UNITED STATES OF AMERICA BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Certification of New Interstate Natural Gas Facilities | Docket No. PL18-1-000

COMMENTS OF THE
AMERICAN ANTITRUST INSTITUTE

The Federal Energy Regulatory Commission ("FERC" or "the Commission") seeks comments on revising its approach to certifying new natural gas transportation facilities in its Notice of Inquiry (NOI) in Docket No. PL18-1-000: *Certification of New Interstate Natural Gas Facilities*.[1] The Commission's inquiry arises in the context of the agency's authority under Section 7 of the Natural Gas Act (NGA). NGA section 7(c) requires that "any person seeking to construct or operate a facility for the transportation of natural gas in interstate commerce must obtain a certificate of public convenience and necessity from the Commission."[2]

I. Interest of the American Antitrust Institute

The American Antitrust Institute (AAI) is an independent, nonprofit organization. The AAI's mission is to promote competition that protects consumers, businesses, and society.[3] We serve the public through education, research, and advocacy on the benefits of competition and the use of antitrust enforcement as a vital component of competition policy. The AAI has provided legal and economic analysis, commentary, and testimony on mergers, market design, energy policy, and competition policy involving the energy industries since the organization's founding in 1998.

The Commission's current policy statement governing certification of natural gas

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[1] *Certification of New Interstate Natural Gas Facilities*, 163 FERC ¶ 61,042 (2018).
[2] 15 U.S.C. 717f.
[3] *See* https://antitrustinstitute.org for more information.

transportation facilities is almost two decades old.[4] Natural gas now accounts for 29% of total U.S. energy consumption and the power sector consumes 36% of natural gas among major sectors.[5] Natural gas also plays a vital role as a fuel source for heating in the U.S. industrial, commercial, residential, and transportation sectors.[6] Since the Commission's natural gas pipeline certification Policy Statement (1999) was issued, there have been significant changes in the markets that are integrally related to natural gas transportation, including upstream natural gas production and downstream natural gas distribution and electricity generation.

The AAI encourages the Commission to revisit its natural gas pipeline certification policies to ensure a process that promotes competition and consumer welfare. That process, and the incentives and outcomes it generates, potentially affect every aspect of the markets that rely on natural gas as a critical input. These include the balance of supply and demand, reliability, incentives for pro-competitive or anticompetitive conduct, market entry, efficiency and innovation, and the ultimate welfare of customers and ratepayers.

The competitive implications of the Commission's certification policy are a critical element of the inquiry set forth in the NOI. The AAI therefore appreciates the opportunity to respond primarily to question A4. These comments recognize that protecting existing customers from subsidizing new pipeline projects is paramount among the Commission's policy goals. However, AAI believes that an exclusive focus on this objective can, in some cases, work against the Commission's goals of promoting competition and consumer benefits.

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[4] *Certification of New Interstate Natural Gas Pipeline Facilities*, 88 FERC ¶ 61,227 (1999), *clarified*, 90 FERC ¶ 61,128, *further clarified*, 92 FERC ¶ 61,094 (2000) (Policy Statement).
[5] U.S. Energy Information Administration, *Natural Gas Explained: Use of Natural Gas*, updated October26, 2017, https://www.eia.gov/energyexplained/index.php?page=natural_gas_use.
[6] *Id.*

II. Communications

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III. The Commission's Current Pipeline Certification Policy is Not Well Aligned With the Goal of Promoting Competition

Fostering competition remains central to the Commission's stated objectives in its 1999 natural gas pipeline certification Policy Statement.[7] The NOI reiterates this goal, highlighting the FERC's purpose "to foster competitive markets, protect captive customers, and avoid unnecessary environmental and community impacts while serving increasing demands for natural gas."[8] The NOI emphasizes that "providing competitive alternatives [in pipeline projects]" is one of several public benefits of the pipeline certification process.[9] The Commission goes further to note that its longstanding policy has been to allow companies to "compete for markets" and to "uphold the results of that competition" absent a showing of anticompetitive or unfair competition.[10]

Promoting competition is an important pre-requisite for advancing other goals associated with the Commission's certification process. As the Commission notes, these goals include: meeting demand and accessing new sources of supply, lowering prices to consumers, enhancing efficiency through interconnections that improve the interstate

