FLORIDA ASSOCIATION OF PLUMBING • HEATING • COOLING CONTRACTORS

ORIGINAL

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August 20, 1999

The Honorable Joe Garcia
Chairman, Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850

Re: Workshop on Rules 25-6.105, 25-6.1351, 25-6.0436

980643-EI

Dear Chairman Garcia,

I am writing to you as President of the Florida Plumbing, Heating and Cooling Contractors. Our national association is a member of a coalition of 10 trade associations representing 35,000 small businesses throughout the United States.

The National Alliance for Fair Competition was formed to educate decision makers about the effect deregulation of utilities could have on small businesses. Our members include: The Air Conditioning Contractors of America (**ACCA**), Air Conditioning and Refrigeration Wholesalers Association (**ARW**), the American Supply Association (**ASA**), Associated Builders and Contractors (**ABC**), the Independent Electrical Contractors (**IEC**), the Petroleum Marketers Association of America (**PMAA**), the Mechanical Contractors Association of America (**MCAA**), the National Association of Plumbing, Heating and Cooling Contractors (**NAPHCC**), the National Electrical Contractors Association (**NECA**), and the Sheet Metal and Air Conditioning Contractors National Association (**SMACNA**).

Attached is a copy of testimony given in July of 1998 to the United States House of Representatives Small Business Subcommittee on Regulatory Reform and Paperwork Reduction. It covers the full range of issues in deregulation from cost-allocation to cross-subsidization.

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Since your rules deal with cost allocation, I refer you to pages 8-10 of the testimony. Any cost allocation adopted by the Florida Public Service Commission should include the following principles:

- a fully distributed cost allocation methodology,
- asymmetric pricing for the transfer of assets,
- full costing of services, including direct and indirect costs, for services provided by the utility to the subsidiary, and
- the fair market value of services which could reasonably be marketed by the utility to be allocated as the imputed cost to the subsidiary for services received from the utility.

The deregulation of utilities is an important issue to our industry. We look forward to working with you as this concept develops in Florida.

Sincerely,

Rick Rickenbaugh

Rick Rickenbaugh

cc: FLPHCC
Richard Watson, Legislative Counsel
Hon. Tom Lee, Chairman, Senate Regulated Industries Committee
Hon. Luis Rojas, Chairman, House Utilities and Communications Committee

Attachment

Before the
United States House of Representatives
Small Business Subcommittee
on
Regulatory Reform and Paperwork Reduction

July 22, 1998

Testimony
of the

National Alliance for Fair Competition

NAFC
305 4th Street, NE
Washington, D.C.
202-547-8202

The National Allianc r Fair Competition

The National Alliance For Fair Competition (NAFC) is a coalition of ten national trade associations representing over 35,000 small businesses throughout the United States.

These organizations consist of small, private sector businesses engaged in the design, supply, rental, sale, design, installation and servicing of electrical and mechanical products, equipment, and systems, as well as providing energy fuels. These firms operate in residential, commercial and industrial markets. While a few larger firms are included within this group, the majority of business are small by any standard of measurement and many are family owned and operated. The organizations themselves are independent entities but share common goals and, in some cases, individual members.

The current members of NAFC include: The Air Conditioning Contractors of America (**ACCA**), Air Conditioning and Refrigeration Wholesalers Association (**ARW**), the American Supply Association (**ASA**), Associated Builders and Contractors (**ABC**), the Independent Electrical Contractors (**IEC**), the Petroleum Marketers Association of America (**PMAA**), the Mechanical Contractors Association of America (**MCAA**), the National Association of Plumbing, Heating and Cooling Contractors (**NAPHCC**), the National Electrical Contractors Association (**NECA**), and the Sheet Metal and Air Conditioning Contractors National Association (**SMACNA**).

INTRODUCTION

The diversification of utilities into areas outside of their publicly regulated role as producers and suppliers of energy has occasioned significant and continuing harm to small, private sector firms engaged in the energy service fields. Utilities (typically through unregulated affiliates or subsidiaries) now routinely sell appliances, provide plumbing, heating, and cooling equipment and service contracts, engage in insulation work and sales of storm windows and doors, provide outdoor lighting and interior lighting fixtures. With the advent of deregulation, not only have such activities substantially accelerated, utilities have also begun to enter into security and alarm monitoring markets, telecommunications, and related energy markets such as energy management and energy monitoring. This competition engenders considerable friction between small private sector firms which have traditionally supplied such services and the utilities, which can call on the considerable marketing advantages associated with monopoly power. Further, and most importantly, utilities are unfairly subsidizing their market entry from their utility rate base. There is also considerable potential for small businesses to be denied access to newly emerging markets which are the key to future expansion, job growth, and profitability as deregulation progresses.

