Before the
United States of America
Federal Energy Regulatory Commission

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

Reply Comment of the
Federal Trade Commission

May 3, 2007

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I. Introduction and Summary

The Federal Trade Commission ("FTC") appreciates this opportunity to present its views concerning the Federal Energy Regulatory Commission's ("FERC's") standards of conduct for transmission providers. This comment focuses on two issues addressed by the initial comments filed in this matter: (1) whether FERC should make permanent the interim rule for natural gas transmission providers that narrows the scope of FERC Order No. 2004; and (2) whether FERC should adopt a similar rule regarding standards of conduct for providers of electric transmission.

Pursuant to a ruling issued last year by the United States Court of Appeals for the District of Columbia Circuit,[1] FERC is required to restrict the applicability of its standards of conduct for natural gas transmission providers (as set forth in Order No. 2004) to the marketing affiliates of those providers, or to strengthen the rationale for reissuing Order No. 2004 with standards of conduct that also are applicable to non-marketing affiliates of such providers. FERC also could accomplish the first of these

[1] *National Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831 (D.C. Cir. 2006). In its January 18, 2007, Notice of Proposed Rulemaking in the instant proceeding, FERC stated: "Specifically, the court [of appeals] rejected [FERC's] attempt to extend the standards of conduct beyond pipelines' relationships with their marketing affiliates to also govern pipelines' relationships with numerous non-marketing affiliates, such as producers, gatherers, and local distribution companies (energy affiliates)." According to the court of appeals, FERC claimed that it relied upon, but did not in fact have examples of, affiliate abuse involving non-marketing affiliates of natural gas transmission providers. The court left open the possibility that FERC could justify Order No. 2004 on the basis of theory alone, but noted that related FERC orders sustained by the courts have been justified on the basis of not merely theory but also complaints or litigated cases.

alternatives by narrowing the application of Order No. 2004 to the marketing affiliates of both natural gas and electricity transmission providers, or by removing all standards of conduct for transmission providers. FERC proposes to limit the applicability of Order No. 2004 permanently to marketing (but not non-marketing) affiliates of natural gas transmission providers and invites comment on whether similarly narrowed standards of conduct should be applied to affiliates of electricity transmission providers.

A number of initial comments recommend that FERC avoid permanently narrowing Order No. 2004 because transmission providers have incentives to discriminate in favor of both marketing and non-marketing affiliates,[2] and because FERC may be able to develop additional evidence of complaints and investigations that would support Order No. 2004.[3] For example, Reliant asserts that "limiting the standards of conduct for electric transmission providers to their relationship with Marketing Affiliates would undermine" the principles of "(i) functional separation of the transmission provider's transmission employees from its merchant employees; and (ii) comparable access to transmission information for all transmission customers." The NGSA encourages FERC to "take a fresh look at the standards of conduct" and "believes that more appropriate regulations, successfully meeting the standards set out by the court in *National Fuel*, are in easy reach." NGSA agrees that incentives to discriminate can apply to both marketing and non-marketing affiliates and (at page 7) invites FERC to consider

[2] A "non-marketing" affiliate of an electricity transmission supplier could be, for instance, a natural gas brokerage firm or a natural gas local distribution supplier. An example of a "non-marketing" affiliate of a natural gas transmission provider would be a retail electricity procurement consulting agency.

[3] *See* the initial comments of the Public Utilities Commission of Ohio, the Natural Gas Supply Association ("NGSA"), the Electric Power Supply Association, and Reliant Energy. (These and other initial comments are available in the "eLibrary" section of FERC's website, under Docket No. RM07-1.)

previous FTC convergence merger cases as examples that could be used to support Order 2004.

As it considers whether to adopt a permanent narrowing of Order No. 2004 to marketing affiliates, FERC may wish to focus on the economic incentives of utilities to discriminate in favor of affiliates in a manner that is likely to result in an inefficient allocation of resources. If there is a sound economic basis to apply standards of conduct with regard to marketing affiliates,[4] FERC may wish to consider closely whether the same is true with regard to non-marketing affiliates.

