U.S. DEPARTMENT OF JUSTICE

Antitrust Division

ANTITRUST ENFORCEMENT IN THE ELECTRIC INDUSTRY

Address by

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Introduction

It is a great pleasure to be here, before such a distinguished audience, and to follow such an interesting and impressive panel. I'll admit though, after government shutdowns and closures due to blizzards, I'm glad to be at work most anywhere.

These are truly exciting times in your industry. It's not a time for the faint-hearted. You face all sorts of challenges that come with change. Your shareholders are counting on you to step up and meet these challenges and take your companies through a successful transition to a more competitive electric industry.

I don't mean to stand here and lecture you. That would be wrong since I come from what lately has been one of the most dysfunctional places around -- Washington D.C. Today is actually the first day my office and the Washington, DC operations of the Antitrust Division have officially been opened in a month.

I don't know whether we will close a third time after January 26 when the funds in the continuing resolution under which we now operate run out. As CEOs, this would just drive you folks crazy. Planning, managing, productivity, and efficiency suffer.

Toward More Competition

In the midst of all this government turmoil, however, there is broad agreement in Washington D.C. and in the capitals of many states that will have a great effect on your business. There is agreement on a fundamental principle. That principle is that competition is better than regulation. That is a simple idea but it is not so easy to give meaning and execute. That principle stands out from the great debates in Washington and elsewhere as a point of agreement.

Why do we have that belief and why are we acting on that belief?

Regulation substitutes the judgments of people for the workings of a market with respect to price and output. In many respects that is both costly and risky. It's hard to get it right, to induce efficiency, investment, innovation and, at the same time, achieve beneficial social ends by regulatory decisionmaking. Where real competition is possible, it is indeed preferable. Our nation has proven throughout its history that markets are superior, that competition produces lower prices, better service, and more innovation.

We can't, however, lose sight of the fact that regulation is the right course where markets don't work. Where there's natural monopoly, or for other compelling public policy reasons markets can't function, regulation shouldn't simply go away.

In this regard, we are mindful that universal service is an important principle in your industry. Nobody wants the poor to lose the ability to have electricity which is necessary for survival or any modicum of a reasonable quality of life. But

competition ultimately ought to lower the price of providing universal service.

As we think about increasing competition and deregulating, we don't want to end up with the worst of all worlds, which I would describe as deregulated monopolies. Simply deregulating a monopoly is not the same thing as facilitating competition. Where there is no consumer choice, consumers should not be left at the mercy of a deregulated monopolist.

There are some important up-sides for you from the increased competition and decreased regulation that is increasingly occurring today. The up-sides include an ability to participate in new businesses and more freedom to participate in the old ones in a way that's efficient and productive for your shareholders.

A quick look at the telecommunications bill pending before Congress illustrates my point about new businesses. The Conference Committee's December 22 draft would amend PUHCA to allow registered holding companies to diversify into telecommunication services, information services, and other regulated services through a new subsidiary. That new single purpose subsidiary will be designated an "ETC" or "exempt telecommunications company."

So it is clear that there will be exciting new opportunities and businesses available to you, at least they're very exciting to me.

<u>The Role of Antitrust</u>

Along with less regulation, comes more freedom. But with that additional freedom comes the tool by which this country has for more than 100 years policed competitive and would be competitive markets...Antitrust.

Antitrust is not regulation. I think that's a very important point that bears repeating, Antitrust is not regulation.

Antitrust is intended to preserve a competitive free market economy. It has done so in all kinds of industries throughout our country's history.

In your industry, with the arrival of reduced regulation, some of the exemptions that have traditionally applied will have less bite, opening the electric industry to antitrust enforcement, where necessary.

Let me illustrate my point. There is a judicially created doctrine known as the State Action Exemption. Under that doctrine, business conduct is exempted from the antitrust laws where it is both (1) undertaken pursuant to a clearly articulated state policy to displace competition with regulation and (2) actively supervised by state regulators.

It is plain that the state action exemption, while it will continue to be given the force that it was intended to have, will and should have much less reach in the future. You can understand that by simply thinking of what you're hearing from the various states in which you operate. Those states are increasingly talking about competition and their goal of promoting competition. Some are beginning to implement changes to effectuate that goal. At the simplest level, where that is the case, it is obvious that it will and should become increasingly difficult to find a clearly articulated state policy displacing competition.

Antitrust Enforcement

I sometimes hear business leaders say that there is uncertainty about the antitrust laws. Antitrust principles are

not uncertain, they are very well established over a 100 year history. On the other hand, the principles often are applied on a case-by-case basis.