The Small Business Administration documented the problems encountered by small businesses from unfair utility competition in two published studies.[1] The SBA concluded that existing legal and regulatory frameworks are inadequate to protect small firms engaged in competition with utilities.

> "... utility supply and installation programs cannot be effectively regulated to eliminate improper subsidies and other competition problems. Such unregulated activity by the utility does not provide significant public benefits which outweigh the hazard to competition and the cost or regulatory oversight."

To some extent, utilities have always engaged in some sales and service activities that parallel those of private sector firms, especially in the sales and installation areas. However, it wasn't until the 1970's that this form of competition greatly expanded. In that decade, Congress passed the National Energy Conservation and Policy Act and the Energy Security Act which federally mandated utilities to provide low cost, or no cost, energy audits. Residential customers were serviced under the provisions of the Residential Conservation Service (RCS) program while commercial establishments were covered under the Commercial and Apartment Conservation Service (CACS) program. The costs of the RCS and CACS audits above $15 were to be subsidized by ratepayers. At that level, virtually no private sector firm could compete with utilities that could recoup their expenses through a ratebase. Small businesses were effectively crowded out of the energy audit business that they had developed.

The collapse of the energy audit market for small businesses provides an telling example of the deleterious effects of well-intentioned but uninformed legislative policy. The Sheet Metal and Air Conditioning Contractors National Association (SMACNA) has documented an irreversible pattern of layoffs and dismissals of employees in that industry who were engaged as energy auditors. Entire divisions of firms were terminated due to the loss of this business. One of the saddest examples occurred in Iowa. There, the state chapter of SMACNA entered into a joint

[1] See: Utility Competition with Small Businesses: Recommendations for States on Utility Energy-Related Programs and the Commercial and Apartment Conservation Service Program, 1984; and, Final Report: Utility Competition with Small Business, June 10, 1986, prepared for the Office of Advocacy, SBA.

arrangement with an agency of the State to train junior college graduates as energy auditors. Funding was provided through SMACNA and state training grants. Hundreds of workers, many of whom were previously unemployed, were trained. However, this laudable program had to be terminated in the face of market losses occasioned by competition from utilities -- competition mandated by legislative policy, praiseworthy in intent and beneficial in aim, but unmindful of the harmful consequences it spawned: loss of a market, loss of jobs, and, for those trained under programs like that in Iowa, loss of the hope of jobs. It is also worth noting that while, in the Iowa case, the true costs of the audits offered by utilities exceeded $300 (compared to private sector rates in the $75-$125 range), the utilities were able to charge customers a price which was less than the utility's and the market price due to cross-subsidization.

Most troubling to NAFC and its members, are certain aspects of deregulation that remove even the current level of legal remedies available to aggrieved small businesses and that can result in an unwarranted interference in the free market while adding to the existing monopolistic advantages utilities enjoy when competing against small businesses.

"UNFAIR" COMPETITION

The primary obstacle to free, fair and open competition in existing markets, as well as emerging ones, is the ability of the utility to leverage its entry into, and penetration of, traditional private sector markets (typically through its non-utility subsidiaries or affiliates) by means unavailable to business entities that do not enjoy a status as a state-sanctioned monopoly.

It must be emphasized that the "unfairness" of such competition does not arise due to the utility's (or its subsidiary's or affiliate's) size, or due to any inherent advantage associated with corporate management, or with expertise in the field or relevant markets. Rather, the "unfairness" arises from the fact that the state has conferred upon a particular business entity, the utility, to the exclusion of all others, a monopoly franchise complete with a captive customer base in the tens, if not hundreds, of thousands of customer sites. This exclusive monopoly franchise provides a mechanism by which costs can be dispersed over this rate base and imparts an enormous reservoir of name recognition to the utility and its affiliates due to monopoly status. This franchise also imparts an ability and a legal right to gather customer site information regarding energy use (and future energy marketing leads) including a complete profile of each customer with respect to billing and credit history.

