

Convergence Mergers: A New Competitive Settlement Model from Detroit

The consent agreement involving the merger of DTE and MCN is the first to extend the release capacity concept from interstate pipelines to the level of the local distribution company. The settlement has implications for reintroducing competition between gas and electric local distribution networks where these networks have merged in the past.

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On May 18, 2001, the Federal Trade Commission (FTC) announced a final consent agreement with the parties in the convergence merger between DTE Energy Company (Detroit Edison) and MCN Energy Group, Inc. (Michigan Consolidated Gas or MichCon). The settlement is the first to extend the release capacity concept from interstate pipelines to the level of the local distribution company (LDC). Further, this settlement has attractive implications for reintroducing competition between gas and electric local

distribution networks where these networks have merged in the past.

In order to obtain clearance from the FTC for its proposed acquisition of MichCon, DTE has agreed to create an easement within MichCon's local natural gas delivery network to preserve competition between the electric and gas distribution systems in the Detroit area. Exelon is the new entrant purchasing the easement.¹ The easement, or straw-in-the-pipe within the MichCon system, allows Exelon to compete with MichCon to pro-

vide natural gas local transportation services to present and future electric displacement customers, i.e., customers who elect to substitute on-site generation of electric power or natural gas-fueled equipment for electric power delivered by DTE from distant central generation plants.²

Small-scale electric generation equipment fueled by natural gas is a widely heralded technical development expected to expand significantly over the next few years.³ Primary examples are fuel cells and microturbines. These devices join various existing cogeneration options as technologies that may present residential, commercial, and industrial customers with practical and economical on-site generation alternatives to traditional local distribution of electric power transmitted from central power plants. Recent months have seen many articles in the electric power trade press expressing increasing confidence that distributed generation technologies are likely to find wide application in this decade. In many ways these new technologies represent a return to Edison's initial vision of dispersed local generation of electric power.⁴

From a customer perspective, electric power can be obtained in two ways. It can be obtained from the traditional electric distribution system or it can be generated on-site. For existing cogeneration technologies and for likely future small-scale generation equipment, natural gas is the fuel of choice.⁵ At present, natural gas typically is available only through

the local distribution services of a franchised LDC.⁶

I. DTE's Proposed Acquisition of MichCon

DTE is the franchised supplier of electric power distribution services in southeast Michigan, including Detroit. MichCon is the franchised supplier of natural gas distribution services in the same area. Absent the easement agree-

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ment, the acquisition would make DTE the franchised distributor of both electric power and natural gas in Detroit and surrounding areas.⁷ Although electric and gas distribution firms are already under joint ownership in many areas of the country, the DTE/MichCon acquisition takes place in a new context: substantially enhanced prospects for convergence between electric power and natural gas distribution services. The settlement may be a model for future acquisitions of this type and may provide an easier route than full divestiture for providing effective competition for electric displacement customers in

situations in which electric and natural gas distribution franchises are already under common ownership.

II. Electric/Gas Convergence and Merger Policy

The antitrust concern about acquisition of a natural gas LDC by the electric distribution supplier in the same area is that such a merger is likely to reduce competition between the two distribution systems. If the natural gas LDC is independent, it has strong incentives to expand sales and profits by encouraging electric distribution customers to switch to on-site generation of electric power using natural gas as fuel. An independent LDC is likely to offer discounts on gas distribution services and other methods of promoting the development and implementation of on-site electric power generation technologies. If the LDC is acquired by the electric distribution firm in the same area, incentives to offer discounts and other promotions for on-site generation will be diminished or eliminated. The merged firm would find that gains from increased gas sales for on-site generation would cannibalize electric distribution revenues. Hence, the merged firm would be likely to curtail promotion of on-site generation by its newly acquired LDC subsidiary. Similar competitive concerns arise with regard to other electric power displacement technologies fueled by natural gas such as gas-powered compression, cooking, and cooling equipment.⁸

Within this competition and

potential competition framework, the proposed acquisition of MichCon by DTE raised antitrust concerns that were consistent with the documents of the parties. For example, the FTC staff found that MichCon aggressively promoted gas-fueled distributed generation and co-generation equipment that would displace customer purchases of electricity distribution services from DTE. Although the simple remedy would have been to ban the transaction, the FTC staff and DTE agreed to consider alternatives that would preserve the relevant competition, but also allow DTE to realize efficiencies it believes it could gain by combining operations between the gas and electric distribution functions.

