

**Before the
United States of America
Federal Energy Regulatory Commission**

Standards of Conduct for Transmission Providers) Docket No. RM07-1-000

**Comment of the
Federal Trade Commission**

May 7, 2008

I. Summary

The Federal Trade Commission (“FTC”) appreciates the opportunity to comment on revised proposals of the Federal Energy Regulatory Commission (“FERC”) regarding standards of conduct for transmission providers. These proposals aim to strengthen competition by preventing discrimination in the provision of transmission services. As set forth below, the FTC encourages FERC to consider structural alternatives to the behavioral approach on which FERC has relied thus far to prevent certain forms of discrimination on transmission systems.

Although discrimination concerns can arise in any transmission market, the potential for discrimination is greater outside of the areas served by Regional Transmission Organizations (“RTOs”) or Independent System Operators (“ISOs”). In electric power markets served by RTOs or ISOs, transmission discrimination issues generally are less significant because the operation of the transmission system is structurally unbundled from generation, local distribution, and power marketing.¹ Independent RTOs and ISOs emphasize the central

¹ All RTOs and ISOs in the United States currently are organized as non-profit entities that serve as the operator for a portion of the electric power grid. In most areas within RTOs and ISOs, the transmission lines are owned, maintained, upgraded, and expanded by distribution utilities that may (or may not) also own generation facilities. In a few areas, the ownership of the transmission lines has been divested to independent transmission companies (“Transcos”).

“Unbundling” is the separation of one or more stages of production from others. It is the opposite of vertical integration. There are various forms of unbundling, ranging from accounting separation, to “functional” unbundling, to “operational” unbundling, to full divestiture. The existing RTOs and ISOs are examples of the intermediate form known as “operational

importance of “neutrality” and “fairness” in their operation of the grid and wholesale markets,² and have no economic incentive to discriminate in providing transmission services.

In contrast with independent RTOs and ISOs, however, when a vertically integrated transmission provider is “net long” – *i.e.*, when it has power to sell on the open market – then it has incentives to sell such power for the highest possible price. It may be able to do this by hampering “inbound” transmission by out-of-area generators that otherwise could have competed with the integrated firm’s generators. Likewise, when a vertically integrated transmission provider is “net short” – *i.e.*, when it must purchase additional power in order to serve its own demand – then it has incentives to buy such power at the lowest possible price, and it may be able to accomplish this by impeding other generators’ ability to transmit their power

unbundling,” which occurs when the original owners continue to hold title to the assets constituting the transmission grid, while an independent entity controls power flows over those assets. Both operational unbundling and divestiture are “structural” forms of unbundling, because they both directly eliminate (or at least reduce) the incentives of the grid operator to discriminate against independent generators.

Other forms of unbundling – such as the “functional” variety – consist of behavioral rules (such as “open access” requirements) that leave the transmission operator’s incentives to discriminate in place but seek to prevent discriminatory conduct by means of regulatory prohibitions. Typically, behavioral rules are accompanied by accounting separation that can help regulators detect anticompetitive discriminatory behavior, particularly with respect to price. See Organisation for Economic Co-operation and Development, “Restructuring Public Utilities for Competition,” OECD Observer (Feb. 2002), *available at* <http://www.oecd.org/dataoecd/0/0/2066164.pdf>; Comment of the Bureau of Economics of the Federal Trade Commission in the Matter of Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities, Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, FERC Docket Nos. RM95-8-000 and RM94-7-001 (filed Aug. 7, 1995), *available at* <http://www.ftc.gov/be/v950008.shtm>.

² For example, “[a]cting neutrally and independently, PJM operates the world’s largest competitive wholesale electricity market and ensures the reliability of the largest centrally dispatched grid in the world.” PJM Interconnection, “About PJM: Overview,” *available at* <http://www.pjm.org/about/overview.html>; see also ISO-New England, “Overview,” *available at* http://www.iso-ne.com/aboutiso/co_profile/overview/index.html.

across the transmission provider's territory to other markets.³ The ownership and operation of both transmission infrastructure and generating assets may:

- make the generation affiliate privy to competing generators' output plans;
- allow the generation affiliate to get higher prices by preventing other suppliers or marketers from competing;
- allow the load-serving affiliate to get lower prices by preventing other loads from competing to buy power; and
- enable the transmission utility to overprice transmission by transferring costs from other lines of business to the transmission operation for ratesetting purposes, thus engaging in cross-subsidization.