None of these advantages is available to a private sector competitor, large or small.

The persistence of monopolies in energy distribution after deregulation.

It must be emphasized that even after current deregulation and restructuring proposals are implemented, utilities will still enjoy a monopoly at the distribution level. Current deregulation proposals focusing on "customer choice" mainly impact the generation and commodity supply functions of a utility but do not significantly change transmission or distribution functions. Inasmuch as unfair competition problems faced by small business, private sector competitors occur mainly at the distribution stage, these problems will continue to exist and, in the face of poorly crafted legislation, become even worse.

A current example of deregulation inimical to the viability of small businesses can be found in the Securities and Exchange Commission (SEC) decision regarding Rule 58 promulgated under its authority conferred in the Public Utility Holding Company Act of 1935 (PUHCA) [2]. Under Rule 58, multi-state registered utility holding companies may now invest in ten new categories of non-utility operations without prior SEC approval and without providing prior notice and opportunity for public comment. Among the ten specified deregulated activities are:

- Energy and demand side management services
- Appliance sales
- Thermal energy products
- Sales and expertise
- Electrotechnologies

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2 Vol 62, No 34 FR 7900, Feb. 20, 1997; 17 CFR Parts 250, 259; SEC Release No. 35-26657; File no.S7-12-95.

These are areas in which private sector businesses are already engaged and for which the potential for domination by utility affiliates or subsidiaries is now significantly expanded.

Cross-subsidization

Of all the abuses which can accompany deregulation, the potential for cross-subsidization is the most substantial and significant. Cross-subsidization, usually impermissible but difficult to uncover and regulate, can occur where the utility's cost of entering and dominating a non-utility market is financed by reliance on the utility's rate base. In such situations, utility subsidiaries or affiliates can offer products and service contracts at below cost thereby driving out established private sector competitors, especially small business competitors.

Existing legal remedies for such subsidized competition are not particularly helpful to competitors seeking to prevent such harm or to obtain compensation for it. Unfortunately, antitrust laws may not be applicable to such situations.

The electric power industry is in the process of transition from a predominantly monopolistic, regulated environment to one characterized by increased competition and decreased regulation. Portions of the industry, e.g., distribution and transmission, will continue to be regulated while generation and other aspects will be unbundled and enter the competitive marketplace. The climate of deregulation, if not its actual occurrence, has prompted utilities to form unregulated affiliates and subsidiaries seeking to capture markets which have not traditionally been served by utilities and which lie, generally, outside the cope of their core functions. Once utilities are required to compete for customers in their commodity business (the generated power) they will need to fend off challenges from lower priced suppliers of electricity. Individual utilities with fixed costs higher than those of a competitor will need some means to prevent erosion of their customer base. Increasingly, utilities have settled on entry into the energy services and related markets as a means of holding on to customers. Thus, utilities now seek to dominate the residential appliance sales and services markets, the HVAC and air conditioning markets for residences and commercial sites, the security and fire alarm markets for such sites, as well as others noted earlier.

This increased dichotomy between regulated and unregulated operations of utilities and their affiliates has created a need for state regulators to examine and reassess the efficacy of existing rules and to devise more appropriate remedies and controls to meet the present circumstances.

The inherent danger of cross-subsidization in mixed regulated and competitive markets has been frequently noted. Professor Alfred Kahn has observed:

> "As long as the regulated prices continue to be set, directly or indirectly, on the basis of total company costs and revenues, or on the basis of some continuing process of allocation of costs between regulated and unregulated operations, there will always be the danger, in principle, of subsidization of the latter by the former."[3]

A further mixed environment of regulatory and competitive operations at the retail level exists between distribution utilities and their unregulated affiliates which may offer energy marketing and related customer energy services (e.g., electrical contracting, HVAC sales and service, appliance repair, engineering and design for electrical, mechanical, and air systems, etc.). While the creation of a separate, non-utility affiliate provides a distinct entity, it does not necessarily imply that the separate affiliate is using personnel, facilities, equipment, and information which are distinct and separate from those of the regulated utility. It is precisely this arrangement of shared assets and employees which utilities now seek and which will lead to unfair advantages and which are unavailable to other private sector competitors.

