

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

Solicitation Processes for Public Utilities)	Docket No. PL04-6-000
Acquisition and Disposition of Merchant)	Docket No. PL04-9-000
Generation Assets by Public Utilities)	

**Comment of the
Federal Trade Commission**

July 14, 2004

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I. INTRODUCTION

The Federal Trade Commission (FTC or Commission) appreciates this opportunity to present its views concerning the Federal Energy Regulatory Commission’s (FERC) policies concerning solicitation processes¹ for public utilities and acquisition and disposition of merchant generation assets by public utilities. This comment addresses whether FERC should reevaluate its policies governing how utilities procure electric power supply through contracts with affiliated generators and whether they acquire previously spun-off (unbundled) generation assets. This comment addresses both topics because they are closely related. Because utilities may have both incentives and the ability to exercise market power and harm consumers by discriminating in favor of their own affiliates and against independent suppliers, FERC may wish to reduce the potential for this harm by using independent third parties to evaluate utility procurement alternatives and by encouraging utilities to assess the market value of procurement alternatives. These approaches are likely to reduce the ability of utilities to discriminate in favor of affiliates and to improve detection of discrimination (and the associated evasion of cost-based rate

¹For the purposes of this comment, “solicitation processes” refers to the procurement arrangements of regulated utilities (or their unregulated affiliates). A primary focus of attention is procurement by regulated utilities of generation contracts. Solicitation processes may also apply to acquisition of generation assets. Typically, the affiliates compete with stand-alone independent generating firms in making sales of energy and assets to utilities.

regulation) by regulators.

The Commission and its staff have stated repeatedly that consumers benefit when electricity markets operate unburdened by substantial and durable market power.² This comment focuses on possible harm to consumers from the exercise of market power by regulated utilities stemming from evasion of economically appropriate cost-based rate regulation. Regulatory evasion is accomplished through anticompetitive discrimination by regulated utilities in favor of their unregulated affiliates. This discrimination can occur in purchases from affiliates at inflated prices or in sales to affiliates at below-market prices. The comment identifies direct harm to consumers from evasion of cost-based rate regulation as well as indirect harms to consumers and to competition that may be caused by discrimination in affiliate transactions. It concludes with a discussion of approaches that FERC may wish to utilize to detect and remedy discrimination in affiliate transactions.

The FTC is an independent agency responsible for maintaining competition and safeguarding the interests of consumers through enforcement of the antitrust and consumer protection laws and through competition advocacy. In the electric power industry, the FTC often analyzes regulatory or legislative proposals that may affect competition or the efficiency of resource allocation and reviews proposed mergers involving electric and gas utility companies. In the course of this work, as well as in antitrust research, investigations, and litigation, the

²*See, e.g.*, Letter of the Federal Trade Commission to Thomas E. Bliley, Chairman, House Committee on Commerce, on H.R. 2944, The Electricity Competition and Reliability Act (Jan. 14, 2000), *available at* <<http://www.ftc.gov/be/v000002.htm>>; Comment of the staff of FTC's Bureau of Economics and the Office of the General Counsel, In the Matter of Application for Approval of Asset Transfer Agreements with Affiliated Company Ameren Union Electric Company, Illinois Commerce Commission, Docket No. 03-0083 (June 18, 2003), *available at* <<http://www.ftc.gov/be/v030012.htm>>.

Commission applies established legal and economic principles and recent developments in economic theory and empirical analysis to competition issues. As part of its competition advocacy program, the FTC has issued two Staff Reports on electric power industry restructuring issues at the wholesale and retail levels.³ The FTC and its staff have also filed numerous competition advocacy comments on electricity restructuring efforts with FERC, the states, and international competition organizations.⁴

II. HISTORICAL AND CONTEXTUAL BACKGROUND

Decisions by firms to make or to buy various inputs required to produce a good or service are an integral part of market economies and have been a focus of economic research.⁵ Make-or-buy decisions that are based on objective analyses and criteria often lead to increased efficiency that intensifies competition and benefits consumers. The situation FERC currently

³FTC Staff Report: Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform (July 2000), *available at* <<http://www.ftc.gov/be/v000009.htm>> (this report compiles previous comments that the FTC staff provided to various state and federal agencies); 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>>.