In assessing the benefits and costs of applying standards of conduct to non-marketing affiliates of natural gas transmission utilities, FERC may wish to consider examples of non-FERC matters in which preferential treatment of affiliates is likely to reduce consumer welfare. For example, FERC could consider the investigations identified in a comment that the FTC staff filed with FERC in December 2001.[5] Among other issues raised in that comment, FTC staff raised the key concern that cross-

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[4] In this reply comment, the FTC focuses on discrimination that is likely to result in an inefficient allocation of resources – for example, a reduction in output below the efficient level, or the replacement of output from a lower-cost supplier by output from a higher-cost supplier. It should be recognized that in some industries, the realization of efficiencies of vertical integration may involve treatment of affiliates in a manner that is different from treatment of non-affiliates.

By a "sound economic basis" for standards of conduct, we mean that such standards are expected to yield benefits for consumers in excess of the costs that they impose. In its recent *National Fuel Gas Supply* decision, the D.C. Circuit observed that one potential cost of behavioral unbundling remedies (such as standards of conduct) is a diminution in the economies of vertical integration. 468 F.3d at 15-17. *See also* the initial comment of the Large Public Power Council. The costs and benefits of standards of conduct also should be compared to the costs and benefits of other potential types of remedies. For example, in various circumstances, structural remedies can be more effective than behavioral remedies (such as standards of conduct) because structural remedies can directly reduce or eliminate incentives to discriminate and cross-subsidize and may entail lower costs for monitoring and administration.

[5] Comment of the Staff of the Bureau of Economics and the Office of the General Counsel of the Federal Trade Commission before the Federal Energy Regulatory Commission 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.

subsidization of an affiliate may cause the affiliate to expand at the expense of more efficient non-affiliates, resulting in higher average costs for the market served by the affiliate and its displaced competitors.[6] Such cross-subsidization may be profitable if, notwithstanding regulatory constraints, the parent firm would be able to recover costs of cross-subsidies by obtaining approval for higher rates for regulated services for which it has market power.

Finally, the questions that FERC is considering with respect to incentives to favor affiliates in a manner that is inefficient – and with regard to whether those incentives exist for both marketing and non-marketing affiliates – arise not just in the context of natural gas utilities but also in the electric power sector. Moreover, it can be extremely difficult to distinguish baseless from legitimate claims by an electric transmission operator that additional transmission activity would threaten system reliability. We discuss these points at greater length below.

II. Interest of the Federal Trade Commission

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. 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 and consumer protection research, investigation, and litigation, the FTC applies established legal and economic

[6] Comment of the Staff of the Bureau of Economics and the Office of the General Counsel, *supra* note 5, at Section I.

principles and recent developments in economic theory and empirical analysis to competition issues.

The natural gas transmission and distribution industries have been an important focus of the FTC's enforcement of the antitrust laws.[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] In addition, the FTC and its staff have filed numerous competition advocacy comments on electricity restructuring efforts with FERC and the states. The FTC staff also contributes to competition filings with international competition organizations.[9]

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[7] For example, on March 14, 2007, the FTC issued an administrative complaint alleging that Equitable Resources, Inc.'s planned acquisition of The Peoples Natural Gas Company from Consolidated Natural Gas Company, a subsidiary of Dominion Resources, Inc., would substantially lessen competition in the local distribution of natural gas to nonresidential users in western Pennsylvania, in violation of Section 7 of the Clayton Act, 15 U.S.C. § 18, and Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45. *Equitable Resources, Inc. et al.*, FTC Docket No. 9322, *available at* http://www.ftc.gov/os/adjpro/d9322/0703admincmp.pdf. On April 13, 2007, pursuant to Section 13(b) of the Federal Trade Commission Act, 15 U.S.C. § 53(b), the FTC filed a complaint in the United States District Court for the Western District of Pennsylvania that seeks a temporary restraining order and a preliminary injunction against the proposed transaction. *See* http://www.ftc.gov/os/adjpro/d9322/070413cmpltforpi-tro.pdf.

