparent and reliable information that supports voluntary market transactions in the trading of natural gas.⁷ In particular, well-functioning futures markets reflect the collective expectations of all market participants regarding how prices will react to any changes in demand and supply conditions.

11. Antitrust laws that promote efficiently functioning, competitive markets are necessary for achieving energy security, though they may not be sufficient because of externalities related to energy security. The key features of competitive markets that help to maintain energy security are the diversity of market participants, the efficient use of resources in the productions and delivery of energy, and superior long-term investment decisions.⁸

3. The United States' Move to a Competitive Market for Natural Gas

12. The United States has not always had a competitive market in natural gas. For many years, the United States natural gas market was tightly controlled by a strict regulatory scheme, which included price controls at the wellhead. Before 1938, the regulation of natural gas was the responsibility of the individual states. In that year, the Natural Gas Act ("NGA")⁹ gave the Federal Power Commission the authority to establish rates for the interstate transmission of gas and to regulate asset acquisitions and changes in facilities and service.

⁴ See Natural Gas Supply Association, *The History of Regulation*, available at <http://www.naturalgas.org/regulation/history.asp>.

⁵ Daniel Yergin, *Ensuring Energy Security*, *Foreign Affairs*, at 4 (March/April 2006). For a recent United States Government statement about energy security in a broader context, see Paul E. Simons, Deputy Assistant Secretary of State for Energy, Sanctions and Commodities, Energy and National Security, Testimony before the Committee on Government Reform, United States House of Representatives, at 1 (May 16, 2006).

⁶ IEA web page, *Shared Goals* ("Undistorted energy prices enable markets to work efficiently."), available at <http://iea.org/Textbase/about/sharedgoals.htm>.

⁷ Paul E. Simons, Deputy Assistant Secretary of State for Energy, Sanctions and Commodities, Energy and National Security, Testimony before the Committee on Government Reform, United States House of Representatives, at 2 (May 16, 2006).

⁸ IEA, *Shared Goals*, at 1 ("Diversity, efficiency and flexibility within the energy sector are basic conditions for longer-term energy security . . ."), available at <http://www.iea.org/Textbase/about/sharedgoals.htm>.

⁹ 15 U.S.C. §§ 717 *et seq.*

13. In the 1970s, new technology and changing market conditions called into question whether comprehensive regulation was still justified, and United States policymakers began to re-evaluate regulatory policy across a number of historically regulated sectors, including natural gas. Among other measures, in 1978, Congress passed the Natural Gas Policy Act¹⁰ (“NGPA”) and established as national policy the movement toward a less regulated natural gas sector. The NGPA started a partial and phased relaxation of wellhead price controls, based on a finding “that direct federal price control exacerbated supply and demand problems by preventing the market from making long-term adjustments.”¹¹ In 1989, the NGPA was amended to require the removal of all remaining wellhead price controls by 1993.¹² Congress also acted to remove a number regulatory restraints that had stifled demand, including restrictions on using natural gas as a primary energy source for new electric power plants and new large industrial boiler facilities.

14. The Federal Energy Regulatory Commission, the successor to the Federal Power Commission, has used its regulatory powers to introduce competition into several previously regulated aspects of the natural gas sector. The centerpiece of this effort was Order No. 636, issued in 1992,¹³ which required pipelines to unbundle their services and become open-access carriers. Order No. 636 required pipelines to separate out the charges for each service and give customers the option of choosing different suppliers for each service. The Order also enabled shippers to sell excess capacity and eased the regulatory burdens for building new pipelines.

15. The Department of Energy, exercising its own regulatory powers, also has promoted competitive markets, in one case specifically finding that energy security is enhanced by selling natural gas from the North Slope of Alaska to Japan. The Department authorized such a sale based on a finding that it expects the “export project to provide important benefits in the areas of energy security, energy production, international relations, trade deficit reductions, and the Alaskan economy.”¹⁴ The Department found that use of the gas in a competitive market sale makes all parties better off because it fosters all aspects of competition. It noted that “the approval is intended to spur competition to develop North Slope natural gas efficiently, with the marketplace determining the course of development. The public interest lies in bringing this immense energy resource to market in an efficient and timely manner.”¹⁵ Congress and the regulatory agencies have made clear and consistent findings that competition enhances energy efficiency, creates incentives to increase supply, and thus bolsters energy security.