Two other ways in which the proposed merger would lessen competition were also identified by the FTC staff. First, Detroit operates a municipal utility that competes directly with DTE for new nonresidential customers in the city. This utility, the Public Lighting Department (PLD), obtains power by either buying it wholesale using Edison's transmission network or running its own generators using natural gas distributed by MichCon. The PLD has no viable option for natural gas delivery other than MichCon, and after the merger, absent the easement agreement, would have had to rely on its only direct retail electricity competitor for delivery of natural gas. Absent the easement agreement, DTE would have the ability and incentive to raise the costs of its rival, the Detroit PLD. Second, as mentioned earlier,

electricity and natural gas compete directly for certain commercial and industrial applications. These applications include air compressors, commercial cooking, and various industrial applications. Customers who choose natural gas for these applications must use the local distribution services of MichCon, and customers who choose electricity must use the local franchised distribution service, usually provided by DTE. MichCon

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aggressively sought to convert electricity customers with such applications to natural gas, typically attempting to convince them of the relative economic benefits of natural gas compared to electricity. Both price and reliability were emphasized. Absent the easement agreement, DTE would have the ability and incentive to reduce or eliminate this competition.

In searching for alternative remedies to the prospective loss of competition occasioned by the proposed merger, the FTC staff, DTE, and MichCon found common ground for discussion in the release capacity sales arrange-

ments commonly found on interstate natural gas transmission pipelines. Release capacity sales effectively create a "straw" within a pipeline that is controlled by a party independent of the pipeline owner and operator. Through release capacity sales, effective competition between natural gas transportation service providers can be developed, even if only one or a few pipelines reach a particular LDC. A number of FTC natural gas pipeline merger cases have been settled with the aid of this concept.⁹ In order both to preserve competition for electric power displacement load and to allow DTE to realize potential operating efficiencies, the parties and the FTC staff developed a proposed settlement that extends the straw-in-the-pipe concept to the MichCon LDC. This settlement agreement is incorporated into the consent order finalized by the FTC in May.

III. Elements of Agreement

The agreement involves several novel elements designed to assure a strong competitive presence in local distribution services that will offer a real choice for existing and potential retail electric power displacement customers. The core elements of the settlement are (1) a 20-year, perpetually renewable, and expandable easement contract between DTE/MichCon and Exelon, and (2) mutual agreement to retain an independent auditor to monitor and enforce compliance with terms of the easement contract. The auditor will also be

responsible for finding another buyer if Exelon elects not to renew the easement agreement at the end of the initial 20-year period or otherwise seeks to withdraw.

The easement form of the straw-in-the-pipe concept minimizes ancillary state approvals and allows the entrant not to be subject to utility obligations under Michigan law. As an inducement to attract a large and sophisticated entrant acceptable to the FTC, DTE elected to provide an initial volume of transportation capacity and associated storage capacity (5 BCF) without any restrictions on the customers served by the entrant. A second increment of capacity will be made available to Exelon, contingent upon Exelon serving electric displacement load for half of each capacity and storage increment (a total of an additional 15 BCF is available in increments of not less than 1 BCF). The purpose of the second capacity element is to insure that Exelon will have strong incentives to seek to serve EDL customers. This incentive is supplied by the substantial margin between regulated rates for many classes of MichCon's existing customers and the price Exelon bid for the capacity in the first two capacity increments. These high-margin customers can only be served by Exelon if Exelon simultaneously serves an equal volume from EDL customers. Beyond 20 BCF, Exelon's acquisition of capacity would be exclusively for on-site generation load and would not be accompanied by associated storage capacity on the MichCon system.¹⁰ In order to provide Exelon

with an ability and incentive to serve industrial customers and residential customers under this third capacity increment, Exelon has access to this additional system capacity at a lower average price if it serves general commercial and residential customers as well as other customers. Since MichCon has pricing discretion (flexible rates) in serving large industrial customers, Exelon is more likely to

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be able to compete effectively for these customers if it has access to capacity at low incremental costs, which it can obtain by also serving general commercial and residential customers with this third capacity increment.¹¹ To allow for electric displacement competition in the event that higher projections for diffusion of fuel cells and microturbines are realized, there is no cap on the third increment of capacity, but Exelon will pay more of the costs associated with any system expansions necessary to serve this load, including all associated storage costs.

