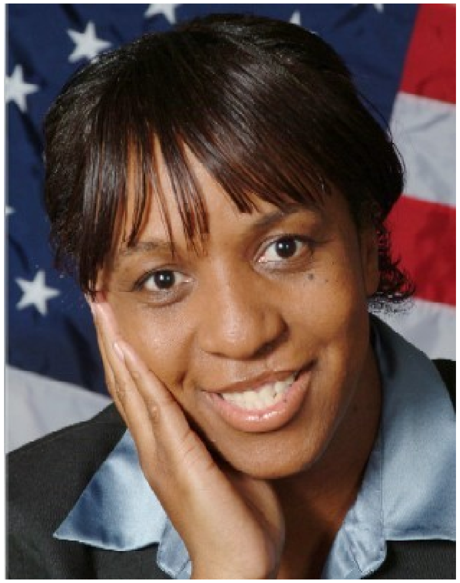

Tools for Ensuring Competition and Free Trade

Legal Incentives
Antitrust
Dominant Utilities

Administrative Law Judge
Jacqueline Miller, BA, MBA, JD
Oklahoma Corporation Commission
Oklahoma City, Oklahoma USA

August 26, 2009
New Delhi, India

Petroleum & Natural Gas Regulatory Board, India

Oklahoma Corporation Commission
EMPOWERING OKLAHOMA

Natural Gas Regulation

- Recent studies reveal basic facts about natural gas. [1]
- natural gas is a fossil fuel composed mostly of methane. It also contains other hydrocarbons (e.g., ethane and butane) and impurities. Natural gas is found in sedimentary rock formations (often alongside petroleum deposits).

[1] The Natural Gas Industry at a Glance Tutorial, Ken Costello, Principal, The National Regulatory Research Institute (NRRI), May 2009 09-06.

Natural Gas Regulation con't

- Natural gas comprises about 25 percent of the total energy consumed in the United States.

- Natural gas is used for a variety of reasons: to heat homes and water cook food, produce electricity, provide heat for industrial processes, fuel vehicles, and as a raw material to manufacture such products as fertilizer, plastics and petrochemicals.

- Over 50 percent of the homes in the U.S. use natural gas as the main heating fuel.

Natural Gas Regulation con't

- Industrial customers are the largest user of gas (consuming about 35 percent of the total), but gas consumption for electricity generation has grown most rapidly since the early 1990s.

- End users in the U.S. spend about $200 billion per year on natural gas.

- Natural gas burns more cleanly than the other fossil fuels, i.e. coal and oil. Many energy experts, including environmentalists, view natural gas as a "bridge fuel" between the present carbon-based economy and a future economy highly reliant on renewable energy and energy efficiency.

Natural Gas Regulation con't

- The production of natural gas in the U.S. occurs in different geographical locations, including the Gulf of Mexico, the Rockies and the Southwest. Texas is by far the largest natural-gas-producing state in the U.S.

- Imports of gas comprise about fifteen (15) percent of the gas consumed in the U.S. These imports originate primarily in Canada and increasingly come from countries exporting liquefied natural gas (LNG) to markets around the world.

Natural Gas Regulation con't

- Natural gas regulation has undergone significant regulatory changes over time with the passage of the Natural Gas Act of 1938 (NGA), the Natural Gas Policy Act of 1978 (NGPA), the Natural Gas Wellhead Decontrol Act of 1989 (NGWDA) and FERC Order No. 636.

Natural Gas Regulation con't

- Among other powers, the NGA gave the Federal Power Commission (FPC) (subsequently the Federal Energy Regulatory Commission) (FERC) the authority to set "just and reasonable rates" for the transmission or sale of natural gas in *interstate* commerce and has been described as the first instance of direct federal regulation of the natural gas industry. The impetus of the Act was concern about the exercise of market power by interstate pipeline companies. Although interstate pipeline companies function differently today (no longer resellers of natural gas to local distribution companies (LDCs)), market power concerns continue to exist in natural gas regulation today.

Natural Gas Regulation con't

- The NGA also contains regulatory provisions regarding LNG.
- Regulatory functions under the NGA were originally delegated to the Federal Power Commission, and subsequently transferred to the Federal Energy Regulatory Commission and to the Department of Energy in 1977, by the Department of Energy Organization Act.
- The NGA does not apply to the production, gathering or local distribution of natural gas.