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[7] *Supra* note 4.
[8] *Supra* note 1 at PP. 16. *See also* Policy Statement, 88 FERC ¶ 61,227 at 61,743.
[9] *Id.,* at PP. 31.
[10] *Id.*, at PP. 29.

pipeline network, increasing electric reliability; and advancing clean air objectives.[11] However, the Policy Statement focuses on a very different goal, namely to ensure that existing customers do not subsidize new pipeline projects. This is, in fact, the "threshold" requirement, *i.e.,* that a pipeline certificate applicant "financially support the project without "relying on subsidization from its existing customers."[12]

Minimizing the risk that existing customers will subsidize new pipeline projects is operationalized through two major requirements. One is non-controversial for the purposes of this NOI: the use of incremental (versus rolled-in pricing) for new pipeline projects to ensure that the pipeline and expansion shippers bear the risks of constructing new capacity.[13] A second is the almost exclusive reliance on demand-side factors in justifying new pipeline capacity. Evidence of "need" includes "precedent agreements, demand projections, potential cost savings to consumers, or a comparison of projected demand with the amount of capacity currently serving the market."[14] Precedent agreements are private contracts between a pipeline developer and a potential customer, including an affiliate of a pipeline company, for long-term firm service.[15] And as explained in the NOI, applicants have most often presented, and the Commission has accepted, precedent agreements with prospective customers as evidence of need.[16]

The AAI is concerned that the Commission's current policy does not align well with promoting competition and consumer welfare. The Commission's equal treatment of precedent contracts between an affiliated pipeline and customer and an unaffiliated pipeline

[11] *Id.*, at PP. 31.
[12] *Id.,* at PP. 26.
[13] *Id.*, at PP. 17. *See also, e.g.,* Transcontinental Gas Pipe Line Corp., 82 FERC ¶ 61,084 at 61,316 (1998).
[14] *Id.*, at PP. 8.
[15] Typically, precedent contracts require a customer to commit to binding, multi-year transportation agreements. Pipeline developers rely on the commitments in precedent agreements to justify the costs of construction, obtain financing, and secure regulatory approvals necessary to move forward with development.
[16] *Id.*, at PP. 35.

and customer works in opposition to the Commission's policy of promoting competition. As discussed in these comments, precedent contracts between a pipeline and an affiliated gas or electricity distributor can actually create incentives to stifle competition and harm the very consumers that the Commission's policy is designed to protect. It is therefore important for the Commission to adjust its approach to ensure that its pipeline certification policy does not facilitate anticompetitive incentives and outcomes, to the detriment of customers and ratepayers.

IV. Changes in Markets Surrounding Natural Gas Transportation Highlight the Dangers of Affiliate Precedent Contracts

The Commission states that its practice has been to not look "behind" or "beyond" precedent agreements when making a determination about the need for new projects or the needs of the individual shippers.[17] But a look behind the "curtain" reveals contracts that can pose competitive dangers and potential consumer harms. The Commission therefore appropriately asks in the NOI whether the agency should apply a different standard to precedent agreements or contracts with affiliates than with non-affiliates.[18] The AAI notes that this is particularly important issue and encourages the Commission to carefully consider the challenges posed by affiliate precedent contracts for fulfilling its important objective of promoting competition.

To better understand the competitive implications of affiliate precedent contracts, the AAI encourages the Commission to consider that the markets surrounding natural gas transportation have changed significantly over the last two decades. For example, the structure of electricity generation markets has been altered through several decades of consolidation following the Commission's transmission open access, Regional Transmission

[17] *Id.*, at PP. 52.
[18] *Id.*, at p. 48, question A4.

Organization, and market-based rate initiatives.[19] There is also more diversity in market participants. Shippers on pipelines now include natural gas producers, gas marketers, traditional electric and gas utilities, and independent or merchant power producers.

Importantly, the repeal of the Public Utility Holding Company Act (PUHCA) in 2005 removed restrictions on integration between energy companies.[20] Vertical integration, particularly between pipelines and electric or gas distribution companies, can create anticompetitive incentives to engage in conduct that restrains competition and harms consumers. These possibilities can strongly influence the incentives motivating pipeline construction and the effects of affiliate precedent contracts on competition and ratepayers.