⁴Related comments include Comment of the Staff of FTC's Bureau of Economics and the Office of the General Counsel, In the Matter of Standards of Conduct for Transmission Providers, FERC, Docket No. RM01-10-000 (Dec. 20, 2001); Comment of the Staff of the FTC Bureau of Economics, In the Matter of Deployment of Wireless Services Offering Advanced Telecommunication Capability, Federal Communications Commission, Docket No. 98-147 (Sept. 25, 1998); Comments of the Staff of the Bureau of Economics, In the Matter of Procedures for Consideration of Contract Rules, Postal Rate Commission, Docket No. RM89-5 (Feb. 20, 1990); Statement of the United States Federal Trade Commission Staff, In the Matter of Inquiry into Alleged Anticompetitive Practices Related to Marketing Affiliates of Interstate Pipelines, FERC, Docket No. RM87-5-000 (Jan. 29, 1987).

⁵When a firm elects to make all of its own inputs, the firm is fully vertically integrated. Decisions on vertical integration may entail detailed considerations of the alternative risks, costs, and benefits of making versus buying inputs.

confronts is that of a regulated utility that operates in the same geographic market as its unregulated affiliates and faces a choice of buying from independent suppliers or effectively making the input by securing it from an unregulated affiliate. FERC already has a policy in place (the *Edgar Policy*⁶) that is intended to promote objective make-or-buy decisions by utilities regarding contracts for power. Because the issues involved in power supply contracts with affiliates are similar to those entailed by affiliate asset transfers, FERC may wish to consider a similar framework for reviewing affiliate asset transfers.

Under its *Edgar Policy*, FERC reviews purchase power agreements between utilities and affiliates as part of determining whether to grant market-based rates.⁷ In the analysis of market-based rate transactions between an affiliated buyer and seller, the *Edgar Policy* requires FERC to ensure that the buyer has chosen the lowest-cost supplier from among the options presented, taking into account both price and non-price terms. The *Edgar Policy* addresses the concern that utilities would choose to purchase power at inflated prices from their affiliates rather than at competitive levels from unaffiliated entities. Such higher costs could be passed on to wholesale (as well as retail) customers that pay cost-based rates, absent restrictions on such discrimination. Recently, with the development of significant amounts of independent generation in every region, competitive alternatives to affiliate purchases have increased, as have expressions of

⁶FERC, Boston Edison re: Edgar Electric Company, 55 FERC ¶ 61,382 (1991).

⁷The federal antitrust agencies generally do not review transactions among closely affiliated companies. Antitrust does not view affiliates of a firm as the firm's competitors or as competitors of each other because the management of the parent firm controls the output and pricing decisions of all of its affiliates and has incentives and the ability to coordinate affiliated activities to maximize profits of the parent and all of its affiliates jointly. Hence, if FERC were not to review these transactions, there likely would be no federal review.

concern about discrimination and cross-subsidization in affiliate transactions. These developments have prompted FERC to review its *Edgar Policy*.

In previous comments to FERC and the states, the FTC staff has advocated use of a cost/benefit analysis framework for selecting approaches to discourage discrimination and cross-subsidization.⁸ These comments have emphasized the potential of structural separation to prevent discrimination and cross-subsidization by directly reducing or eliminating the incentives to engage in those practices.⁹

By contrast, FERC's *Edgar Policy* applies in those circumstances in which the incentives to engage in discrimination or cross-subsidization still exist. Even within the *Edgar Policy* framework, however, FERC may wish to consider some remedies that are more structural than behavioral.¹⁰ These include, for example, economically appropriate transmission upgrades that expand the scope of the geographic market, elimination of impediments that make entry less likely, divestiture of assets that will reduce the ability and incentive to discriminate or cross-subsidize, and steps to encourage price-responsive demand (such as economically efficient real-

⁸Comment of the Staff of the Bureau of Economics of the Federal Trade Commission, Public Utilities Commission of Nevada, Regulations Governing Conditions Under Which Affiliates of Distribution Companies May Offer Potentially Competitive, Discretionary or Other Competitive Components of Electric or Natural Gas Service, LCB File No. R087-98 and PUCN Docket No. 97-5034 (Sept. 22, 1998), *available at* <<http://www.ftc.gov/be/v980027.htm>>.