For most non-criminal conduct, a rule of reason analysis applies, which requires on the part of both prosecutors and judges a balancing of the procompetitive and anticompetitive effects of the relevant conduct in evaluating whether it violates the antitrust laws. In fact, the same practices may be legal in one set of circumstances, for example where there is no market or monopoly power, and illegal in another set of circumstances, such as where there is indeed market or monopoly power and high barriers to entry. The case in which we secured a consent decree against Microsoft involved licensing practices that were anticompetitive and illegal for Microsoft to engage in, but might have been lawful for a firm with no market power. Antitrust is very fact specific.

I recognize that you all want to comply with the law. In this regard, I will give you some sound advice, and that is to consult with experienced antitrust counsel. It is important that your company evaluate your activities in light of the new competitive environment, and some careful planning now can avoid serious problems later.

In the merger area, antitrust principles are likewise well established and applied on a case-by-case basis, requiring careful analysis. To facilitate this analysis, the Department, together with the FTC, issued the 1992 Merger Guidelines which set forth the analytical framework we use as antitrust enforcers to evaluate the legality of mergers. For example, the Department considers the anticompetitive effects of a transaction, but then it also considers any real efficiencies from the transaction. These are fact specific matters.

Certainly, applying these established principles requires special care in a market with changing rules. It is easier to police transactions that impede actual competition rather than potential competition. I must tell you, however, that under our Merger Guidelines we look to the shape of competition to come in evaluating competitive impact and do not rely only on what we see today. We engage in a dynamic, forward-looking analysis.

In the electric industry, what might some antitrust problem areas be?

One area to watch is tie-ins. Tie-ins are most likely where there is a monopoly of a relevant product or service, such as transmission, and that monopoly is used to require purchase of other products or services which a buyer might have preferred to purchase elsewhere on other terms. Put simply, in a regulated industry, the goal of a tie-in might be to circumvent price regulation -- a tie-in might be designed to collect on the sale of a second product which is unregulated, the monopoly profits prevented by price regulation of a tying product.

An example of this kind of tie-in is our El Paso Natural Gas Company case in which we secured a consent decree in 1995. We brought that case because El Paso, a pipeline company, required natural gas gatherers to have El Paso rather than the gatherers themselves or an independent contractor, do all of the connection services to the pipeline. Simply put, El Paso required that only it do the necessary construction and installation of metering equipment on its pipeline. Our investigation showed that El Paso's connection service was substantially overpriced. Pipeline transmission rates were regulated but El Paso could collect extra profits attributable to its pipeline monopoly by charging above market rates on the unregulated connection services. We obtained a consent decree which allowed other companies besides El Paso to provide these services.

Another area to watch is joint conduct. First, let me reassure you that most of the joint conduct you are likely to engage in is legal. The notion that joint conduct among competitors is often lawful and procompetitive is well established in antitrust law. In some instances, for example, there may even be a product created by the joint conduct that couldn't otherwise exist. For example, take league sports -- a single team can't produce the same product that is produced by a league enforcing rules designed to foster competition and entertaining sporting matches. Similarly, in the area of music licensing, there is much to be gained through a joint venture that allows music to be used by other artists without dozens of negotiations. I would also note, in the electric area itself, that the Department has submitted comments to FERC which are supportive of RTG's and Poolcos. The rule of reason would normally apply to this kind of joint conduct.

I would suggest, nonetheless, that you be attentive to your pooling arrangements. There certainly are, as I say, legitimate reasons for competitors in your industry to act jointly, such as to foster reliability, etc. Most pooling arrangements serve many lawful and procompetitive purposes. But when many pools were established, companies who now participate were competitors in a much more limited sense, if at all. Today, there is more competition between participants. It is worthwhile for you to direct a review of the activities of pools and other joint arrangements in which you participate, in order to ensure that their activities are indeed tailored in a way that serves only legitimate and lawful objectives. For example, you should review exchanges of information, and determine whether these exchanges are necessary to assure the success of the procompetitive objectives of the pool and do not instead effectively prevent purchases of generating capacity from companies who are not in the pool. Overly broad exchanges of information without controls could raise questions in some circumstances.

In this regard, I also want you to be aware that prior FERC approval of a pooling arrangement will not protect activities that violate the antitrust laws or dispose of questions as to whether a rule of reason analysis permits the conduct under the antitrust laws. The Federal Power Act does not expressly or impliedly immunize regulated electric utilities from the antitrust laws. Also, as I have said, competitive circumstances have changed dramatically in the last few years and conduct that may have been permissible under the antitrust laws before could conceivably be anti-competitive and impermissible now.

The Department of Justice has at least three avenues to involve itself in competitive issues in the electric industry, not counting criminal antitrust enforcement.