Private sector businesses small and large welcome competition, as a rule. The deregulation of the utility industry in this country may be accorded a similar response if it is accompanied by steps designed to ensure that resulting competition is in fact free, fair, and open. Absent this, deregulation will be imperfect, unbalanced, and generally unfair, discriminatory and, ultimately, anti-competitive.

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3. A. Kahn, The Economics of Regulation, xxxvi, (Paper ed. 1988). Professor Kahn previously served as Chairman of the New York Public Service Commission.

One of the most pernicious forms of cross-subsidization which occurs is that of misallocation of costs between the regulated and unregulated entities, or cost-shifting. [4] It is rare that a naked subsidy from the regulated entity to the affiliated entity would be found absent some cost justification for the transfer. Because regulated entities receive a return based on their costs, there is a well recognized tendency for such entities to over-purchase and hold assets which can be used for both regulated and unregulated operations. [5] Since the regulation of the regulated entity (e.g., the local utility) is tied to reported costs, increasing, or shifting, such costs to the regulated market operations need not negatively impact the utility. If the shifted costs are capital expenditures, the regulated entity gets an added revenue increase since the rate of return regulation is tied to capital investment.[6]

The problems associated with such cost shifting create a significant detriment for electricity consumers since such action makes for higher electricity prices. Further, detection of the occurrence of such shifting is exceedingly difficult. The establishment of agreed upon and enforceable rules governing cost allocation is a necessary prerequisite to the adequate protection of ratepayers. However, the establishment of cost allocation rules invariably include a judgmental and subjective element. For example, those costs which should be allocated must first be identified and then a suitable allocator must be selected. Those areas where the utility directly or indirectly provides resources must be identified At each step of the process, subjective decisions must be made.

> So far as I can see, there is no possible method that will not be essentially pragmatic, indeed arbitrary. Some states are attempting to throughly separate the accounts of the two operations. .... it is not likely to suffice, not merely because it will inevitably involve all sorts of arbitrary allocations .... but because, so long as the two sets of services continue to be provided for largely from common facilities, regulators will never be able to get out of the business of making those arbitrary allocations on a continuing basis the very process that makes partial deregulation so unsatisfactory. [7]

This view was recently echoed in California in the adoption of Standards of Conduct Governing Relationships Between Utilities and Their Affiliates. There, the California Commission stated:

> We have faced the issue of enacting appropriate affiliate transaction rules before ... we largely relied upon the corporate separation of the regulated and unregulated entities and some cost accounting measures to protect against anticompetitive behavior within the new markets. With the advent of a new marketplace characterized by increasing competition, we wish to ensure that the utilities market power does not discourage competition and does not foreclose the entrance of, or disadvantage, electric service providers or other businesses that are unaffiliated with the utilities. Rules focusing primarily on corporate separation and cost accounting may not be adequate to overcome the incumbents advantage. (Emphasis added.) [8]

The Department of Energy issued a report in 1993 which noted some of the problems associated with cross-subsidization and small business competitors. [9]

> A regulated firms advantage in unregulated markets might arise, not from economies of scale or scope, but from evading regulation. By evading regulation, utilities could compete with independent firms by cross-subsidizing their unregulated service. Two means of evading regulation (and disadvantaging ratepayers) are self-dealing and cost shifting. A utility could use

4 Some commentators view cross-subsidization and cost shifting as distinct. However, in a regulated environment, the two are so closely linked that, for the purposes of this submission, cost shifting will be considered as a form of cross-subsidization.

5 This has been termed the A-J effect. See, Behavior of the Firm Under Regulatory Constraint, Averch & Johnson, 1962 and, generally, A. Kahn, The Economics of Regulation, supra, at pp 49 - 59.

6 See J. Abel, ,An Economic Analysis of Marketing Affiliates in a Deregulated Electric Power Industry, National Regulatory Research Institute, February 1998, pp 18 - 19.