In any arrangement in which effective competition may be curtailed by discrimination against the entrant, a major concern is monitoring and enforcing the agreement. The FTC staff is particularly sensitive to this concern because events in the electric power transmission business provide strong evidence that behavioral rules may be ineffective in preventing discrimination. The FTC staff has filed numerous comments to the Federal Energy Regulatory Commission (FERC) and to the states expressing this concern in the context of the electric power industry.¹² Despite these misgivings, the FTC staff and DTE were able to reach a mutually agreeable remedy that also satisfies the concerns of the entrant. Under the settlement proposal, DTE and Exelon formally agree to retain an independent auditor responsible for monitoring and enforcing compliance with the letter and intent of the easement agreement.¹³ The auditor is empowered to arbitrate disputes decisively and quickly. If necessary, the auditor can direct payments of monetary damages. To the extent possible, MichCon will pre-file maintenance schedules and other system operation plans with the auditor. As a last resort, the auditor is empowered to initiate new procedures or new rules to effectuate the agreement, although the Commission retains ultimate authority over such matters.

One of the most difficult issues in such a settlement is system expansions. What would happen if Exelon could only serve a new

electric displacement customer if MichCon expanded one or more aspects of its system? How could timely and cost-effective system expansions be assured in this situation? The agreement answers these questions differently for different increments of capacity. For the first two increments of capacity, DTE agrees to provide expeditious expansion cost and scheduling estimates. DTE also agrees to pay for all small-scale expansions and a share of larger expansions. In addition, Exelon has the option of performing the work itself and then selling the expansion back to DTE at the price DTE quoted.¹⁴ For the third increment of capacity, the uncapped, 100-percent on-site generation portion, system expansions are primarily the responsibility of Exelon, with the proviso that DTE will provide as much financial assistance for these system expansions as it provides for system expansions required to serve its regular retail customers.¹⁵

IV. Application to Mergers Outside Detroit

The antitrust/competition concerns that led the FTC staff to seek a remedy for the proposed acquisition of MichCon by DTE are unlikely to be unique. The technical developments that drive convergence between electric power and natural gas distribution are national in scope. The shifts in electric power demand toward greater reliability, triggered by computerization and growth of the Internet, are also a national trend. And, of course, California's pricing and reliability difficulties have done

much to accentuate customers' reliability and pricing concerns. Although elements that encourage on-site generation, such as time-of-day metering for electric power and high electricity prices, will likely vary considerably from place to place, overall it appears that the elements supporting competitive concerns based on convergence are strong enough to warrant at least a detailed antitrust review of pro-

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posed mergers between electric and natural gas distribution firms with overlapping franchise areas.¹⁶ Firms contemplating such acquisitions may wish to consider this new competitive Detroit model as an attractive alternative to time in the courtroom.

V. Application to Existing Joint Ownership of Gas the Electric Distribution Local Franchises

The same competitive concerns that attach to convergence mergers between electric power and natural gas distribution networks serving overlapping areas also apply to

existing joint ownership relationships, even if antitrust agencies have traditionally been reticent to revisit these long-established arrangements. The concern is that where joint ownership prevails, development and promotion of on-site generation and other forms of electric displacement load competition may be restricted compared to situations in which separate ownership prevails. To the extent that on-site generation provides greater reliability, lower costs, or less environmental degradation, local economies with slower diffusion of these technologies may find themselves at a competitive disadvantage and their consumers may have less attractive choices for obtaining electric power.

One response to this economic risk is for state and local officials to take steps to separate ownership of electric power and natural gas distribution franchises. Another alternative, potentially quicker and less dramatic, would be to encourage jointly owned franchises to implement a version of the new Detroit model. Doing so can create competition between the gas and electric distribution systems for electric displacement customers that would not otherwise arise at all or would not arise as quickly. ■

Endnotes:

1. DTE and MichCon reached an initial merger agreement on Oct. 4, 1999. Exelon won the bidding competition for the easement that was conducted by MichCon.
2. Under the easement agreement, electric displacement load (EDL) primarily

means natural gas consumption for on-site generation or for electric displacement equipment (such as gas-fueled chillers, air compressors, commercial dishwashers and fryers, but not direct-fired space heating and hot water applications). There is also a small component of general generation that can be counted as EDL under the agreement. General generation can count as EDL up to 8,750,000 kWh per year per each unit of generation equipment; provided that this generation may not exceed 8,750,000 kWh at any contiguous customer location (Exhibit D of the *Amended and Restated Easement Agreement*). Available at <http://www.ftc.gov/apa/2001/03/michcon.htm> (accessed Sept. 20, 2001).