Natural Gas Regulation con't

The Natural Gas Policy Act of 1978 granted the FERC authority over *intrastate* as well as *interstate* production [see title V of the NGPA]. Prior to the NGPA, the federal government only regulated the *interstate* natural gas market.

Natural Gas Regulation con't

- The NGWDA of 1989 removed all price ceilings dictated by the NGPA of 1978 by January 1, 1993. The NGWDA moved the natural gas industry toward market conditions with new contracting (demise of take-or-pay contracts) and an increase in the spot market and transportation services for natural gas. Due to the impact of regulation in lessening access to natural gas by pipelines, incentives were created to enter into long term contracts, however long term contracts coupled with take or pay provisions (non price competition) created large financial obligations for pipelines, requiring the FERC to address this issue in postderegulation.[1]

[1] Incentives led to non price competition in the form of take or pay arrangements.

Natural Gas Regulation con't

- FERC Order No. 636 became a final rule April 8, 1992. The introduction of the rule provided in pertinent part: "The Commission believes that this rule, when fully implemented, will finalize the structural changes in the Commission's regulation of the natural gas industry. This rule will therefore reflect and finally complete the evolution to competition in the natural gas industry initiated by those changes so that all natural gas suppliers, including the pipeline as merchant, will compete for gas purchasers on an equal footing. […] this promotion of competition among gas suppliers will benefit all gas consumers and the nation by "ensur[ing] an adequate and reliable supply of [clean and abundant] natural gas at the lowest reasonable price."

Natural Gas Regulation con't

Antitrust Protections and Anti-Competitive Practices

The following Acts outline the parameters of antitrust for consideration in pertinent part.

Sherman Act of 1890[1]

Section 1 of the Sherman Act is directed towards price-fixing arrangements (combinations in restraint of trade) while Section 2 concerns market dominance (monopolization).

[1] Small businesses urged the passage of this Act to combat the formation of large trusts in the 1880s. These trusts were formed by various industries including, petroleum, meat packing, sugar, lead, tobacco and gunpowder.

History and Incentives in Natural Gas Regulation con’t

1. Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding one million dollars if a corporation, or, if any other person, one hundred thousand dollars or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

Natural Gas Regulation con't

2. Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony, and on conviction thereof, shall be punished by fine not exceeding one million dollars if a corporation, or, if any other person, one hundred thousand dollars or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

Natural Gas Regulation con't

Clayton Act of 1914[1]

The Clayton Act followed the Sherman Act to more clearly define anticompetitive acts such as price discrimination, tying clauses, exclusive dealing agreements and mergers between competitors. The Clayton Act was later amended as referenced in footnote 7.

[1] Section 7 of the Clayton Act which largely dealt with mergers was amended in 1950 by the Celler-Kefauver Act of 1950. Section 2 which largely dealt with price discrimination was amended in 1936 by the Robinson-Patman Act.

Natural Gas Regulation con't

2. a. It shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any-

Natural Gas Regulation con't

person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them: Provided, That nothing therein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered.

Natural Gas Regulation con't

b. Upon proof being made, at any hearing on a complaint under this section, that there has been discrimination in price or services or facilities furnished, the burden of rebutting the prima facie case thus made by showing justification shall be upon the person charged with a violation of this section, and unless justification shall be affirmatively shown, the Commission is authorized to issue an order terminating the discrimination: Provided, however, That nothing herein contained shall prevent a seller rebutting the prima facie case thus made by showing that his lower price or the furnishing or services or facilities to any purchaser or purchasers was made in good faith to meet an equally low price of a competitor, or the services or facilities furnished by a competitor.

Natural Gas Regulation con't

c. It shall be unlawful for any person engaged in commerce, in the course of such commerce to pay or grant, or to receive or accept, anything of value as a commission, brokerage, or other compensation, or any allowance or discount in lieu thereof, except for services rendered in connection with the sale or purchase of good wares, or merchandise, either to the other party to such transaction or to an agent, representative, or other intermediary therein where such intermediary is acting in fact for or in behalf, or is subject to the direct or indirect control, of any party to such transaction other than the person by whom such compensation is so granted or paid.