4. Competition Policy Applied to the Natural Gas Industry in the United States

16. Policies that promote competition will be ineffective without an enforcement system designed to make sure that those policies are carried out. Both the Federal Trade Commission and the Antitrust Division of the Department of Justice have been active in enforcing the federal antitrust laws in the natural gas industry. Most of the enforcement action has taken place in the context of mergers involving natural gas transportation and storage infrastructure.

¹⁰ 15 U.S.C. §§ 3301 *et seq.*

¹¹ *Transcontinental Gas Pipe Line Corp. v. State Oil & Gas Board*, 474 U.S. 409, 424 (1986).

¹² Natural Gas Wellhead Decontrol Act of 1989, Pub. L. No. 101-60.

¹³ Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 57 Fed. Reg. 15267 (Apr. 16, 1992); *order on rehearing*, Order No. 636-B, 57 Fed. Reg. 57911 (Dec. 8, 1992).

¹⁴ DOE/FE Opinion and Order No. 350, Yukon Pacific Corporation (ERA Docket No. 87-68-LNG), Order Granting Authorization to Export Liquefied Natural Gas from Alaska (Nov. 6, 1989).

¹⁵ *Id.* at 7.

17. The following cases are examples of how the United States antitrust agencies have protected competition in the industry, enhancing energy security in the process.¹⁶

4.1 *In the Matter of Dan L. Duncan; EPCO, Inc.; Texas Eastern Products Pipeline Company, LLC; and TEPPCO Partners, L.P.*¹⁷

18. On August 18, 2006, the Commission announced a law enforcement action challenging a 2005 acquisition that was not reportable under the Hart-Scott-Rodino Act. The transaction combined the natural gas liquids (“NGL”)¹⁸ storage business of Enterprise Product Partners, L.P. and TEPPCO Partners, L.P. under the common ownership of Dan L. Duncan. The NGL storage system in Mont Belvieu is the largest in the world and represents a critical component in the United States natural gas infrastructure. According to the Commission’s complaint, the acquisition violated Section 7 of the Clayton Act and Section 5 of the Federal Trade Commission Act by reducing competition in the market for salt dome storage for NGLs in Mont Belvieu. Specifically, the complaint alleged that the transaction likely would result in higher prices and service degradations by reducing from four to three the number of commercial salt dome NGL storage providers in Mont Belvieu. In settling the Commission’s charges, TEPPCO was required to sell its interest in an NGL storage facility and associated assets to a Commission-approved buyer by December 31, 2006.¹⁹

¹⁶ See, e.g., *In the Matter of TC Group, L.L.C., a limited liability company, Riverstone Holdings LLC, a limited liability company, Carlyle/Riverstone Global Energy and Power Fund II, L.P., a limited partnership, and Carlyle/Riverstone Global Energy and Power Fund III, L.P., a limited partnership* (“Carlyle/Kinder Morgan”) FTC Docket No. C-4183 (2007) (complaint alleging competition issues in terminal services for refined petroleum products); *In the Matter of Chevron Corporation and Unocal Corporation*, FTC Docket No. C-4144 (2005) (consent order including a requirement not to enforce certain reformulated gasoline patents); *In the Matter of Enterprise Products Partners L.P., and Dan L. Duncan* (“Enterprise Products Partners/GulfTerra Energy Partners”), FTC Docket No. C-4123 (2005) (consent order resolving issues in natural gas pipeline transportation system and a propane storage and terminaling services facility); *In the Matter of Conoco Inc. and Phillips Petroleum Company*, FTC Docket No. C-4058 (2003) (consent order requiring divestiture and agreements to resolve issues related to the markets for natural gas gathering, fractionation of natural gas liquids, and propane); *In the Matter of Southern Union Company and CMS Energy Corporation*, FTC Docket C-4087 (2003) (consent order requiring termination of agreements to manage pipeline and natural gas delivery, and limiting future pipeline activity); *In the Matter of El Paso Energy Corporation and The Costal Corporation*, FTC Docket No. C-3996 (2001) (consent order requiring divestiture of natural gas pipeline systems); *In the Matter of Valero Energy Corporation and Ultramar Diamond Shamrock Corporation*, FTC Docket No. C-4031 (2001) (consent order addressing competition issues in California Air Resources Board refining and market assets); *In the Matter of El Paso Energy Corporation and Sonat Inc.*, FTC Docket No. C-3915 (2000) (consent order requiring divestitures in transportation of natural gas).

