January 16, 2009

VIA ELECTRONIC FILING

The Honorable Kimberly D. Bose
Secretary
Federal Energy Regulatory Commission
888 First St. N.E.
Washington, D.C. 20426

Re: Comments of the American Antitrust Institute in Docket. No. PL09-3-000

Dear Secretary Bose:

Enclosed are the comments of the American Antitrust Institute in the abovementioned proceeding. Should you need any additional information, please do not hesitate to contact me.

Very truly yours,

Diana L. Moss

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Enclosures

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Control and Affiliation for Purposes of the Commission's Market-Based Rate Requirements under Section 205 of the Federal Power Act and the Requirements of Section 203 of the Federal Power Act	Docket. No. PL09-3-000

Comments of the American Antitrust Institute

Pursuant to the Federal Energy Regulatory Commission's ("Commission") notice of December 9, 2008, the American Antitrust Institute (AAI) hereby respectfully submits comments in the above-captioned matter. The AAI is an independent, Washington D.C.-based non-profit education, research, and advocacy organization. The AAI's mission is to increase the role of competition, assure that competition works in the interests of consumers, and challenge abuses of concentrated economic power in the American and world economy.[1] The AAI speaks on behalf of the public interest in a wide range of matters involving competition policy and consumer protection in antitrust enforcement and regulation.

I. Introduction

On September 2, 2008, the Electric Power Supply Association (EPSA) submitted a "petition for guidance regarding 'control' and 'affiliation'" for transactions under sections 203 (mergers and acquisitions) and 205 (market-based rate requests) of the

[1] More information on the AAI is available at http://www.antitrustinstitute.org.

Federal Power Act (FPA).[2] The petition requests that the Commission adopt a number of proposals. Among them is a "bright-line" test ("test") that would deem an investment in a publicly-held company by an investor holding less than 20 percent of the voting securities, and with a Schedule 13G on file with the Securities and Exchange Commission (SEC), not to convey control or result in affiliation for section 203 or 205 purposes.

On December 3, 2008, the Commission Staff convened a workshop to discuss issues raised by the abovementioned EPSA filing, including the meaning of the term "control" for purposes of sections 203 and 205; what actions by upstream investors should be deemed to constitute the exercise of control for purposes of sections 203 and 205; whether the Commission should rely on representations made by an investor to the SEC for purposes of determining whether the investor can exercise control over a public utility; and what actions by an upstream investor should be deemed to affect a seller's market-based rate authority.

The AAI submits that EPSA's proposal that the Commission use SEC Schedule 13G as a criterion for what does not constitute "control" for evaluating competitive issues in section 203 and 205 applications is misconceived. The test raises a number of problems and questions, as described in the body of these comments. Section 203 and 205 transactions involving partial ownership shares in rival generation assets by an investor (i.e., "cross-ownership") often raise complex competitive issues. This suggests

[2] Federal Energy Regulatory Commission, *Petition of the Electric Power Supply Association for Guidance Regarding "Control" And "Affiliation"* by the Electric Power Supply Association, Docket No. EL08-87 (September 2, 2008).

the need for: (1) a more robust screening test for transactions that would clearly have a *de minimis* effect on competition and (2) reasoned analysis for those that will not.[3]

II. Competitive Problems Associated with Cross-Ownership

A. Background

Section 203 transactions that involve only partial ownership of generating assets are relatively new for the Commission. Indeed, most of the section 203 matters considered to date involve complete mergers or acquisitions. In light of the constraints on lending created by the recent financial crisis and general economic uncertainty in the U.S. today, it is likely that the financing for investment in the unregulated (and regulated) generation sector will come more frequently from private equity sources.

Private equity transactions are a fundamentally different and novel type of strategy for investment in the electricity sector. Namely, private equity investors effect rapid changes in management and strategy to "turn the company around" and cash out of the investment in a relatively short period of time.[4] In the generation sector, private equity firms typically purchase a partial ownership stake in a company.[5] That stake often

[3] These comments address horizontal problems involving cross-ownership, i.e., a private equity investor that holds partial shares in generating assets that compete in the same relevant markets. Cross-ownership concerns can also arise in a vertical context, i.e., in which a private equity investor holds partial shares in complementary market assets, such as upstream inputs (e.g., fuel or transmission) and downstream generation. These situations would also warrant careful analysis by the Commission but are not explored in these comments.