Natural Gas Regulation con’t

d. It shall be unlawful for any person engaged in commerce to pay or contract for the payment of anything of value to or for the benefit of a customer of such person in the course of such commerce as compensation or in consideration for any services or facilities furnished by, or through such customer in connection with the processing, handling, sale, or offering for sale of any products or commodities, manufactured, sold, by such person, unless such payment or consideration is available on proportionally equal terms to all customers competing in the distribution of such products or commodities.

Natural Gas Regulation con't

e. It shall be unlawful for any person to discriminate in favor of one purchaser against another purchaser or purchasers of a commodity bought for resale, with or without processing, by contracting to furnish or furnishing, or by contributing to the furnishing of any services or facilities connected with the processing, handling, sale, or offering for sale of such commodity so purchased upon terms not accorded to all purchasers on proportionally equal terms.

Natural Gas Regulation con't

f. It shall be unlawful for any person engaged in commerce, in the course of such commerce, knowingly to induce or receive a discrimination in price which is prohibited by this section.

Natural Gas Regulation con't

3. It shall be unlawful for any person engaged in commerce, in the course of such commerce, to lease or make a sale or contract for sale of goods, wares, merchandise, machinery, supplies or other commodities, whether patented or unpatented, for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, or fix a price charged therefor, or discount from, or rebate upon, such price, on the condition, agreement, or understanding that the lessee or purchaser thereof shall not use or deal in the goods, wares, merchandise, machinery, supplies or other commodities of a competitor or competitors of the lessor or seller, where the effect of such lease, sale, or contract for sale or such condition, agreement, or understanding may be to substantially lessen competition or tend to create a monopoly in any line or commerce.

Natural Gas Regulation con't

7. No corporation engaged in commerce shall acquire, directly or indirectly, the whole of any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly. This section shall not apply to corporations purchasing such stock solely for investment and not using the same by voting or otherwise to bring about, or in attempting to bring about, the substantial lessening of competition.

Natural Gas Regulation con't

Nor shall anything containing in this section prevent a corporation engaged in commerce from causing the formation of subsidiary corporations for the actual carrying on of their immediate lawful business, or the natural and legitimate branches or extensions thereof, or from owning and holding all or a part of the stock of such subsidiary corporations, when the effect of such formation is not to substantially lessen competition.

Natural Gas Regulation con't

The Federal Trade Commission was created with investigatory and adjudicative powers at a time when the Antitrust Division of the Department of Justice functioned as the sole enforcement body in antitrust matters.

Natural Gas Regulation con’t

5. a. (1) Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are declared unlawful.

Natural Gas Regulation con't

(2) The Commission is empowered and directed to prevent persons, partnerships or corporations, except banks, common carriers subject to the Acts to regulate commerce, air carriers and foreign air carriers subject to the Federal Aviation Act of 1958, and persons, partnerships, or corporations insofar as they are subject to the Packers and Stockyards Act, 1921, as amended, except as provided in section 406 (b) of said Act, from using unfair methods of competition in or affecting commerce and unfair or deceptive acts or practices in or affecting commerce.

Natural Gas Regulation con't

- Antitrust cases pursuant to federal law may be brought by private actions as well as by the federal government. Remedies in antitrust cases range from damages, settlements, consent decrees, orders, divestiture of assets to injunctions. Fines or prison terms may be utilized in criminal cases brought under the Sherman Act.
- While federal antitrust laws are emphasized in this paper, states also enact antitrust statutes enforced by the respective state's Attorney General.

Natural Gas Regulation con't

Cases in Antitrust

- In *United States v. American Tobacco Co.,* 221 U.S. 106, 1979 (1911), the Supreme Court, held:
- The words restraint of trade … only embraced acts or contracts or agreements or combinations … which, either because of their *inherent nature* or *effec*t or because of the *evident purpose* of the acts, etc., injuriously restrained trade.

Natural Gas Regulation con't

- These tests were later defined as the per se rule and the rule of reason. Pursuant to the per se rule, one would only need to prove that the conduct occurred, for example, price fixing by a cartel is illegal per se. The rule of reason invokes the tests of inherent effect and evident purpose. If the per se rule does not apply, the rule of reason may be applied. The test applied for inherent effect has been market share, ie. intent to monopolize the market measured quantitatively.