V. Affiliate Precedent Contracts Raise Significant Concerns Over "Regulatory Evasion" or "Self-Dealing"

With increased competition in natural gas transportation and wholesale electricity markets has come the formation of energy-related subsidiaries within larger holding companies. These subsidiaries can include pipelines, merchant generators, and regulated electric and gas distributors. Competitive issues surrounding contracting between an integrated input supplier and distributor pose a core concern in antitrust and regulation. Transactions between affiliates raise the concern referred to in antitrust as "regulatory evasion."[21] The same issue in regulatory parlance is "self-dealing."

The competitive concern surrounding regulatory evasion is straightforward. Contracts between an affiliated upstream input supplier and a downstream regulated entity

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[19] *See, e.g.,* https://www.ferc.gov/industries/electric.asp for more information.

[20] *See, e.g., Repeal of the Public Utility Holding Company Act of 1935 and Enactment of the Public Utility Holding Company Act of 2005*, 18 CFR Parts 365 and 366 (Docket No. RM05-32-000), Sept. 16, 2005.

[21] *See, e.g.*, Michael H. Riordan and Steven C. Salop, *Evaluating Vertical Mergers: A Post-Chicago Approach*, 63 ANTITRUST L.J. 513 (1995). *See also* Mohammad Harunuzzaman and Kenneth Costello, *State Commission Regulation of Self-Dealing Power Transactions*, National Regulatory Research Institute *(90-06)* (January 1996), http://nrri.org/download/1996-06-state-commission-regulation-of-self-dealing-power-transactions/; *see also*, Richard P. O'Neill, *Natural Gas Pipelines*, in NETWORK ACCESS, REGULATION AND ANTITRUST (D. Moss ed., 2005).

with a common profit interest can create the incentive to inflate the costs of the input because those costs can be passed on to ratepayers of the regulated entity. Higher prices to customers of the downstream affiliate, because they typically are served by a monopoly utility and have no economic alternatives, not only harm consumers but also dampen competitive discipline in the downstream market. In most cases, public utility regulation is not equipped to detect regulatory evasion because regulators cannot or do not review and challenge input purchases, particularly if input prices are below a maximum tariffed rate.

Regulatory evasion has a robust history in antitrust enforcement. For example, in the government's 1982 antitrust case in *United States v. AT&T*, A&T allegedly used its purchases of equipment at inflated prices from its subsidiary, Western Electric, to artificially increase its costs and justify higher regulated prices.[22] In the Federal Trade Commission's (FTC's) case against *Occidental Petroleum Corp.* in 1986, the Commission's consent order required that Occidental divest the only natural gas pipeline serving a city. This remedy removed the incentive for Occidental to pay its affiliate inflated prices for gas reserves, to be passed through to captive customers.[23] In the FTC's case against *Fresenius Medical Care AG & Co.*, the Commission's concern was that the proposed transaction would give Fresenius, the largest provider of end stage renal disease dialysis services in the U.S., the ability to increase Medicare reimbursement payments for Venofer, a dialysis medication.[24]

VI. Regulatory Evasion Involving Natural Gas Pipelines is an Established Competitive Concern

Antitrust cases involving regulatory evasion are highly relevant to the Commission's inquiry regarding affiliate precedent contracts. For example, in 2005 the FTC challenged the acquisition of Koch's Gulf South Pipeline Company LP (Gulf South) by the joint venture

[22] 552 F. Supp. 131, 226-34 (D.D.C. 1982).
[23] 109 F.T.C. 167 (1986).
[24] KGaA and Daiichi Sankyo Company, Ltd No. 081-0146 (F.T.C. Sept. 15, 2008).

Entergy-Koch LP (EKLP). The FTC's complaint alleged that when merged and sharing in joint profits, Entergy and Gulf South would have the incentive and ability to pay higher prices for transportation on Gulf South, and "purchase a level of transportation service from Gulf South above what is necessary for effective operation of Entergy's utilities."[25] The FTC explained that prices in the relevant markets are "likely to rise as a result of Entergy passing on inflated costs for natural gas transportation to consumers."[26]

Moreover, the FTC explained that Entergy would have the incentive and ability to accept prices from third parties *above* prevailing market prices in order to prevent regulators from detecting that Entergy paid artificially inflated prices to EKLP. Such evasion of regulation was likely to lessen competitive discipline on prices substantially in relevant downstream electricity and gas distribution markets in Louisiana and Mississippi.[27] In such markets, Entergy affiliates were monopoly distributors and consumers had no economic alternatives to those affiliates for the purchase of electricity or gas.