[8] *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); *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.

[9] The FTC and the Department of Justice participate as United States delegates in a number of international organizations, such as the Organization for Economic Cooperation and Development. As part of this process, the FTC staff contributes to the United States' "country reports" on competition topics. *See, e.g.*, U.S. Department of Justice and U.S. Federal Trade Commission, "Note by the U.S. Department of Justice and U.S. Federal Trade Commission," OECD Roundtable on Energy Security and Competition Policy (Feb. 21-22, 2007), *available at* http://www.ftc.gov/os/2007/02/WD200725OilGasUnited%20States.pdf. When requested by the Department of State, the FTC staff also contributes to comments by the United States on proposed regulatory reforms in other nations.

III. A Natural Gas Transmission Provider Is Likely to Have Similar Incentives to Discriminate and Cross-subsidize with Regard to Both its Marketing and its Non-Marketing Affiliates

As stated in the comment that the FTC staff filed with FERC in December 2001, "[t]here are two competitive concerns raised by the interaction between regulated transmission providers (whether they are electricity transmission or natural gas pipelines) and their unregulated affiliates."[10] 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. For example, a transmission provider might inform an affiliate that the affiliate's closest competitor in a highly concentrated market planned to close a facility during a specific time period, and this information might enable the affiliate to reduce its own supply in order to raise prices above the competitive level.

Similarly, the initial comment of the Ohio Public Utilities Commission states that a transmission provider might evade prohibitions against flows of commercially sensitive information to its marketing affiliates by passing the same information through its non-marketing affiliates.[11] Reliant states that a transmission provider's affiliated transmission customers and affiliated financial institutions often are Reliant's competitors.[12] If a transmission provider were to furnish non-public information to these affiliates, the affiliates could free-ride on Reliant's information-gathering efforts and undermine its incentives to make these procompetitive investments.

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[10] Comment of the Staff of the Bureau of Economics and the Office of the General Counsel, *supra* note 5.

[11] Initial Comments Submitted on Behalf of the Public Utilities Commission of Ohio at 4.

[12] Comments of Reliant Energy at 6.

The second problem identified in FTC staff's December 2001 comment is that "the transmission utility could engage in anticompetitive cross-subsidization in favor of its unregulated affiliates. This conduct adversely affects competition and economic efficiency. For example, cross-subsidization of an affiliate may allow a less-efficient affiliate to expand at the expense of more efficient non-affiliates."[13] This type of cross-subsidization could allow the transmission utility to shift profits into unregulated markets served by the affiliate and thus evade regulatory restraints on its market power in transmission markets. Regulators may find it difficult to substantiate claims of increased transmission costs that finance subsidization of the affiliate. "The result will be high average costs for the market served by the affiliate and its displaced competitors."[14] A utility may have incentives to discriminate and cross-subsidize with regard to non-marketing as well as marketing affiliates, and such behavior in favor of either type of affiliate may harm consumers.[15]

Any basis for distinguishing between marketing and non-marketing affiliates may be reduced by the important role of natural gas as the fuel for the marginal generators that

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[13] Comment of the Staff of the Bureau of Economics and the Office of the General Counsel, *supra* note 5.

[14] *Id.*

[15] FERC's Opinion No. 473, issued on July 28, 2004, in the matter of Ameren Energy Generating Company and Union Electric Company, d/b/a AmerenUE, FERC Docket Nos. EC03-53-000 and EC03-53-001, identified incentives to discriminate in favor of and cross-subsidize all types of affiliates. *See also* Comment of the Federal Trade Commission in FERC Docket Nos. PL04-6-000 and PL04-9-000, Solicitation Processes for Public Utilities; Acquisition and Disposition of Merchant Generation Assets by Public Utilities (filed July 14, 2004), *available at* http://ftc.gov/os/comments/ferc/v040022.pdf.