[4] E.g., TPG Capital cashed out of Oxford Health Plans, which it bought in 1998 and sold in 2000-2001 with a return of about 28 percent. See *TPG Cashes Out of Oxford*, THE DEAL (March 9, 2002). Available http://www.tpg.com/news/articles/deal03.09.02.pdf. Last visited January 15, 2009. TPG Capital cashed out of Beringer Wine Estates with about a 9 percent return after about four years. See *Texas Pacific Group Gives Farewell Toast to Beringer Wine Estates*, BUYOUT (November 6, 2000). Available http://www.tpg.com/news/articles/Buyouts110600_farwell.pdf. Last visited January 15, 2009.

[5] See, e.g., Federal Energy Regulatory Commission, *Entegra Power Group LLC, Gila River Power, L.P., Union Power Partners, L.P., Harbinger Capital Partners Master Fund I, Ltd., Harbinger Capital Partners Special Situations Fund, L.P.*, 125 FERC ¶ 61,143 (2008).

adds to an investment portfolio that already includes a partial interest in a rival generating asset. These cases can raise competitive issues for regulators and antitrust enforcers since the private equity investor has a common ownership interest in rival assets. If those assets "overlap" in relevant product and geographic markets that are not conducive to competitive outcomes, then common ownership can diminish competition, resulting in higher prices, lower output, reduced product quality, or reduced innovation. These outcomes can result from both unilateral and coordinated competitive effects. Some transactions that create cross-ownership patterns and significant issues of ownership and influence over competitive decision-making may be evaluated as complete mergers.

Cross-ownership transactions are not particularly new for antitrust enforcement. But recent cases involving private equity investment in competing assets illustrate the importance of a careful and reasoned analytic approach to evaluating competitive effects. In 2006, for example, the Federal Trade Commission (FTC) challenged an attempt by each of two private equity firms—the Carlyle Group and Riverstone Holdings--to acquire an 11.3 percent interest in Kinder Morgan. Carlyle and Riverstone, however, had a collective 50 percent ownership interest in Kinder Morgan's competitor, Magellan Midstream Holdings. The FTC ultimately negotiated a consent order requiring a number of conditions that would prevent Carlyle and Riverstone from influencing competitive decision-making.[6]

[6] See Federal Trade Commission, *In the Matter of TC Group, LLC, Riverstone Holdings LLC, Carlyle/Riverstone Global Energy and Power Fund II, LP, and Carlyle/Riverstone Global Energy and Power Fund III, LP (Complaint)*, Docket No. C-4183 (January 24, 2007) and *(Decision and Order)* (January 25, 2007). Available http://www.ftc.gov/os/caselist/0610197/complaint.pdf. Last visited January 15, 2009.

In 2003, the U.S. Department of Justice (DOJ) challenged under Section 7 of the Clayton Act the acquisition of a 50 percent ownership interest in Southern Belle Dairy Co. by Dairy Farmers of America (DFA). DFA also owned a 50 percent interest in Southern Belle's competitor, National Diary Holding, in the market for school milk.[7] While the foregoing examples are partial ownership shares that are clearly outside of the EPSA's proposed safe harbor zone, ownership share alone is not determinative of the ability to influence a firm's competitive decisions.

B. Analyzing the Competitive Effects of Private Equity Transactions

In both the *Dairy Farmers* and *Kinder Morgan* cases, it is clear the the DOJ and the FTC performed a reasoned analysis of competitive effects that drew in part upon the principles set forth in the Department of Justice/Federal Trade Commission *Horizontal Merger Guidelines*.[8] The Commission currently employs a similar version of this analysis in evaluating section 203 applications under the guidance set forth in the *Merger Policy Statement*.[9] In *Dairy Farmers* and *Kinder Morgan*, however, the antitrust agencies also considered theories of harm relevant specifically to cross-ownership transactions. Those theories are equally applicable to the generation cross-ownership questions at issue in this inquiry.

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[7] See *United States v. Dairy Farmers of America*, Competitive Impact Statement, Civil Action No.: 6:03-206-KSF (E.D. Ky. October 2, 2006). Available http://www.usdoj.gov/atr/cases/f221700/221713.htm. Last visited January 15, 2009. See also *United States v. Dairy Farmers of Am., Inc.*, 426 F.3d 850 (6th Cir. 2005).

[8] U.S. Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines* (April 2, 1992). Available http://www.usdoj.gov/atr/public/guidelines/hmg.htm. Last visited January 15, 2009.