⁹For example, the FTC staff's central concern with FERC's approach to transmission open access was the continued incentives that a transmission operator would have to discriminate in providing access to unaffiliated generators as compared to its own generation assets. Comment of the Staff of the Bureau of Economics of the Federal Trade Commission, FERC, Docket Nos. RM95-8-000 and RM94-7-001 (Aug. 7, 1995).

¹⁰Our companion comment in FERC Docket RM04-7-000 places remedy issues in the broader context of FERC's decisions whether to grant market-based rates.

time metering and distributed generation).¹¹ We recommend that FERC consider these structural remedies.

The issues involved in assuring that regulated utilities' make-or-buy decisions are objective are not unique to the electric power industry. The FTC staff has been active in two other contexts in which similar issues arise: privatization and contracting-out decisions of municipal, state, and federal agencies,¹² and the workshare discounts offered by the United States Postal Service.¹³

III. INCENTIVES TO ENGAGE IN THE EVASION OF RATE REGULATION AND THE FORMS SUCH EVASION MAY TAKE

The power supply solicitation and asset transfers of regulated utilities often pose no threat to competition and, in fact, enhance competition and benefit consumers, just as similar transactions do in other industries. Nevertheless, two types of discriminatory affiliate transactions in which a utility favors its affiliates could harm competition and customers. The first source of consumer harm is the purchase of electric power or the transfer of assets from an unregulated affiliate at inflated prices. This practice increases the utility's costs (and rates) and

¹¹Many of these structural remedies could be most effectively implemented through cooperation between FERC and the states.

¹²The FTC's antitrust and consumer protection training missions with foreign antitrust and privatization agencies often focus on these issues. *See also* the written Contribution from the United States of America for the Organization for Economic Cooperation and Development, Working Party No. 2 on Competition and Regulation, Roundtable on "Promoting Competition in Local Services: Solid Waste Management" (Oct. 18, 1999); written Contribution from the United States of America for the Organization for Economic Cooperation and Development, Working Party No. 2 on Competition and Regulation, Roundtable on "Non-Commercial Service Obligations and Liberalization" (Oct. 13, 2003); John C. Hilke, Competition in Government-Financed Services (1992).

¹³Comments of the Staff of the Bureau of Economics, Postal Rate Commission, Docket No. RM89-5, *supra* note 4.

discriminates against independent suppliers that offer lower prices for equivalent service or assets. A second potential source of harm is preferential sales or provision of services by the utility to its affiliates. These practices increase the costs (and rates) of the utility, while they decrease the costs and increase the profits of the affiliate. These practices also discriminate against the affiliate's competitors by charging them higher prices (for services supplied by the utility) than the prices paid by the affiliate.

A. Evasion of Utility Rate Regulation Through Inflated Procurement Prices

In a market with economically efficient cost-based regulation of prices¹⁴ in which the regulated utility has market power, some mechanism is appropriate to assure that power purchases and asset transfers – for example, from an unregulated affiliated generator to the parent utility – do not take place at inflated prices that will allow the firm to evade these rate regulations. A rate-regulated parent utility with market power has incentives to engage in such transactions because, by shifting profits to the affiliate, the firm evades the rate regulations. In the case of inflated power supply agreements with affiliates, customers of the regulated utility are harmed because they pay higher rates to cover the utility's higher procurement costs that are caused by the inflated prices paid to its unregulated affiliates. In a similar fashion, the costs of the inflated asset base for the regulated utility would be covered by higher regulated rates, while the gains from the asset sale at an inflated price would be realized by the affiliate outside of the scope of the regulator's cost-based rate determination. Both types of actions would be forms of regulatory evasion and would result in the exercise of market power, with captive customers

¹⁴Although nearly all utilities have authority from FERC to charge market-based rates for wholesale electricity sales, FERC's recently revised market power assessment process may result in certain utilities' loss of market-based rate authority.

paying higher regulated rates to cover the regulated utility's inflated costs.