The extent to which discrimination in favor of an affiliate injures consumers depends at least in part on the degree to which such behavior harms economic efficiency. It is necessary to examine the specific facts underlying each claim of discrimination in order to ascertain the practice's economic effects.

play a key role in determining market prices for wholesale electric energy.[16] For example, a natural gas pipeline and its affiliated natural-gas-fueled electric generator may gain from discrimination – primarily in the form of higher charges by the pipeline for natural gas transportation – against rival firms that employ gas-fueled generators.[17] The same type of advantage from discrimination against non-affiliated gas-fired generators could accrue to an affiliate with coal-fired or nuclear generators. Nevertheless, a generation affiliate fueled by, for example, coal might be deemed a "non-marketing" affiliate of a natural gas transmission provider, whereas a generation affiliate fired by natural gas would be viewed as a marketing affiliate. In that case, the policy toward a transmission provider's dealings with its marketing and non-marketing affiliates might turn on the type of fuel used, even though the type of fuel did not have a significant bearing on the discrimination's economic effects.

IV. Matters Concerning Discrimination and Cross-Subsidization of Non-Marketing Affiliates by Natural Gas Transmission Providers

If FERC elects to supplement the record in order to reissue Order No. 2004, it may wish to include examples of favoritism toward utilities' non-marketing affiliates, both within and outside the natural gas transmission industry. Such examples can serve to support the theoretical concern about utilities' favoritism toward their affiliates.

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[16] "Marginal generators" are the generators with the highest marginal costs among the generators that are producing energy during a given hour. The FTC found reason to believe that the proposed merger between DTE (the Detroit-area electric utility) and MCN (the Detroit-area natural gas distribution utility) would give MCN an incentive to discriminate against non-affiliated gas-fired generators in order to increase the prices at which DTE would sell electric power. *See DTE Energy Co. et al.*, Analysis of the Proposed Consent Order and Draft Complaint to Aid Public Comment, *available at* http://www.ftc.gov/os/2001/03/dteanalysis.htm.

[17] The degree to which the affiliated group of companies profited from discrimination would depend on the extent to which the electric generating affiliate's gain exceeded any loss that the pipeline company incurred from engaging in such discrimination.

The FTC staff based its 2001 comment (cited by FERC and discussed by the D.C. Circuit in *National Fuel Gas Supply*, 468 F.3d at 21-22) on examples that included cases in the natural gas transmission industry. That FTC staff comment discussed four merger investigations that may furnish FERC with illustrative reasons to be concerned about discrimination and cross-subsidization of affiliates that are relevant to FERC Order No. 2004. Those matters – and similar instances from real-world experience[18] – could help alleviate concerns such as those expressed by the court in *National Fuel Gas Supply*, or could be used to bolster the relevance of the theoretical justifications for Order No. 2004.

V. Transmission Discrimination in the Context of Electricity Markets

FERC asks whether Order No. 2004 – narrowed as contemplated for the natural gas sector – also should apply to the electricity sector. One issue relevant to this determination is whether, in light of specific industry conditions, the benefits and costs of case-by-case enforcement of behavioral rules in the electricity transmission industry differ from those in the natural gas transmission industry. It can be more difficult to distinguish between discrimination and legitimate concerns over system reliability in

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[18] FERC may wish to consider the numerous complaints about discrimination and cross-subsidization of utility affiliates articulated by the National Alliance for Fair Competition ("NAFC") and its member organizations. *See, e.g.*, NAFC's statement entitled "Unfair Utility Competition and Cross-Subsidization," *available at* http://www.smacna.org/pdf/legislative/issues/CQCcross-subsidization.pdf.