3. See the FTC staff comment on the California Public Utility Commission's distributed generation and competition in electric distribution service proposals, California PUC Docket No. R98-12-015, March 17, 1999.

4. Ashwani K. Gupta, *Chair's Message*, American Society of Mechanical Engineers' Fuels and Combustion Technologies Division Newsletter, Spring 2001, at 1 & 2.

5. A primary advantage is that the natural gas delivery system is already in place. Other forms of fuel would likely entail higher costs (including substantial storage investments and delivery costs) and would likely involve higher environmental risks.

6. An exception may be large industrial customers who may be able practicably to obtain natural gas directly from independently owned pipelines that cross through an area.

7. The overlap area includes much of Southwest Michigan, including all or substantial portions of Macomb, Monroe, Oakland, Washtenaw, and Wayne counties. These counties include most of metropolitan Detroit.

8. For some uses, electric power and natural gas are not particularly close substitutes in some areas. The settlement acknowledges that direct space heating and hot water applications are unlikely to be demands for which electric power and

natural gas are close substitutes in the Detroit area. This distinction is less likely to hold in areas with milder winters.

9. David Balto (White and Case LLD) and James Mongoven (FTC), *Antitrust Merger Enforcement in the Natural Gas Industry*, unpublished manuscript describing recent FTC matters in the natural gas pipeline industry. Available from the authors.

10. Storage capacity is readily available in Michigan outside of the MichCon system.

11. Section 6.a of the Amended and Restated Easement Agreement, *supra* note 2.

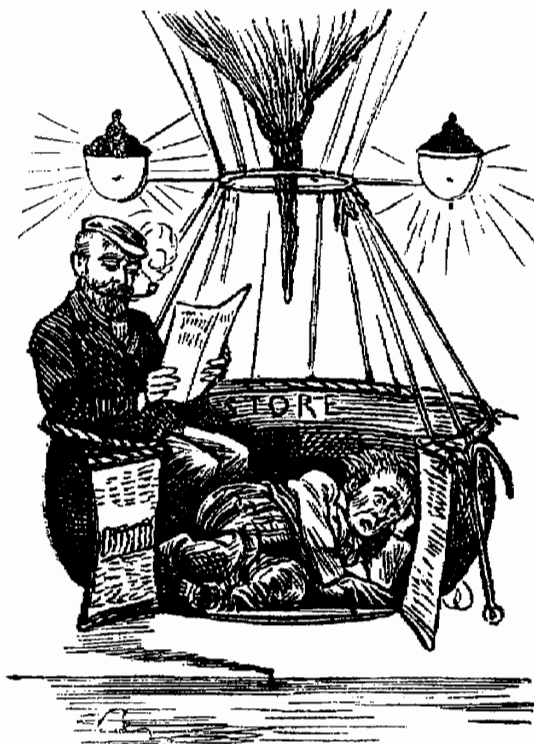
12. See, for example, Comment of the Staff of the Bureau of Economics, Regional Transmission Organizations, FERC Docket No. RM99-2-000, Aug. 16, 1999, Section I. FTC staff comments to FERC and to the states are available on the Commission's web page, www.ftc.gov/be/advofile.htm.

13. A major consulting firm has been designated as the auditor under the settlement.

14. One of Exelon's subsidiaries already does a portion of the gas distribution system expansion work in the MichCon service areas.

15. Amended and Restated Easement Agreement, Exhibit D, Section D-5.c.d., *supra* note 2.

16. Distinctions between the DTE case and a recent proposed merger of electric and gas distribution firms in Wisconsin include higher electric power rates in Michigan, greater rate flexibility in Michigan, lack of state review authority in Michigan, and a rising rival's cost element in Michigan (the Detroit Public Lighting Department). Although the unusually high natural gas prices we have seen lately, other things equal, discourage most forms of distributed generation, increasing environmental concerns, reliability concerns, and time-of-day metering options for electric power are likely to boost customer interest in distributed generation.



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