The same framework may also apply where a wholesale customer depends on a regulated transmission provider (with generation assets in the same geographic market) to act as its agent in acquiring electric power. In this situation, the dependent wholesale customer pays higher prices (and its retail consumers pay higher rates) because the regulated transmission provider, acting as a buying agent, buys at inflated prices for the dependent wholesale customer from the transmission provider's generation affiliates.

B. Evasion of Rate Regulation Through Below-Market Sales to Affiliates

A utility whose exercise of market power is constrained by cost-based rate regulation also may find it profitable to evade rate regulation by cross-subsidizing the costs of its unregulated affiliates.¹⁵ This may entail selling to an affiliate at below-market prices or providing better service to the affiliate than to competitors of the affiliate.

For example, selling supplies or services to an affiliate at below-market prices could allow the parent to prevent the affiliate's bankruptcy by reducing its costs and, therefore, increasing its profits. With the cross-subsidization, the affiliate may face lower costs than its

¹⁵Cross-subsidization in this context generally means that the utility with regulated rates is paying more than the market value for the service or asset that it is buying from its unregulated affiliate or that it is selling to its affiliate at below market value (or other preferential terms). Cross-subsidization in this context is distinct from issues concerning attributable or incremental costs, common costs, joint costs, and economies of scale or scope that may arise in determining whether regulated rates for one type of service are cross-subsidizing the regulated rates for another type of service offered by a regulated firm. This type of cross-subsidization issue arises often, for instance in postal ratemaking. *See* Comments of the Staff of the Bureau of Economics, In the Matter of Procedures for Consideration of Contract Rules, *supra* note 4.

competitors.¹⁶ In this example, the utility's owners could avoid the legal and administrative costs associated with the bankruptcy process (while increasing the likelihood that owners of independent generation in the same market would face these costs).

Cross-subsidization of an affiliate by its parent utility also could allow the affiliate to increase its market share, even if all of the same competitors remain in the market. Because of the cross-subsidization the affiliate receives, it will be able profitably to take sales from equally efficient or more efficient independent suppliers. The cross-subsidization allows the parent utility to transfer higher revenues (due to higher rates) in its regulated operations to higher profits in its unregulated operations. The affiliate would have higher profits that would not be constrained by rate regulation (as are the profits of the parent utility). Again the direct harm to customers is the higher rates charged by the utility in order to finance the cross-subsidization of its affiliates' costs.

Because cross-subsidization of affiliates' costs may have effects similar to those from paying inflated prices for services or assets of affiliates, FERC may wish to consider amending its *Edgar Policy* to enable it to address below-market sales to affiliates as well as inflated prices of purchases from affiliates. Doing so may help assure FERC that utilities do not substitute cross-subsidization of affiliates' costs for inflated procurement prices in order to evade economically efficient cost-based rate regulation. In general, if two forms of discrimination can

¹⁶Incentives for cross-subsidization may also be present in an electricity retail competition setting. In a retail competition setting, the utility often processes consumers' requests to switch suppliers, including switches to and from the utility's retail marketing affiliates. Here the utility might well have incentives to slow the net switching of retail customers to independent suppliers. It could accomplish this by devoting additional utility personnel to processing customer requests to switch to the affiliated retail marketers. In this scenario, customers would face higher utility prices to pay for these additional personnel.

achieve the same evasion of rate regulation and only one is addressed by regulators, utilities will have incentives to utilize the other form.