[9] See Federal Energy Regulatory Commission, *Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement*, Order No. 592, 61 FR 68,595, December 30, 1996. Available http://www.ferc.gov/industries/electric/gen-info/mergers/rm96-6.pdf. Last visited January 15, 2009.

Partial ownership by a private equity firm in competing assets can adversely affect competition in three possible ways. One is the ability of the private equity firm to control or influence the competitive decisions of the partially-owned firms. A second is the softening or dimunition of rivalry between firms that results from changed incentives associated with common ownership. A third is the potential exchange of competitively sensitive information between the commonly owned firms--using the private equity firm as a conduit--that could facilitate coordination.

The foregoing considerations serve as a useful three-part framework in which to evaluate EPSA's proposal for a bright-line test for determining what constitutes a lack of control for section 203 and 205 purposes. For example, EPSA's Schedule 13G proposal inadequately addresses the issue of control, participation, and influence over competitive decision-making. Moreover, the proposed Schedule 13G test may not thoroughly address the changed incentives for commonly-owned rival generators to compete. Finally, the proposed test ignores the potential for diminished competition between the commonly owned rival generators due to the exchange of competitively sensitive information. As discussed later in these comments, these issues are useful in developing a manageable approach to evaluating cross-ownership transactions that do not pass an appropriately defined screening test.

III. The Proposed Bright-Line Test Does not Adequately Address Issues of Control and Influence Over Competitive Decision-Making

A. Using a Regulatory Standard for "Control" that is Designed to Protect Investors Imperils the Consumers FERC is Statutorily Required to Protect

By adopting a criterion for what constitutes "control" from another regulatory venue, the Commission will bind itself irrevocably to a standard used by an agency

whose purpose, context, and powers are quite different. As EPSA itself points out, the purpose of Schedule 13G is to "alert the marketplace to every large, rapid aggregation of or accumulation of securities. . .which might represent a potential shift in corporate control."[10] Under Schedule 13G, investors must provide a sworn certification that the securities "were not acquired and are not held for the purpose or with the effect of changing or influencing the control of the [publicly held company] and were not acquired and are not held in connection with or as a participant in any transaction having that purpose or effect."[11] "Control" is defined by the SEC as "the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through he ownership of voting securities, by contract, or otherwise."[12]

Arguably, the focus of the SEC regulation is the interests of investors, not the consumers that the FERC is statutorily required to protect under sections 203 and 205. Thus, any good screening test for determining if further investigation into potential anticompetitive effects is warranted must be geared to the party that could be harmed. If such a test is the Commission's preferred approach, then there are other models that are better suited for the task. Take, for example, the investment-only exemption under the Hart-Scott-Rodino (HSR) Premerger Notification Act. This provision applies to investment in 10 percent or less of outstanding voting securities.[13] The HSR exemption also states that securities are held for investment purposes only if the acquirer ". . .has no

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[10] *Supra* note 2, at 14, footnote 32.

[11] 17 C.F.R. 240.12b-2 (2008).

[12] 17 C.F.R. 240 13b-1 (2008).

[13] 16 C.F.R. 802.9 (2005).

intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer."[14]

The purpose of the HSR investment-only exemption is to screen out transactions that will clearly have a *de minimis* effect on competition. As a result, the criteria for what constitutes a lack of control under the HSR exemption is different from that set forth in Schedule 13G. Schedule 13G makes no reference to the "basic business decisions" referred to in the HSR requirement and which are the key to effectuating an anticompetitive strategy that could harm consumers. Thus, the real competition question at issue in this inquiry is not whether an investor seeks (or gains) control, it is whether the investor seeks (or gains) control, participation in, or influence over competitive decision-making.

B. Using Schedule 13G Needlessly Links FERC Decision-Making to a Vague Regulatory Standard

The proposed Schedule 13G test also suffers from lack of clarity associated with what constitutes "control." This is the very question the Commission is attempting to answer in this proceeding. Unlike the HSR exemption, there is a gray area around the issue of control and the acceptable range of involvement by investors in governance activities under Schedule 13G. The Schedule 13G cases cited in the EPSA petition reinforce this notion. For example, the central question for judicial interpretation in those cases appears to revolve around the *degree* of control and influence possessed by the investor, not whether the investor had *any* control or influence.[15] In contrast, the FTC has

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[14] 16 C.F.R. 801.1(i)(1) (2005).