As stated in previous FTC comments, these types of activities can adversely affect competition and economic efficiency, to the detriment of consumers.⁴

The basic premise of the current proceeding is that both FERC and the affected parties (primarily vertically integrated utilities) consider unworkable FERC's existing behavioral rules aimed at preventing these two types of discriminatory behavior. The NOPR proposes a revised

³ James B. Bushnell, Erin T. Mansur, and Celeste Saravia measure the impact on power prices of integrated firms' long and short positions in "Vertical Arrangements, Market Structure, and Competition: An Analysis of Restructured US Electricity Markets," 98:1 *Am. Econ. Rev.* 237 (Mar. 2008).

⁴ Reply Comment of the Federal Trade Commission in the Matter of Standards of Conduct for Transmission Providers, FERC Docket No RM07-1-000 (filed May 3, 2007), available at <http://www.ftc.gov/be/V070009.pdf> (quoting from the Comment of the Staff of the Bureau of Economics and the Office of the General Counsel of the FTC in the Matter of Standards of Conduct for Transmission Providers, FERC Docket No. RM01-10-000 (filed Dec. 20, 2001), available at <http://ftc.gov/be/v020001.shtm>). Cross-subsidization concerns are most acute when the regulated transmission price is below the price that a profit-maximizing monopoly would charge for transmission. Where this occurs, a firm can have an incentive to shift costs from unregulated affiliates to its regulated business. Doing so can allow a utility to earn an abnormally high return on its unregulated business while passing the costs of the cross-subsidization to its regulated customers. Transmission rates are regulated on a cost basis as well and are similarly subject to cross-subsidization.

set of behavioral rules that FERC hopes will be clearer to affected parties, easier for FERC to administer at reasonable cost, and sustainable in a judicial proceeding.⁵

The FTC encourages FERC to consider an alternative perspective. After more than a decade of efforts to develop effective, workable behavioral rules against transmission discrimination, FERC may wish to weigh the possibility that accounting separation and accompanying behavioral rules (*i.e.*, functional separation) are insufficient to meet that objective – particularly in the electric power sector, where transmission arrangements can be vulnerable to subtle discrimination that is difficult to detect and document. FERC’s Order No. 2000 developed the basis for the conclusion that behavioral rules are not fully effective.⁶ That order established structural unbundling of transmission under the control of RTOs and ISOs. Structural unbundling of transmission not already under the control of RTOs and ISOs would reduce the potential for discrimination on these transmission systems. The FTC encourages FERC to undertake an evaluation of the benefits and costs of such additional structural unbundling. Even if FERC moves forward with the NOPR’s new version of behavioral rules against transmission discrimination, it may wish to establish a date by which to determine whether it should take further steps to induce the structural unbundling of transmission.

II. Interest of the Federal Trade Commission

⁵ The concern about defensibility in court stems from *National Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831 (D.C. Cir. 2006). See FERC, Notice of Proposed Rulemaking, *Standards of Conduct for Transmission Providers*, 73 Fed. Reg. 16228 (Mar. 27, 2008).

⁶ The Commission of the European Communities has reached a similar conclusion regarding transmission discrimination.. See “Communication from the Commission, Inquiry pursuant to Article 17 of Regulation (EC) No. 1/2003 into the European gas and electricity sectors (Final Report)” (released Jan. 10, 2007), *available at* http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/energy/final_report.pdf.

The FTC is an independent agency of the federal government responsible for maintaining competition and safeguarding the interests of consumers through enforcement of the antitrust and consumer protection laws and through competition policy research and advocacy. The FTC often analyzes regulatory or legislative proposals that may affect electric industry competition or allocative efficiency. It has reviewed proposed mergers that involve electric and gas utility companies. In the course of this work, as well as in antitrust and consumer protection research, investigation, and litigation, the FTC applies established legal and economic principles and incorporates into its work appropriate recent developments in economic theory and empirical analysis.

The energy sector, including electric power, has been an important focus of the FTC's antitrust enforcement and competition advocacy.⁷ The FTC's competition advocacy program has produced two staff reports on electric power industry restructuring issues at the wholesale and retail levels,⁸ and FTC staff also contributed to the work of the Electric Energy Market

⁷ See, e.g., Deborah Platt Majoras, Chairman, Federal Trade Commission, Opening Remarks at the FTC Conference on *Energy Markets in the 21st Century: Competition Policy in Perspective* (Apr. 10, 2007), available at <http://www.ftc.gov/speeches/majoras/070410energyconferenceremarks.pdf>. FTC merger cases involving electric power markets have included *DTE Energy/MCN Energy* (2001) (consent order), available at <http://www.ftc.gov/os/2001/05/dtemcndo.pdf>; and *PacifiCorp/Peabody Holding* (1998) (consent agreement), available at <http://www.ftc.gov/os/1998/02/9710091.agr.htm>. (The FTC subsequently withdrew the *PacifiCorp* settlement when the seller accepted an alternative acquisition offer that did not pose a threat to competition.)