IV. HARM TO UTILITY CUSTOMERS AND OTHER CONSUMERS DUE TO DISCRIMINATION IN POWER SUPPLY SOLICITATIONS AND ASSET TRANSFERS

The previous section discussed the incentives of those utilities with market power that are subject to cost-based rate regulation to evade this regulation by paying inflated prices to affiliates or by selling at below-market prices to affiliates. The direct harm to utility customers from these practices is higher rates caused by higher costs for the utility. There are additional sources of potential harm to utility customers and other consumers from the impact of these practices on competition in the markets served by the utility affiliates. We also present three potentially significant, indirect losses of efficiency and harm to consumers associated with such favoritism.¹⁷

Exit of More Efficient Generators: One potential adverse impact is that discrimination in affiliate transactions (procurement of generation assets or power supply contracts from affiliates at inflated prices, or below-market sales to affiliates) may result in the exit of more efficient generation assets and the retention of less efficient generation assets in the event, for example, that demand declines enough to force some exit from the market. In a market where capacity exceeds demand, some assets may exit from the market. Absent discrimination, the least efficient assets are the most likely assets to exit. In the presence of discrimination, less efficient assets owned by the utility or its affiliates are more likely to remain in the market while more

¹⁷Other indirect inefficiencies may result as well. Customers may make investment decisions based on geographic and temporal distortions in electricity prices caused by rate evasion.

efficient independent suppliers are forced to exit. As a result, average social costs of production in the market served by these assets will increase and innovations that would have been brought to market by the exiting firms may be lost.

Less Timely and Likely Entry: A second potential adverse impact of discrimination is to make entry less timely and likely by increasing the expected level of unrecoverable costs associated with entry.¹⁸ Absent discrimination, any specific generation entrant can reasonably expect to sell its generation assets at the fair market price in the event that its entry fails. In the presence of discrimination by utilities, the selling price for liquidated stand-alone generation assets is likely to be lower where the distribution utility in the area is one of the most likely purchasers of such assets, absent discrimination, or where there are few potential buyers. The result of this increased risk is that entry becomes less likely.¹⁹

Loss of Benefits from Previous Vertical Unbundling: A third potential adverse impact is that where cost-based regulation can be evaded by affiliate transactions, there is an incentive for inefficient vertical integration (including rebundling of previously unbundled affiliates).²⁰ When this occurs, consumers are harmed both by the evasion of efficient rate regulation that may occur

¹⁸See Jonathan B. Baker, "Responding to Developments in Economics and the Courts: Entry in the Merger Guidelines," 71 *Antitrust L.J.* 189 (2003) (includes a discussion of the history of the terms "entry barriers" and "entry impediments"). See also John C. Hilke and Philip B. Nelson, "The Economics of Entry Lags: A Theoretical and Empirical Overview," 61 *Antitrust L.J.* 365 (1993).

¹⁹The potential combination of exit of more efficient assets and less timely and likely entry may create an extended period in which production costs of electricity will be higher on average than they otherwise would be. If the exiting assets are owned by smaller suppliers, concentration may also be higher than it otherwise would be, and this may contribute to concerns about the potential for coordinated interaction among the remaining suppliers.

²⁰Given this incentive, FERC and state regulators may wish to be cautious about accepting arguments by utilities for vertical rebundling.

and by the higher costs associated with inefficient vertical integration. These costs could include the loss of innovation, of price discounts, or of service improvements.

V. EVASION-DETECTING MECHANISMS

A number of mechanisms to detect and, therefore, help prevent the types of regulatory evasion discussed above are available to FERC. One widely applied method for detecting discrimination in supply contracts and asset transfers is to compare the terms of the proposed transaction with the transaction's market value. If the terms of the proposed transaction are less favorable to the regulated utility rate payers than the corresponding market value, then inefficient discrimination and evasion of rate regulation may be present. Market values for affiliate transactions can be established in several ways, including holding an open solicitation for supply bids, putting some of the affiliate assets up for sale, doing a "comparables" analysis (including using econometric techniques to develop an estimated market price based on recent sales prices of similar properties), or doing a discounted cash flow analysis of expected earnings.²¹ All of these approaches present challenges in their implementation, but they are likely to be more accurate than using historic book values or an administrative determination to estimate the market value of affiliates' assets.²²

²¹Bid solicitation processes are generally appropriate in making market value determinations for a wide variety of power supply contracts and generation assets. Other methods may be difficult to apply where the contracts or assets are unusual or transactions are rare.

