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Working Party No. 2 on Competition and Regulation

STRUCTURAL SEPARATION RECOMMENDATIONS: COUNTRY EXPERIENCE

-- United States --

The attached document is submitted by the delegation of the United States to the Working Party No. 2 of the Competition Committee FOR DISCUSSION under Item IV of the agenda at its forthcoming meeting on 11 October 2004.

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Telecommunications

1. The U.S. has moved away from structural separation between vertically related carriers. As of 2003, the Regional Bell Operation Companies were allowed into long distance services in all the states of the US. And while the Telecommunications Act of 1996 requires them to have separate subsidiaries to provide long distance for a limited 3-year period, in some of the states where entry authority under Section 271 of the Act was first granted, this limited period has run and the Bells are now able to provide local and long distance even on an integrated basis in certain states. However, the situation in the US now is somewhat different than what is contemplated in the OECD recommendation, since even the local markets in the US are no longer considered legal monopolies and are open to competition. The Bells remain the dominant providers but local competitors have taken in the aggregate a 16% market share according to the latest FCC data from the end of 2003. Concern regarding vertical integration of local and long distance telephony providers has lessened, in part, due to the growth of other technologies such as wireless, cable-based telephony services and Internet-based telephone services, although it is unclear the extent to which these will become substitutes for landline services. Recently the FCC facilitated competition between suppliers and between telephony technologies by allowing customers to keep the same telephone number even if they switch suppliers.

Railroads

2. In the U.S. there have been a number of proposals to increase the ability of shippers to insist upon service from competing train companies over monopoly track -- i.e. moving closer to the pure separation model -- but they have not been successful. Amtrak is a non-integrated tenant operator, but the integrated incumbents have no desire to run passenger trains of their own.

Postal Services

3. The United States has some degree of experience with “financial” separation of accounts, in that the Postal Rate Commission (PRC) is charged with responsibility for recommending domestic postage rates that must satisfy a statutory requirement in 39 USC 3622(b)(3) that each class or type of mail service must cover its attributable costs and make reasonable contribution to overhead. (Unlike most sector regulators, however, the PRC does not have subpoena power to obtain data or documents from the USPS.) Nevertheless, the Postal Service has not been "structurally" separated in the form of physical separation of competitive and market dominant services. A noteworthy exception is the workshare program of the USPS. Under this program, many large customers obtain discounts equal to the avoided costs of the USPS if they perform any of a wide variety of sorting and transportation functions that the USPS would otherwise have to perform. The PRC evaluates the level of these discounts in its rate hearings.

Gas/Electricity

4. The Federal Energy Regulatory Commission (FERC) has promoted structural separation in the energy sectors since the early 1990s. Even prior to this action, natural gas pipeline companies in the United States did not explore for or produce natural gas. Instead, the pipelines were vertically integrated into the production sector via long term contracts with independent producers. The pipelines regulated by the FERC made bundled sales of gas and transportation to the “city gate” of Local Distribution Companies (LDCs). The sales price for this delivered wholesale gas was regulated. LDC’s in turn made regulated bundled sales of natural gas to retail customers.

5. The natural gas industry is now separated into clear production, transmission, distribution and sales sectors. Through a series of rulemakings, the FERC barred bundled sales of natural gas by interstate pipelines, effectively making them open access transportation-only companies. The terms and conditions

for transportation on these pipelines are regulated by the FERC. Natural gas prices are unregulated. Pipelines and producers renegotiated their long term gas supply contracts. LDCs then made separate contracts for gas supply directly with producers and marketers and purchased interstate transportation from the pipelines. Large industrial customers that are able to connect directly to interstate pipelines can also purchase natural gas directly from producers and pay the pipeline for transportation only.

6. Local distribution of natural gas in the United States is regulated by states and has not, for the most part, been structurally separated. Most residential and commercial natural gas distribution customers cannot buy their supply directly from a producer or marketer at unregulated prices but must buy from the local monopoly LDC at a regulated rate. This is changing, however, and many states have separated local distribution from gas sales, at least for large commercial and industrial customers of the LDCs. A notable example occurs in the Atlanta, Georgia, area where all retail natural gas is sold by independent suppliers because the LDC does not have an affiliated retailer.