Importantly, the FTC's complaint noted that it "would be difficult for state and local regulators to determine whether Entergy improperly incurred inflated costs of natural gas transportation than before the transaction."[28] The FTC further explained that the "decision regarding the purchase of natural gas transportation involves the consideration of multiple factors; the process by which Entergy purchases gas transportation is not transparent; and existing market benchmarks are inadequate to assist regulators in determining whether the

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[25] Complaint at 21, In re Entergy Corporation ad Entergy-Koch LP, Case No. C-3998 (Jan. 31, 2001). https://www.ftc.gov/sites/default/files/documents/cases/2001/01/entergycmp.pdf (Entergy-Koch Complaint). *See also* Analysis of the Complaint and Consent Order to Aid Public Comment, Entergy-Koch (Jan. 31, 2001), https://www.ftc.gov/sites/default/files/documents/cases/2001/01/entergycorpana.htm (Analysis of the Complaint and Consent).
[26] Entergy-Koch Complaint, *supra* note 25, at PP. 29.
[27] Analysis of the Complaint and Consent, *supra* note 25.
[28] *Supra* note 25, at PP. 22.

cost was prudently incurred."[29]

Harm to the competitive process and adverse effects on consumers that result from regulatory evasion violate the FERC's objective of promoting competition and protecting ratepayers. Concerns surrounding the competitive effects of self-dealing in the context of affiliate precedent contracts for pipeline certification were raised in the Commission's 1999 Policy Statement.[30] They continue to be a controversial issue in Commission cases, including, most recently, in connection with the Okeechobee Lateral pipeline project.[31] Other recent cases where concerns over self-dealing arise include, among others, FERC's 2016 decision on the Florida Southeast Connection projects (the "Sabal Trail" decision) and in Constitution Pipeline (2017).[32]

To be sure, the Commission did not find that precedent contracts with pipeline affiliates in the foregoing cases was evidence of self-dealing. The likelihood of competitive and consumer harm from self-dealing depends on a number of factors, the foremost of which is whether consumers in the downstream markets have effective alternatives to the regulated affiliate for end use purchases. This is not likely to be the case for consumers of local electricity and gas distribution utility companies. It also depends, as noted above, on regulators' ability to detect abuse, which is likely to be limited, or nonexistent. Moreover, justifications for self-dealing, such as economies of coordination between affiliated companies, should not and do not justify anticompetitive conduct and the harm it delivers to consumers.

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[29] *Id.*
[30] *Supra* note 4.
[31] *See, e.g.,* Gavin Bade, FE*RC splits again on affiliates, climate in Florida pipeline approval*, utilitydive.com, June 5, 2018, https://www.utilitydive.com/news/ferc-splits-again-on-affiliates-climate-in-florida-pipeline-approval/525006/.
[32] See Florida Southeast Connection LLC, et al., 154 FERC ¶61,080 (2016), "Order Issuing Certificates and Approving Abandonment" (Docket Nos. CP14-554-000, CP15-16-000 and CP15-17-000). Constitution Pipeline Company, LLC, and Iroquois Gas Transmission System, LP, 149 FERC ¶ 61,199 (2014), "Order Issuing Certificates and Approving Abandonment" (Docket Nos. CP13-499-000 and CP13-502-000).

VII. Accepting Affiliate Precedent Contracts as Evidence of Need Can Facilitate Regulatory Evasion

In light of the foregoing analysis, including strong evidence of previous regulatory evasion issues, the AAI suggest that the Commission reconsider its policy of accepting affiliate precedent contracts as evidence of need. Because such contracts pose particularly troubling issues, the current policy works against the Commission's objectives of promoting competition. The Commission might consider a range of options to address concerns over regulatory evasion.