¹⁷ See <http://www.ftc.gov/os/caselist/0510108/0510108.htm>.

¹⁸ NGLs comprise a group of light hydrocarbons – including ethane, propane, normal butane, isobutane, and natural gasoline – that are used for a variety of purposes, including as feedstocks in the production of ethylene and propylene, as fuel for heating or industrial processes, and in blending components for gasoline. They primarily are stored in large underground wells formed out of geological salt domes under the Earth’s surface until they are delivered to end-users, usually via pipelines. Mont Belvieu, Texas, contains the largest NGL storage system in the world, including pipeline connections that allow NGL marketers to reach the broadest array of end users. There were no viable competitive alternatives for NGL salt dome storage in Mont Belvieu.

¹⁹ The Commission’s order required TEPPCO to divest its interest in the Mont Belvieu Storage Partners NGL salt dome facility, as well as certain related pipeline, land, and other assets, no later than December 31, 2006. The Commission received an application for approval of divestiture in November 2006, and public comments on the application were received until December 27. The Commission will determine whether to approve the divestiture.

19. The market for salt dome storage for NGLs in Mont Belvieu is highly concentrated, and Enterprise and TEPPCO were the two largest suppliers based on storage volumes at the time of the acquisition.²⁰ Before the acquisition, Enterprise and TEPPCO competed directly for NGL salt dome storage volumes in Mont Belvieu based on price and service levels, with many customers ranking Enterprise and TEPPCO as their first and second choices for NGL storage. Both companies were connected to the Dixie Pipeline and competed for customers that wanted to ship products – primarily propane – into the southeastern United States. The acquisition significantly increased concentration in NGL salt dome storage in Mont Belvieu, leaving the merged entity with ownership of a dominant share of storage volume and capacity. The Commission alleged that a merged Enterprise/TEPPCO – combining the market leaders for NGL salt dome storage – would have an enhanced ability to exercise market power unilaterally, given that the remaining suppliers in the market could not replace the lost competition. Finally, entry into the Mont Belvieu NGL salt dome storage facility market was not likely to be timely or sufficient to offset the alleged anticompetitive effects of the transaction. The Commission’s challenge to this transaction preserved competition among vital facilities to ensure that Americans do not pay more for products derived from natural gas liquids, including plastics, heating fuels, and gasoline.

4.2 *In the Matter of Chevron Corporation and Texaco, Inc.*²¹

20. On October 14, 2000, Chevron agreed to acquire all of the outstanding common stock of Texaco in exchange for common stock of Chevron, resulting in Chevron shareholders’ holding approximately 61 percent of the new, combined company (and Texaco shareholders’ owning the rest). On September 7, 2001, the FTC issued a complaint, alleging that the acquisition violated Section 7 of the Clayton Act and Section 5 of the Federal Trade Commission Act. The complaint specifically alleged that the merger, as proposed, would substantially reduce competition in eleven markets, two of which specifically pertained to natural gas: the pipeline transportation of offshore natural gas to shore from locations in the Central Gulf of Mexico²² and the fractionation of raw mix into natural gas liquids products at Mont Belvieu.²³ Pursuant to the consent order that settled the case, Texaco was required to divest, within six months after the merger, (1) its one-third interest in the Discovery natural gas pipeline system in the Central Gulf of Mexico and (2) its interest in the Enterprise fractionating plant in Mont Belvieu.

21. The pipeline transportation of offshore natural gas to shore from each of the markets²⁴ is highly concentrated and would have become significantly more concentrated as a result of the proposed merger,

²⁰ The merging companies together accounted for approximately 70 percent of all commercially available salt dome storage capacity in Mont Belvieu. Two other firms owned the remaining volume.

²¹ See <http://www.ftc.gov/opa/2001/09/chevtex.htm>.