⁸ FTC Staff Report, *Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform: Focus on Retail Competition* (Sept. 2001), available at <http://www.ftc.gov/reports/elec/electricityreport.pdf>; FTC Staff Report, *Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform* (July 2000), available at <http://www.ftc.gov/be/v000009.htm> (compiling previous comments that the FTC staff provided to various state and federal agencies).

Competition Task Force, which issued a *Report to Congress on Competition in Wholesale and Retail Markets for Electric Energy*.⁹ The Commission also has held public conferences on energy topics.¹⁰ The FTC and its staff have filed numerous competition advocacy comments with FERC and the states concerning electricity restructuring initiatives.¹¹ The FTC staff also participates in preparing United States Government filings before international competition organizations regarding energy policy matters.

III. Incentives to Discriminate and the Difficulties of Identifying and Documenting Discrimination

As noted, the interaction between a regulated provider of transmission (of either electricity via wires or natural gas via pipelines) and its unregulated affiliates can raise competitive concerns.¹² First, a transmission provider may discriminate in the provision of information to its affiliates in ways that are not covered by FERC's existing affiliate standards of conduct. In addition, even if such means of conveying information were addressed by FERC's

⁹ That report is available at <http://www.ferc.gov/legal/fed-sta/ene-pol-act/epact-final-rpt.pdf>.

¹⁰ The most recent FTC conference on energy issues was *Energy Markets in the 21st Century: Competition Policy in Perspective*, held on April 10-12, 2007 (conference materials available at <http://www.ftc.gov/bcp/workshops/energymarkets/index.shtml>). See also the FTC's public workshop on *Market Power and Consumer Protection Policies Issues Involved with Encouraging Competition in the U.S. Electric Industry*, held on September 13-14, 1999 (workshop materials available at <http://www.ftc.gov/bcp/elecworks/index.shtml>); and the Department of Justice and FTC Electricity Workshop, held on April 23, 1996.

¹¹ FTC competition advocacy filings after mid-1994 are available in reverse chronological order at http://www.ftc.gov/opp/advocacy_date.shtml. FTC competition advocacy efforts regarding the electric power sector began in 1994 with a Comment of the Staff of the FTC Bureau of Economics to the South Carolina Legislative Audit Council on the Statutes and Regulations Covering the South Carolina Public Service Commission (Feb. 28, 1994).

¹² See comments cited in note 4, *supra*.

standards, the transmission provider could have economic incentives to violate the standards, and such violations could be difficult to detect and document. For example, a transmission provider might inform an affiliate that the latter's closest competitor in a highly concentrated market planned to close a facility during a specific time period – information that might enable the affiliate to exercise its market power by raising its price above the competitive level.¹³

Second, the transmission utility could engage in anticompetitive cross-subsidization in favor of its unregulated affiliates. For example, cross-subsidization of a less efficient affiliate may raise rivals' costs or enable that affiliate to expand at the expense of more efficient, but non-affiliated, firms. This type of cross-subsidization could allow the transmission utility to shift profits into unregulated markets served by the affiliate and thus evade regulatory limitations on its market power (and thus its profitability) in transmission markets. This inefficient cross-subsidization would result in a higher average cost for the market served by the affiliate and its displaced competitors.

FERC has engaged in an extended series of efforts to refine behavioral rules designed to prevent transmission discrimination. In its current round of rulemaking using this approach, FERC has found that the existing behavioral rules are not easily understood by transmission providers and are difficult and costly for FERC to administer.

The FTC believes that there are additional reasons to be concerned about these behavioral rules. Vertically integrated electric transmission providers have ongoing incentives to discriminate, and it is difficult to detect and document such behavior. For example, system

¹³ The most profitable action that a firm could take in the face of a competitor's decision to reduce output is difficult to anticipate *ex ante*. It could encompass a variety of price and output changes that depend in part on the firm's prediction as to how other competitors will react to one competitor's output reduction. ("Conjectural variations" is the economic term for a firm's assessment of how competitors will react when the firm alters its own pricing or output.)

operators' decisions about whether they can accommodate additional requests for transmission without threatening system reliability may reflect unbiased judgments about conditions on the grid. But such decisions also may be influenced by incentives to sell power at a higher price by discriminating against independent generators that compete with generators affiliated with the transmission operator.¹⁴ Some factors that go into decisions about available transmission are subtle and must be based on prior operating experience or may depend to some extent on fleeting conditions on the grid. In view of the critical system reliability issues involved in decisions whether to accommodate additional requests for transmission, it can be difficult and risky for a regulator to second-guess such judgments based on suspicions about discrimination.¹⁵

IV. The Structural Unbundling Alternative

Behavioral rules against transmission discrimination are not the only available way to unbundle transmission from other stages of production. Indeed, FERC has approved elements of structural unbundling in both the natural gas and electricity sectors. FERC's implementation of the "straw-in-the-pipe" concept in 1992 introduced structural unbundling of a portion of natural

¹⁴ In the alternative, as noted above (*supra*, pp. 2-3), a transmission operator that is "net short" of generation will have incentives to buy the needed extra power at the lowest possible price, and may be able to achieve this objective by hampering independent generators' efforts to transmit power out of the market.