[15] See *General Aircraft Corp. vs. Lampert*, 556 F.2d 90, 92 (1st Cir. 1977), *Chromalloy Am. Corp. v. Sun Chem Corp*. 611 F.2d 240, 246 (8th Cir. 1979); and *Gulf & W. Indus. V. Great Atl. & Pac. Tea Co., Inc.*, 476 F.2d 687, 695-97 (2nd Cir. 1973), cited by EPSA, *supra* note 2, at 17-19.

narrowly construed the HSR exemption, determining that having a representative on the board, or nominating a director, is inconsistent with the investment purpose required under the exemption.[16] Schedule 13G apparently imposes no prohibitions that would preclude an investor from controlling, participating in, or influencing competitive decision-making.

Moreover, by asking FERC to adopt a bright-line test that would give the green light to certain section 203 transactions under a Schedule 13G safe harbor, EPSA is asking the Commission to rely almost entirely on a *commitment* by the investor not to seek control of the acquired company. As the Commission is well aware in other areas of its purview, conduct-based fixes (as opposed to structural remedies) for competitive problems are notoriously difficult to enforce, largely because a company's decision to break the rules will depend on an analysis of whether the benefits exceed the punitive costs.[17] Indeed, it is highly unlikely that monetary sanctions[18] could effectively deter the strategic competitive behavior that could net significant profits from the exercise of market power.[19]

C. Bright-Line Tests for What Constitutes Control are at Odds with Accepted Competition Policy Analysis

One need not go too far to get a sense of how competition enforcers approach the

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[16] Stephen M. Axinn, Blaine V. Fogg, Neal R. Stoll, and Bruce J. Prager, ACQUISITIONS UNDER THE HART-SCOTT-RODINO ANTITRUST IMPROVEMENTS ACT (1998), New York Law Pub Co., at 6-101.

[17] See, e.g., Federal Energy Regulatory Commission, *Revised Policy Statement on Enforcement*, 123 FERC ¶ 61,156 (2008) at 15 for a discussion of enforcement problems addressed by the Commission.

[18] *Supra* note 2, at 21-22.

[19] The exercise of market power in electricity markets can be hugely profitable. See, e.g. *Enron Power Marketing, Inc.,* 103 FERC ¶ 61,343 P 52 (2003); Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices, 99 FERC ¶ 61,272 (2002).

complex competitive questions presented by cross-ownership. And nowhere in its current approach to section 203 applications does the Commission apply a bright-line test of the type proposed by EPSA. Nor do the antitrust agencies apply bright-line tests. In fact, both the agencies and courts have tended to approach this question with an abundance of caution. For example, in *Dairy Farmers*, the Sixth Circuit held that a "lack of control or influence in a partial-ownership acquisition does not preclude a violation of Section 7."[20] In one enforcement action, the FTC found that even a minority voting interest could provide the acquirers with a swing vote that could affect the competitive behavior of one company in regard to another.[21]

Thus, while ownership confers the power to exercise control, in the words of two prominent economists, "control or ownership are never absolute."[22] Even EPSA's case examples illustrate this point. For example, in *General Aircraft Crop. V. Lampert,* the court questioned an investor's actions with regarding to control when it held an ownership interest of only 12 percent.[23] Likewise, the Second Circuit addressed the issue of investment vs. control in *Gulf & Western* when an investor owned only 19 percent of the voting securities.[24] These cases illustrate the difficulty in establishing a bright-line for what constitutes an ownership level below which competitive issues become *de minimis*. Analyzing competitive effects when an owner's potential influence over key competitive

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[20] See Laura A. Wilkinson and Jeff L. White, *Private Equity: Antitrust Concerns with Partial Acquisitions*, 21 ANTITRUST 28 (2007), at 28, quoting *United States v. Dairy Farmers of Am., Inc.*, 426 F.3d 850, 852-55 (6th Cir. 2005).

[21] *Supra* note 20, at 30.

[22] Sanford J. Grossman and Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 JOURNAL OF POLITICAL ECONOMY 691 (1986), at 694.

[23] *Supra* note 2, at 18.

[24] *Supra* note 2, at 19.

decisions is important depends on a variety of evidence and analysis that far exceeds the capability of the type of bright-line test proposed by EPSA.

IV. The Proposed Bright-Line Test Inadequately Considers Important Parts of a Competitive Analysis Involving Cross-Ownership

The bright-line test proposed by EPSA ignores the possibility that private equity investment in competing generators can result in the anticompetitive exchange of information, using the private equity firm as a conduit. Through this mechanism, for example, the commonly owned generator could gain advance access to its rivals' competitively sensitive information, including: pricing strategy, output levels, maintenance schedules, transmission service, costs, and entry and expansion plans. Such information sharing could facilitate coordination between generators, undermining competition and harming consumers.