The first means of antitrust oversight would be civil enforcement. We usually do that by applying the Sherman Act. I've talked a little bit about the kinds of concerns we might have under the Sherman Act such as tie-ins and anti-competitive exchanges of information.

Currently, we have several investigations underway that involve potential Sherman Act claims. This area is a priority for us. With the increase in reliance on market forces in electric markets, we are devoting increased resources to Sherman Act enforcement in the electric industry. I would also note, however, that you can minimize your exposure in this area by reviewing your activities with the help of antitrust counsel.

Most of our antitrust investigations begin with a complaint by a business. That complaint might well be your complaint just as it might be a complaint from someone who is dissatisfied by your treatment of them. If you think that you have an antitrust problem, our doors are open and I invite you to bring it to us.

And finally, related to the civil area, I want to mention that we sometimes provide what I will refer to as "business review letters." Businesses can submit to us a full and accurate description of contemplated conduct and ask us what our enforcement intentions would be if they engage in that conduct. I must emphasize that the conduct must not be something that is ongoing but rather something that is contemplated. We often give guidance through that business review procedure.

Competition Advocacy

The second area of involvement for us can be participation in the regulatory process through competitive advocacy. The Department frequently goes before other agencies and advocates positions that advance competition.

Some of you may be familiar with the Department of Justice's submission to the FERC in connection with the Mega NOPR. We urged that FERC implement "operational unbundling" in the electric industry. This is a form of separation short of full divesture. We agreed with the FERC that some mechanism for vertical disintegration of integrated utilities will maximize the potential for competition in the electric generation market. But we urged adoption of a solution -- "operational unbundling" -- that will produce procompetitive results closer to those of complete divesture of generation from transmission, but at less risk to potential efficiencies. We have not reached a conclusion to date that the competitive benefits of divestiture always outweigh any loss of efficiency. By operational unbundling, we mean structural, institutional arrangements short of divesture in order to separate operation and dispatch of generating plants from the operation of the transmission system, and in that way to better assure that transmission market power will not be used to

distort the market for generation. We believe that this approach would require less regulation than the approach proposed by FERC.

We also noted that the FERC suggested that the open access regime it proposed could allow it to decline to monitor prices in wholesale generation markets. We told the FERC that while open access and operational unbundling will encourage competition and generation, ownership of generating capacity may remain concentrated in some regions of the country, and that this may warrant continued regulation in those areas. We urged that FERC examine particular generation markets on a case-by-case basis.

We took no position on an issue that is of great importance to many of you, that of stranded costs. We didn't urge any particular method of calculation and we didn't address whether recovery of stranded costs should be allowed. The Department did suggest, however, that any mechanism for recovery of stranded costs be designed to minimize distortion of competition for generation and, along these lines, we also specifically urged the FERC to avoid use of transmission adders as a means of stranded cost recovery.

We also submitted comments to the FERC in another proceeding, addressing "poolcos." In case there is any confusion about this, I want to clear it up. When the Department spoke about poolcos, we were speaking of a general concept of our own, which we tried to define, and not about a particular model or style of implementation. What we had in mind was not the same as what was then under consideration in California nor was it the same as has been implemented in the United Kingdom.

We told the FERC that if certain market conditions and safeguards were in place, poolcos could help complete the transformation of the electric power generation industry from

regulated monopolies to openly competitive and effectively unregulated markets. We set out a list of important safeguards which I won't go through in its entirety other than to note that we think that Poolco operations must be independent of any owner of generation, that participation should be voluntary, that the arrangements should be developed through private negotiations, and that poolcos only makes sense in areas where there are not highly concentrated generation markets.

I can answer questions about this if necessary.

Electric Utility Mergers

The third broad area in which we're involved is mergers. Merger enforcement under the antitrust laws, as in other areas of antitrust enforcement, protects competition, not competitors. I know that mergers are of interest to all of you and that this area has occupied an increasing amount of your thinking in recent months. There has been a significant increase in the announcement of mergers in recent months. And as with other combinations in the electric utility industry, mergers raise more serious concerns for the Department of Justice today than in the past because utilities are more likely to be competitors than before.

The Department's review of mergers under the antitrust laws is substantively and procedurally different from the FERC's approval process. We apply Section 7 of the Clayton Act. Section 7 of the Clayton Act prohibits transactions that threaten "substantially to lessen competition in any line of commerce in any section of the country." The central issue under the Clayton Act is whether the merger will result in increased prices or reduced services. Despite regulation at the state and federal level that requires approval of maximum tariffs and minimum terms of service, electric utilities have significant discretion

in proposing prices and services in tariffs. As regulatory reform pushes for more wholesale prices and, in the near future, more retail prices, to be set by market conditions, merger enforcement becomes crucial to the success of deregulatory efforts.