²²Similarly, most states that undertook retail customer choice programs were reluctant to rely solely on book value (generally asset purchase price less depreciation) of stranded generation assets in evaluating the magnitude of stranded costs, and instead employed a variety of evaluation techniques to estimate the market value of these assets. The stranded cost recovery approaches of several states are described in Appendix A of the September 2001 FTC Staff Report, *supra* note 3. See also Protest of the Electric Power Supply Association, In re Cinergy

To address the ability of utilities to discriminate in transactions with affiliates, FERC may wish to extend one of its core principles underlying non-discriminatory transmission access. FERC found in Order No. 2000 that independent control of the operation of the transmission system is the best method to prevent discrimination. The same insight is likely to apply to transactions between utilities and affiliates. In particular, FERC may wish to encourage one or more independent third parties to conduct market value assessments of bids in bidding situations or to provide market value assessments of offers from affiliates in non-bidding situations. Third-party assessments also may bring additional objectivity to evaluations of concerns about preferential services provided by a utility to its affiliates. Independent evaluations are likely to make the procurement and sales processes involving affiliates more objective. This objectivity, in turn, is likely to reduce the risk of evasion of economically appropriate rate regulation through discrimination in purchases from affiliates or in cross-subsidization of affiliates' costs (by selling to affiliates at below-market prices).²³

VI. CONCLUSION

Evasion of cost-based rate regulation associated with discrimination in transactions

Services, Inc., FERC, Docket No. EC02-113-000 at Section 2 (filed Oct. 7, 2002), *available at* <<http://www.epsa.org/Positions/FERC.cfm?what=796&docBody=3225>>.

²³This approach has been applied to situations in which in-house governmental departments compete with outside private contractors to perform certain government-financed services. *See, e.g.,* John C. Hilke, Competition in Government-Financed Services, *supra* note 12, at 16-20, 67-68. For example, in 1979, Phoenix, Arizona, implemented a system of competitive bidding in which outside contractors compete against government departments for contracts to provide various services financed by the city. Before a city agency can submit a bid, however, the Office of the Comptroller – an entity independent of the city administration – must certify that the bid is realistic. The city has saved substantially through this bidding process. A description of this program, its procedures, and the cost savings is available at <<http://www.ci.phoenix.az.us/Auditor/public1.html>>.

between utilities and their affiliates can harm consumers in wholesale and retail electricity markets and other markets.²⁴ Although FERC's *Edgar Policy* focuses on utility procurement, similar concerns may arise regarding preferential sales by utilities to affiliates. Either form of discrimination is likely to harm utility customers directly by increasing utility costs and rates. Additional consumer harm may stem from the effects of discrimination on competition in the markets served by the affiliates. Accordingly, FERC may wish to adjust its *Edgar Policy* to include sales by utilities to their affiliates. Detecting anticompetitive discrimination in affiliate transactions is often best accomplished by comparing the proposed affiliate transaction to the market value of the transaction. Objectivity in this process is often best pursued through the use of independent third-party evaluators. FERC may wish to adjust its *Edgar Policy* to more directly reference market values of affiliate transactions and analysis of market values by independent third-party specialists in such evaluations. If discrimination concerns persist, FERC may wish to consider remedies that will make the market structure more competitive and will thus reduce the incentive and ability to engage in anticompetitive discrimination.

²⁴The September 2001 FTC Staff Report, *supra* note 3, explains the close relationship between wholesale and retail electricity markets. Unlike many markets in which inventories held by retailers or wholesalers have a substantial (if occasionally short-term) role in determining prices, inventories have only a de minimis role in electricity pricing because electricity cannot be practicably stored (inventoried) in large quantities. Steven Stoft, Power System Economics: Designing Markets for Electricity at 40 and Ch. 5.1 (2002).