1. The Commission Should Evaluate the Implications of Changes in Electricity and Gas Distribution Markets for Precedent Contracts More Generally

FERC should consider how competition in downstream electricity and gas distribution markets has changed over time and how those changes relate to precedent contracts more generally. For example, electricity markets are economically and physically linked to gas markets. Changes in the wholesale power markets for electric energy and capacity directly affect how generators enter into long-term natural gas transportation agreements. Likewise, as the NOI points out, LDCs have migrated away from contracting for pipeline capacity from the point of production to the city gate and toward purchasing supplies further downstream at market pooling areas.[33] Newer pipeline projects have therefore shifted toward moving gas to distribution points, rather than the city gate or a defined end-use market.[34]

In light of fundamental changes in markets, the AAI encourages the Commission to ask whether precedent contracts more generally create new risks or the potential for market distortions. While long-term contracts for gas transportation address risk allocation between the pipeline and the shipper, they also limit purchasers' ability to respond to market forces,

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[33] *Id.*, at PP. 22.
[34] *Id.*, at PP. 21.

to switch fuels, invest in more efficient generation capacity, and to respond to new efficiency initiatives. These possibilities, and others, directly affect the ability of market participants to compete, and could interfere with advancing the Commission's competition objectives, not only in pipeline markets, but also in electricity generation and gas distribution markets.[35]

2. The Commission Should Study the Evolution of Affiliate Precedent Contracts

The Commission should study past affiliate precedent contracts in pipeline certification proceedings. This is particularly important given consolidation in the electricity generation markets triggered by industry restructuring and repeal of PUHCA since the 1999 Policy Statement. The AAI suggests that the Commission look not only at whether the incidence of affiliate precedent contracts has increased (or decreased), but closely examine the circumstances surrounding such contracts.

For example, was an affiliate precedent contract struck in close proximity to the consummation of a merger or acquisition involving the pipeline and affiliated customer? In which cases, if at all, have customers faced viable alternatives to downstream affiliates for gas or electricity supply? In which cases was there competition at the pipeline level? Have market participants complained in antitrust or regulatory proceedings that regulatory evasion has resulted in harm to competition or consumers? These lines of inquiry, if properly structured, will provide the Commission with important information on how to modify certification policy moving forward.

3. The Commission Should Consider Special Rules for Affiliate Precedent Contracts

The Commission might consider a number of options for addressing regulatory evasion issues raised by affiliate precedent contracts. For example, the Commission could, moving forward, prohibit affiliate precedent contracts as evidence of need in pipeline

[35] *Id.*, at p. 47.

certification projects. This would effectively eliminate the risk of evasion and associated harm to competition and consumers.

If the Commission continues to consider affiliate precedent contracts as evidence of need, we suggest that policy reforms include procedures that protect competition and consumers from the dangers of regulatory evasion. For example, such procedures would ensure that if a pipeline enters into a precedent agreement with an affiliate they demonstrate, among other things, that the affiliate engaged in an open and transparent procurement process for gas supplies, including a request for proposal process that demonstrates the regulated entity considered other options for gas transportation.[36]

4. The Commission Should Ask How Changes in Policy Regarding Affiliate Precedent Contracts Will Affect Market Outcomes

Finally, the AAI encourages the Commission to consider how any policy change will affect market outcomes. For example, if the Commission considers a prohibition on affiliate contracts, then what is the likely impact of such a policy on bringing forth pipeline proposals necessary to meet market demand? One approach to answering this question may be to consider a series of "pilot projects" to test the effects of a prohibition on, or other changes to procedures involving, affiliate precedent contracts. Such projects would target areas of the U.S. where markets for pipeline transportation are robust and well developed, where there is competition for pipeline projects, and contracting and pricing for end user markets reflect more robust competitive forces.

Among other factors that would bear on possible candidate areas for pilot projects, the AAI suggests that the Commission consider any history of complaints regarding the competitive conduct involving market players. Areas where there are fewer documented

[36] *See, e.g.,* the FTC's remedy in Koch-Entergy. Agreement Containing Consent Order, Koch-Entergy, File No. 001-0172 (Jan. 31, 2001), https://www.ftc.gov/sites/default/files/documents/cases/2001/01/entergyagree.pdf.

concerns about anticompetitive conduct may be better candidates for pilot projects. To incent pipeline developers to participate in such pilot projects, the Commission might consider performance regulation in transportation rate policy to reward developers for accurately forecasting demand for gas transportation, minimizing costs, efficiently allocating risks, and innovating in pipeline development. The experience gleaned from appropriately structured and monitored pilot programs would provide important information on the possible effects of a policy change regarding affiliate precedent contracts, and would inform the Commission's pipeline certification policy more generally.

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