Natural Gas Regulation con't

- In the IBM monopolization case, *United States v. Container Corp. of America*, 393 U.S. 333, 341 (1969), Justice Thurgood Marshall described the per se rule:

  Per se rules always contain a degree of arbitrariness. They are justified on the assumption that the gains from imposition of the rule will far outweigh the losses and that significant administrative advantages will result. In other words, the potential competitive harm plus the administrative costs of determining in what particular situations the practice may be harmful must far outweigh the benefits that may result. If the potential benefits in the aggregate are outweighed to this degree, then they are simply not worth identifying in individual cases.

Natural Gas Regulation con't

- In earlier cases, the Supreme Court had not been so clear in this area. In *United States v. Trenton Potteries Company et al.,* 273 U.S. 392, 396-398 (1927), the Supreme Court determined that the price fixing of twenty manufacturers of pottery with 82% of the market was for the purpose of elimination of one form of competition and violative of the Sherman Act. The Supreme Court, later held, however, in *Appalachian Coals, Inc. v. United States*, 288 U.S. 344, 360 (1933), that the "mere fact that the parties to an agreement eliminate competition among themselves is not enough to condemn it." This represented a reversal of the per se reasoning of Trenton Potteries. In *Appalachian Coal* 137 companies joined together to operate as an exclusive selling agent for its formed companies. The companies possessed 12% of the market in bituminous coal and 54% of the production market. The Supreme Court determined that the companies did not violate the Sherman Act.

Natural Gas Regulation con't

- In *United States vs. Socony-Vacuum Oil Co. et al.,* 310 U.S. 150, 218 (1940), the Supreme Court issued a ruling against Socony-Vacuum for violation of the Sherman Act. In Socony-Vacuum, individual refiners sold gasoline at very low prices then selected certain refiners to purchase its surplus, in order to keep prices up. The Supreme Court found Socony-Vacuum guilty under the Sherman Act stating that "price fixing agreements are unlawful per se under the Act." The Court would have entertained, however, as a defense, a showing that the activity that occurred was for the purpose of eliminating competitive abuses.

Natural Gas Regulation con't

- Market structure and strategic competition play a significant role in antitrust determinations regarding mergers. The Sherman Act only applied to mergers resulting in substantial monopoly power. The Clayton Act was passed (specifically Section 7) to cure this issue.

Natural Gas Regulation con't

- However, the Clayton Act only addressed acquisition of stock, but not acquisition of assets. The Clayton Act was amended by the Celler-Kefauver Act to address this legal loop hole.[1]

[1] That no corporation engaged in commerce shall acquire, directly, or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire whole or part of the *assets* of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.

Natural Gas Regulation con't

Dealing with Utilities in Dominant Positions

- Under a restructured utility industry, the role of the regulator is to protect the public from excessive market power in sectors that are naturally competitive. Market-power problems can arise from the mispricing of utility-affiliate transactions, cost-shifting, cross-subsidization, discriminatory regulated service from "essential facilities" mandatory tying of "essential facilities" service and unregulated service, and discriminatory release of information from a utility to an affiliated entity. [1]

[1] Briefing Note: Some Basic Concepts of Market Power for State Public Utility Commissions to Consider, Kenneth Costello, Principal, National Regulatory Research Institute, July 2009, 09-11.

Natural Gas Regulation con’t

- Benign or excessive market power are key indicators to the regulator. The regulator should evaluate whether the market power is harmful to consumers, then take appropriate action, proceeding without this factor could likely result in the erosion of incentives for future product and cost savings innovations.

Natural Gas Regulation con't

- Market power is commonly defined as the ability of a firm to profitably set a price above competitive levels for a sustained period without substantial loss of sales. The competitive price corresponds to a firm's long-run marginal costs. A firm with market power would be able to charge a price above marginal cost.[1]

[1] Id at page 3.

Natural Gas Regulation con't

- Regulators must be prepared to utilize the Herfindahl-Hirshman index (HHI) to measure market concentration and the Lerner Index to measure market performance.
- Once the relevant market is defined, the HHI is calculated as the sum of the squared market shares of each firm in a designated market. The Lerner index measures the price-marginal cost gap as the inverse of the price elasticity of demand facing a firm. Lerner Index:LI=(P-MC)/P=1/e,Where P=price MC=marginal cost E=price elasticity of demand facing a firm. [1]

[1] Id at page 4.

Petroleum & Natural Gas Regulatory Board, India

Oklahoma Corporation Commission