²² Natural gas pipelines are used to transport natural gas from offshore producing platforms to the shore for processing and distribution. There are no alternatives to pipelines for the transportation of natural gas from offshore gas producing platforms. Chevron and Texaco owned controlling interests in competing offshore natural gas pipelines. Chevron and its affiliate Dynegy owned a combined 77 percent interest in the Venice Gathering System. Texaco owned approximately 33 percent of the Discovery Gas Transmission System. Texaco’s ownership share was sufficient to allow it to exercise effective control over important aspects of the business of the Discovery pipeline.

²³ Fractionators are specialized facilities that separate raw mix natural gas liquids into “specification products” by means of a series of distillation processes. These specification products are ultimately used in the manufacture of petrochemicals, in the refining of gasoline, and as bottled fuel, among other uses. There are no substitutes for fractionators for the conversion of raw mix natural gas liquids into individual specification products.

²⁴ The relevant offshore natural gas markets consisted of more than 60 individual lease blocks in the Central Gulf of Mexico.

giving the combined Chevron and Texaco controlling interests in the only two pipelines, or in two of only three pipelines, in each of the markets.²⁵ Moreover, the acquisition of Texaco, as proposed, would have given Chevron a financial interest in three of the four fractionators in Mont Belvieu.

22. According to the Commission, if the transaction had been allowed to proceed as proposed, either unilateral behavior by the combined Chevron/Texaco, or coordinated behavior among Chevron/Texaco and its remaining competitors, would have led to higher consumer prices.²⁶ The Commission contended that new entry was unlikely to constrain anticompetitive behavior in the identified markets, that new entrants typically face significant obstacles to become effective competitors, and that it was unlikely that such entry would constrain a price increase resulting from the merger as proposed.

5. Conclusion

23. Energy security – including for natural gas – has become an important part of the energy policy debate in industrialized countries.²⁷ The United States antitrust agencies believe that security, in its broadest sense, is enhanced by private ownership of the means of production and distribution, buttressed by antitrust laws and enforcement policies that provide the maximum incentives for an efficient, diverse, and robust industry. In our view, competitive markets are an important part of achieving energy security, though some government action may be necessary in response to externalities related to energy security. Part of ensuring that markets are free includes enforcement of antitrust laws to prevent, for example, mergers that would substantially lessen competition in energy markets. Sound enforcement of antitrust laws in this area therefore furthers energy security.

²⁵ Chevron and Texaco are competitors for the pipeline transportation of offshore natural gas to shore from certain locations in the Central Gulf of Mexico, including the South Timbalier and Grand Isle Areas (and their South Additions), as defined by the Department of Interior Minerals Management Service, including, but not limited to, South Timbalier Blocks 30, 37, 38, 44, 45, 58, 59, 61-63, 86-88, 123-35, 151-53, 157, 158, 178-80, 185-87, 205-08; South Timbalier South Addition Blocks 223-27, 231, 233-37, 248, 251, 256 and 257; Grand Isle Blocks 52, 53, 59, 62, 63, 70-76, 84, and 85; and Grand Isle South Addition Block 86.

²⁶ With regard to the pipeline transportation of offshore natural gas, the Commission's complaint alleged that the proposed merger eliminated direct competition between Chevron and Texaco; increased the likelihood of collusion or coordinated interaction among the combined Chevron/Texaco and its competitors; and increased the likelihood that the combined Chevron and Texaco would unilaterally exercise market power, with each of these effects increasing the likelihood that the price of offshore natural gas pipeline transportation would increase in the relevant sections of the country. With regard to the fractionation of natural gas liquids, the complaint alleged that the proposed merger eliminated direct competition between Texaco and Chevron's Dynegy affiliate; provided Dynegy with access to sensitive competitive information from one of its most important competitors at Mont Belvieu; provided Chevron with the ability to prevent competition among fractionators in Mont Belvieu; and increased the likelihood that the combination of Chevron and Texaco would unilaterally exercise market power, with each of these effects increasing the likelihood that prices would increase for fractionation services in the vicinity of Mont Belvieu.

²⁷ On April 10-12, 2007, the FTC will host a public conference on "Energy Markets in the 21st Century: Competition Policy in Perspective." For more information, see: <http://www.ftc.gov/opa/2007/01/energywrkshp.htm>.