EPSA's proposal also fails to address the concern that cross-ownership involving generating assets can change the acquired companies' unilateral incentives to compete. For example, cross-ownership can create incentives for one of the acquired companies to compete less aggressively in relevant electricity markets or where both companies presently compete, or could affect a market where one or both plan (or have the potential) to enter. The boards of both companies have a fiduciary duty to their shareholders to pursue every means to ensure profitability, including a strategy to reduce rivalry in markets where the two generators possess enough market power to affect prices and output.

For example, assume that a private equity firm has a stake in one generator in a relevant market. If that generator engages in economic or physical withholding to drive up the price, some of the lost sales from such as strategy will be captured by other, non-

affiliated generators. Now assume that the same private equity firm acquires a stake in another generator in the same relevant market. Losing sales to the commonly owned generator from a withholding strategy will then potentially increase profits for the private equity owner. This could change the profit-maximizing prices charged by the generators after the acquisition. Whether the private equity owner could take action to cause one of the generators to compete less aggressively depends on a number of factors that are not captured by a bright-line test.

V. Proposed Framework for Evaluating the Competitive Effects of Cross-Ownership Transactions

This brief overview of the complex competitive issues raised by cross-ownership illustrates the need for the Commission to carefully consider how it will approach the problem. Improperly constructed bright-line tests are unlikely to adequately address the full complement of factors that should be considered in evaluating the competitive implications of sections 203 and 205. The fact that the FERC and the antitrust agencies perform careful, reasoned merger review—as opposed to applying bright-line tests--is largely a function of the problem that once mergers and acquisitions are consummated they are difficult, if not impossible, to "unscramble." [25]

The downside of getting a merger decision wrong is significant for both competition and consumers. The AAI recognizes the need for the Commission to expeditiously process applications under sections 203 and 205 and, as noted by EPSA, to encourage needed investment in the industry. However, we note that adopting the wrong test and giving potentially anticompetitive transactions a safe harbor could chill competition and stifle entry by new generation (and even transmission) resources.

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[25] See e.g., s*upra* note 9, at 33-34 for a discussion of the Commission's reluctance to revisit merger applications.

As an alternative to the EPSA proposal, the AAI suggests that the Commission consider a test that will set the bar higher than Schedule 13G. Such an alternative could be the HSR exemption discussed earlier that limits ownership and precludes any form of control, participation, or influence over competitive decision-making. The AAI suggests that the Commission should, in addition, satisfy itself that its codes of conduct governing exchanges of competitively sensitive information between affiliated energy companies apply to the types of relationships characteristic of cross-ownership transactions. If not, then the AAI suggests that the Commission consider appropriate revisions to the regulations to prevent anticompetitive information exchanges. For transactions that do not meet this screening criteria, the AAI suggests the Commission consider the following kinds of analysis in evaluating competitive issues in cross-ownership transactions.

1. The analysis should first determine whether the generator to be acquired competes in the same relevant product and geographic markets as existing (or prospective) generators in which the private equity investor already has a stake. If so, then the inquiry should go on to evaluate market shares and market concentration, as described in the Commission's sections 203 and 205 guidelines. This analysis is routinely performed by applicants under the Commission's filing requirements. Clearly, if there are no actual or potential "overlaps" between generators and levels of market share and concentration do not warrant further analysis of a transaction's competitive effects, then the transaction may proceed.

2. If overlaps between the products sold by the commonly owned firms exist, then the Commission may wish to proceed to consider the degree to which the private equity investor will have control, participation, or other influence over decisions that affect

competitive strategy. Thus, the Commission may want to examine a number of factors, including: (1) the size of the investors equity interest, (2) the makeup of the board of directors; (3) voting rights and procedures; (4) ability of board members to influence decision-making; (5) the incentives facing other board members that could promote agreement on an anticompetitive strategy; and (6) other ways in which an investor holding a partial ownership share but without representation on the board of directors can influence competitive decision-making.

3. If the private equity investor is able, in the Commission's judgment, to exert substantial influence over competitive decision-making, then the AAI suggests the Commission designate these cases for further inquiry—either at hearing or through data requests. An acquisition that confers majority control on the private equity investor should be evaluated as a full-fledged merger under the Commission's section 203 guidelines. Those that confer minority control but for which the private equity investor is potentially able to control, participate in, or influence decision-making should be appropriately investigated.

Respectfully submitted,

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