¹⁵ As a result of the physical requirement that generation instantaneously match consumption in electricity systems, negotiations between generators and wholesale or retail transmission customers are vulnerable to subtle misrepresentations about transmission conditions that delay (or add uncertainty about) finalizing transmission arrangements. Hesitancy or uncertainty on the part of the grid operator in providing information about transmission availability can disrupt bilateral transactions between an independent generator and its prospective wholesale customers, and can impel such customers to buy from the transmission operator's generation affiliates in the interest of avoiding such uncertainty. FERC is likely to find it challenging to distinguish objectively between, on the one hand, illegal discrimination and, on the other hand, the system operator's bona fide technical uncertainty about transmission availability.

gas pipeline capacity that transmission customers subsequently can trade among themselves without needing the consent of the pipeline owner.¹⁶ In the electric power sector, structural unbundling takes the form of lodging control of the grid with an independent third party – an RTO or ISO – that has little or no economic incentive to discriminate against generators that are unaffiliated with transmission owners.¹⁷ Moreover, if an RTO or ISO were organized as an independent Transco that also owned the transmission assets, the structural unbundling would be even more complete.

We encourage FERC to review the fundamental efficacy and administrability issues associated with behavioral rules against transmission discrimination. Within that context, we also encourage FERC to consider the costs and benefits of additional structural unbundling. To the extent that FERC finds that previous structural unbundling of transmission has been (or

¹⁶ FERC, Order No. 636, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations; Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol* (issued Apr. 8, 1992), available at <http://www.ferg.gov/legal/maj-ord-reg/land-docs/rm91-11-000.txt>. See remarks of Don Santa (former FERC Commissioner) at the Organisation for Economic Co-operation and Development Roundtable on Energy Security and Competition Policy, DAF/COMP(2007)35, (2007), at 314-19, available at <http://www.oecd.org/dataoecd/5/21/39897242.pdf>; John C. Hilke, "Background Note of the Secretariat," Organisation for Economic Co-operation and Development, Roundtable on Access to Key Transport Facilities, DAF/COMP(2006)29 (2006), § 4.1, available at [http://www.oelis.oecd.org/olis/2006doc.nsf/LinkTo/NT0000703E/\\$FILE/JT03217453.PDF](http://www.oelis.oecd.org/olis/2006doc.nsf/LinkTo/NT0000703E/$FILE/JT03217453.PDF).

¹⁷ Although operational unbundling can make a transmission owner powerless to discriminate in the *operation* of the grid, such an owner still may have incentives and the ability to hold back on *expanding* or *maintaining* the grid if that would reduce the competition that its generation assets will face. Regulatory efforts to prevent such behavior through regional transmission planning and maintenance or through reliability standards are an ongoing challenge. Vertically integrated utilities' full divestiture of transmission assets to entities (whether for-profit or not-for-profit) that are not vertically integrated could neutralize transmission owners' incentives to underinvest in transmission. By contrast, an independent Transco derives revenue solely from transmission services and thus should have incentives to increase the use of transmission.

likely will be) more effective than behavioral rules in preventing anticompetitive transmission discrimination, FERC may wish to take further steps to substitute structural unbundling for behavioral rules against transmission discrimination. In the event that FERC adopts the proposed revisions in the behavioral rules against discrimination, it may wish to augment them with incentives for transmission owners to undertake efficient structural unbundling of transmission. Structural unbundling can substitute for behavioral rules (and indeed can reduce or eliminate the need to engage in continuous efforts to recalibrate such rules).

V. Conclusion

Although FERC's focus in this proceeding appears to be to make its behavioral rules against transmission discrimination clearer and easier to administer, the FTC recommends that FERC broaden its review of remedies for transmission discrimination to give greater consideration to structural unbundling alternatives. The FTC's experience in crafting remedies to prevent anticompetitive conduct, as well as the materials supporting FERC Order No. 2000, indicate that structural unbundling can be a more attractive alternative – or at least a valuable complement – to behavioral rules.