In most industries, our review of a merger begins with the receipt of a filing under the pre-merger notification provisions of the Hart-Scott Rodino Act. Routine mergers that raise no antitrust issues may be consummated after a 30-day waiting period has expired. Sometimes the antitrust agencies support early termination of an investigation, before 30 days. Where a merger raises antitrust concerns and we determine before the expiration of the initial 30 days that we need additional information from the parties to complete our investigation, we can issue what we refer to as a "second request" for information. That second request extends the waiting period in most cases (the period during which the transaction cannot be consummated) until 20 days after the parties supply the requested information.

Now in an unregulated setting, this procedure causes a short, but important delay between the agreement of the parties to merge and consummation of the merger.

But, our review of electric utility mergers can often proceed somewhat differently in light of the fact that those mergers undergo a regulatory review by FERC and state agencies. Very often, the parties to these mergers will not file under the Hart-Scott Rodino Act with the Department of Justice until those other approvals are far along or perhaps obtained. The Department of Justice, however, is not actually required to wait for a Hart-Scott Rodino filing to begin its own investigation of the announced merger. Even before a Hart-Scott-Rodino filing, using the provisions of the Antitrust Civil Process Act, we can seek documents, depositions, and interrogatory responses from the

parties and others. I think that the interest of the Antitrust Division is the same as the interest of the companies during the period before a Hart-Scott-Rodino filing. I would encourage electric companies, even before they make these filings, to come forward, and to work with us while the regulatory approval process is underway. During the period that FERC considers your merger, we could be learning about the merger as well and obtain basic documentation so that when you are ready to proceed with us later, we will be prepared to give you a more prompt answer. This approach has worked very well for us and merging parties in the banking industry. So I would urge you not to ignore us during the time you are pursuing FERC and other regulatory approvals, even if you haven't made a Hart-Scott- Rodino filing.

As you know, if we conclude that a merger transaction as structured would violate the antitrust laws, and if we cannot obtain a voluntary settlement, the Department must go to court to seek injunctive relief to prevent the transaction from going forward as contemplated. You should take some comfort from the fact that only a relatively small percentage of mergers that come before the Department actually are challenged in court.

As for how we look at proposed mergers in this industry, I would point you to the 1992 Horizontal Merger Guidelines, which were issued jointly by the Department of Justice and the Federal Trade Commission. Under the merger guidelines, we assess likely harm to competition and then consider any efficiencies that may outweigh potentially harmful effects. As a starting point, our competitive analysis in the electric industry, as in all other industries, takes account of the position of each of the merging firms in each economically meaningful "relevant market," the concentration in those markets, the extent to which concentration would be increased, the competitive conditions likely to exist in the market after the transaction, and ease of entry by new firms or firms not now serving the market. We are trying to assess the

ability of the resulting firm profitably to raise prices or reduce service. We define relevant markets carefully and include in our analysis an evaluation of any effective substitute a customer might have for the services provided by the merging firms. We also consider which firms might provide these substitutes.

As part of our analysis, we define relevant product markets. One relevant product would obviously be energy. We would consider the effect of the merger with respect to energy or bulk power. Another relevant product market may be that for retail energy. In this regard, we may also take a look at state law to see to what extent retail wheeling may be allowed or appears to be coming in the near future.

Another generation product could be capacity. In addition to capacity as we normally think of it, given that this industry is regulated and that regulators sometimes require that reserves be maintained, there may be some products that are unique creations of regulation.

It may also be appropriate to separate these product markets into short-term, intermediate, and long-term energy or capacity markets.

Of course, transmission markets are often critical to the analysis of electric utility mergers and also must be seriously considered.

As in other industries, we must give some thought to geographic market issues, that is, where are the sellers located to whom a buyer can reasonably turn. In identifying those sellers, we consider the cost of transmission to the buyer. We also consider any physical constraints there may be on transmission. We recognize with respect to the area from which

buyers can obtain alternative availability of electricity that there may be changes over a season and even over a day, some of which may even result from different weather conditions.

Finally, there are potential regulatory evasion issues that need to be considered as well. As I indicated before, there are some unique concerns in regulated industries. Where the ability of a monopolist to charge monopoly rates is suppressed through regulation, there can be evasion through the sale of products in adjacent markets that are unregulated. I gave you an example with respect to tie-ins earlier, and this could be an area for concern in a merger.

Conclusion

It's plain that there are great changes going on around you and new challenges. It's plain that not all of the old rules and exemptions will apply. I wish you all great success as you find the right strategy and move forward. And, I think that you should look at the increasing relevance of antitrust law in your industry essentially as good news -- it's a reflection that regulation is diminishing somewhat and that markets are changing to enable a more flexible and competitive future.

Thank you very much.