FERC also may wish to consider the FTC's 2001 consent order that settled the investigation of the merger of Chevron Corporation and Texaco, Inc. One market involved in that case was the fractionation of natural gas liquids at Mont Belvieu, Texas. As stated in the "Note by the U.S. Department of Justice and U.S. Federal Trade Commission" for the OECD Roundtable on Energy Security and Competition Policy, *supra* note 9: "With regard to the fractionation of natural gas liquids, the [FTC's] complaint alleged that the proposed merger . . . provided Dynegy [Chevron's affiliate] with access to sensitive competitive information from one of its most important competitors at Mont Belvieu . . . increasing the likelihood that prices would increase for fractionation services in the vicinity of Mont Belvieu." Under a narrow version of Order No. 2004, Dynegy – primarily a generator and marketer of electricity – might not formally be classified as a marketing affiliate of ChevronTexaco's natural gas transmission operations, despite the potential harm to competition found in the FTC's investigation. *See also Chevron Corporation and Texaco, Inc.*, *available at* http://www.ftc.gov/opa/2001/09/chevtex.htm.

electric power transmission than in natural gas transmission, both because electricity transmission is technically more complex and because natural gas transmission is buffered by substantial storage capacity. Previous FTC comments to FERC have raised this issue,[19] and previous FERC decisions have focused on the difficulties of preventing electricity transmission discrimination through behavioral rules.

For example, in the Notice of Proposed Rulemaking ("NOPR") that culminated in Order No. 2000,[20] FERC noted that actual and perceived discriminatory conduct by transmission owners remained notwithstanding the implementation of behavioral rules against such conduct. Behavioral rules can fall short in the electricity sector because electricity transmission discrimination can be particularly subtle and thus difficult to detect and document.[21] For example, system operators' decisions about whether additional requests for transmission can be accommodated without threatening system reliability reflect judgments about conditions on the grid. Some of the factors that go into those decisions are subtle and must be based on prior operating experience. It can be difficult to second-guess such judgments without running the risk of causing future reliability problems.

As a result of the requirement that generation and consumption in electricity systems instantaneously match, negotiations between generators and wholesale or retail

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[19] *FTC Staff Report* (July 2000), *supra* note 8, Chapter III.

[20] FERC Docket No. RM99-2-001, Regional Transmission Organizations (May 13, 1999), Section III.A.2.

[21] The difficulty of detecting violations of behavioral rules also supports a preference for structural unbundling over the use of behavioral rules. The Commission of the European Communities reports a conclusion regarding transmission discrimination similar to that reached by FERC in Order No. 2000. *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..

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 pressure such customers to buy from the generation affiliates of the transmission operator. It is likely to be challenging for FERC to distinguish objectively between, on the one hand, illegal discrimination and, on the other hand, genuine technical uncertainty on the part of a grid operator. FERC's recent review and refinement of its rules against transmission discrimination in electricity markets also stems from continued concerns about the limited effectiveness of earlier behavioral rules against discrimination.[22]

Difficult-to-detect discriminatory practices can be used to favor the marketing and non-marketing affiliates of electricity transmission providers in ways that are inefficient. For example, if a transmission provider is part of a vertically integrated utility with an affiliate that is not involved in marketing electricity but instead sells backup generators to industrial customers, the transmission provider could favor the affiliate's customers in scheduling upgrades and maintenance of the transmission system. This could allow the backup generator affiliate to displace more efficient competitors that do not receive favored scheduling treatment from the transmission provider.

VI. Conclusion

The proposal to narrow the scope of standards of conduct in both electricity and natural gas – so that the standards would cover only marketing affiliates – may fail to

[22] FERC Order No. 890, Preventing Undue Discrimination and Preference in Transmission Service (Feb. 16, 2007), *available at* http://www.ferc.gov/whats-new/comm-meet/2007/021507/E-1.pdf.

recognize that incentives to discriminate and cross-subsidize in ways that are likely to cause inefficient resource allocations apply to both natural gas transmission providers and electric transmission providers, and apply to both their marketing and non-marketing affiliates. In weighing the benefits and costs of modifying or reissuing Order No. 2004, FERC may wish to consider the evidence of abuses that these standards would address. For example, FERC may wish to consider the several investigations and subsequent settlements that FTC staff cited in response to the NOPR that led to Order No. 2004, and also may wish to review other evidence regarding discrimination and cross-subsidization in favor of utilities' non-marketing affiliates.