7. Another form of separation is found in the Detroit, Michigan, area where the LDC has divested part of the capacity of its system to a competitor. This arrangement stemmed from settlement of a merger case by which the electricity distribution company in the area acquired the natural gas LDC. The competitive concern addressed by the divestiture was that after the merger, the LDC would have diminished incentives to offer discounts to customers considering investments in on-site electricity generation fueled by natural gas. On-site generation competes with the local electric utility. Potential conflicts over operation of the local distribution network and associated natural gas storage facilities are handled by an independent third party agreed to by the two competitors.

8. After restructuring the natural gas industry, the FERC sought to encourage structural separation in the electricity industry as well. The electricity industry in the United States was traditionally highly vertically integrated with the owner of the local distribution network owning all of the generation and high voltage transmission that served its customers. The FERC sought to separate these functions by encouraging entry by independent generators, but it lacked authority to order a company to transmit power over its transmission lines for a third party generator. Through a combination of legislation and regulatory changes, the FERC restructured the wholesale (generation) sector by requiring all owners of transmission to publish open access tariffs. Wholesale customers (for example municipal systems or third party utilities) could then get access to a variety of generation sources via the interstate transmission grid. Terms and conditions for transmission are set by a FERC-regulated tariff. The price for the electricity remained regulated but the regulated rate is set at the market price (so called “market based” rates) rather than based on some accounting of historical costs of production.

9. The FERC has taken further steps to separate the generation and transmission sectors, although not through actual divestiture of ownership. (As described below, some states did require divestiture of generation assets as part of their implementation of retail competition.) The FERC has encouraged creation of Regional Transmission Organizations (RTOs). In regions with RTOs, transmission-owning utilities have ceded operation of their wires to a neutral operator that is unaffiliated with any generator in the region. This organization then schedules power without regard to the ownership of the plants generating the power. While there are a set of basic principles to enforce the independence of the operator, each RTO has its own set of operating rules. Some RTOs also operate a spot wholesale electricity sales market. Prices for electricity in such markets are “market based,” with the exception of some severe load pockets.

10. Retail electricity operations (all deliveries and sales of electricity to ultimate consumers) are not regulated by the FERC and have traditionally been regulated by the states. Separation of supply, distribution and sales to ultimate consumers is thus a function of state and not federal policy. Many states considered restructuring their retail sectors. Some retained a traditional, regulated, vertically integrated

model for retail supply. Some ordered divestiture of all generation by local wires companies. Some deregulated electricity prices for all or a portion of retail customers.

11. Deregulation of retail electricity markets and the FERC's continued liberalization of wholesale electricity markets slowed in the wake of problems in the California electricity markets in the summer and fall of 2000. The volatile and high prices for retail electricity as well as allegations of fraudulent behavior by marketers caused political pressure toward reregulation. California ultimately revoked its deregulation statute (although it is again considering retail competition for large commercial and industrial customers) and some states considering retail deregulation have stopped or delayed their efforts. The prospect of re-integration of generation with distribution has been raised by companies that have sought to buy back or otherwise re-integrate generation that was separated as part of FERC's restructuring efforts. The FERC has recently determined that it will review reintegration of affiliated generation services and assets to make sure that they are not discriminatory and that they do not result in evasion of rate regulation. States also review these transactions to various degrees.

12. The FERC responded to the issues raised by California's problems by strengthening its enforcement capability. It established and Office of Market Oversight and Investigations with staffing and technology necessary to more effectively monitor trends in energy markets. It continues to encourage well structured electricity markets through its initiatives to create Regional Transmission Organizations and a "best practices" (standard) market design for competitive trading of day-ahead and hourly electricity. FERC's efforts have been met with resistence by some state governments that fear competition would be less favorable to their local citizens than traditional rate regulation. Recently one of the original RTOs has expanded into one of the regions where RTO activity has been slow to develop.

13. In August of 2003, the Great Lakes region of North America suffered a serious and widespread electrical blackout. An international panel promptly began to investigate the causes of the system failure. Notably, the panel's report did not blame deregulation of electricity markets for the outage. The report found that a major cause of the outage was some utilities' failure to comply with the voluntary National Electric Reliability Council's engineering and operational best practice standards in operating its regulated transmission assets. Based on the report and the recommendations of the panel, Congress is proposing to create an organization responsible for monitoring and enforcement of the reliability of the electrical transmission grid. The new organization would have authority, subject to FERC oversight, to promulgate and enforce (via penalties) engineering standards for transmission facilities.