7 A. Kahn, supra

8 Opinion Adopting Standards of Conduct Governing Relationships Between Utilities and Their Affiliates, CPUC Decision 97-12-088, 12/16/97

9 Report To The President and Congress of the United States On the Current Status and Likely Impacts of Integrated Resource Planning, U.S. Dept. of Energy (1995). To be precise, the Report is a DOE study in which the FTC provided certain information in response to the framework devised by DOE. This framework did not include a broad investigation into the general issue of utility competition with small business.

self-dealing and cost shifting strategies if:

1) its rates are based on costs, and

2) its expenditures cannot be monitored adequately." [10]

The Report then concludes that "eliminating unfair competition may require preventing cost shifting and self-dealing. One way to reduce both of these problems is to eliminate the link between reported costs and allowable rates." [11]

This conclusion is echoed by former New York Public Service Commission Chairman, Prof. Alfred Kahn:

> "The only way of reconciling full deregulation of competitive markets with continued protection of captive customers is to find ways of breaking the link between prices to the monopoly customers and the revenues and costs ascribed to the competitive operations."[12]

State Commission Decisions

Further support on this point comes from the conclusions contained in a study done for the National Association of Regulatory Utility Commissioners through its research arm, the National Regulatory Research Institute (NRRI). After proving that prices below true marginal cost of the unregulated affiliate operating in the competitive market are feasible and that cross-subsidization resulting from cost shifting can exist as a profit-maximizing solution in the unregulated competitive market, the Report concludes:

> "Thus, based on the above analysis, regulators concerned abut cross-subsidization in a mixed market environment have sufficient reason to do so when a positive possibility of cost shifting exists. This is because cross-subsidization from the regulated market to the unregulated market is consistent with parent company profit-maximization under a regulatory constraint that allows the utility to recover the shifted costs from its consumers. Because this result implies no intent to drive rivals out of the market, no inference can be made that predatory pricing drives this behavior Instead it is caused by the regulation itself, which under traditional practices provides utilities the incentive and generally the ability to engage in cost shifting. This result brings into question the effectiveness of traditional rate of return regulation as a regulatory constraint in a mixed market environment." [13]

Following the advice of Prof. Kahn to break the link between prices to the monopoly customers and the revenues and costs ascribed to the competitive operations, and mindful of the observations contained in the NRRI Report, the State of California has acted to severely restrict dealings between a utility and its unregulated affiliates. Noting that it is in the public interest to establish rules which ensure utility affiliates do not gain unfair advantage over other market players, and to ensure utility ratepayers are not somehow subsidizing unregulated activities, the California Public Service Commission (CPUC) adopted prohibitions on the shared or joint use of utility assets such as equipment, facilities and employees.

> "The fewer the transactions between the utility and its affiliate, the greater confidence we have that the affiliate lacks market power. In an ideal world, the utility would treat the affiliate as it would other, nonaffiliated firms." [14]

This succinctly states the position of NAFC and other small business competitors of utilities and their affiliates. Furthermore, the CPUC specifically rejected utility arguments concerning the benefits ratepayers and

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10 Id.

11 Id at 67

12 A. Kahn, supra, note 3.

13 J. Abel, An Economic Analysis of Marketing Affiliates in a Deregulated Electric Power Industry, supra at pp 27 -31.

14 Supra note 7, CPUC Decisions 97-12-088, December 16, 1997

consumers might enjoy from sharing resources between a utility and its affiliate; arguments which have been raised in this forum to justify utility/affiliate transactions on the basis of economies of scope and scale.

California

The California Energy Commission (CEC) submitted comments in connection with the adoption of the separation standards in that state. The CEC advised the CPUC to consider the inevitable tension between allowing the benefits of economies of scope which result from affiliation and the benefits of market competition and observed that electric utility restructuring was undertaken on the assumption that the benefits of market competition would outweigh the foregone benefits of scale and scope that were inherent in regulated utilities. The CEC concluded that limitations on utility and affiliate transactions were necessary to create a level playing field which would produce greater market efficiencies. The CPUC agreed.

> "We agree with the CEC. ... it is not clear that the near-term savings that result, for example, from joint utility and affiliate procurement, would actually translate into lower prices for consumers or ratepayers. ... A firm which has a singular competitive advantage, for whatever reason, may retain extraordinary profits for some period rather than pass them through in the form of lower prices. Or, if an affiliate's costs are lower than other market participants or potential entrants, it could use this cost difference to undercut bids to drive out incumbents or to prevent other potential competitors' entry. ... The consumer interests we seek to protect go hand in hand with promoting competition. For example, we wish to prevent cross-subsidization, so that a utility's customers will not subsidize the affiliate's operation. This is especially important in our transition to a competitive market, since such leveraging, together with a utility's market power could inefficiently skew the market to the detriment of other potential entrants." [15]

It should also be noted that the CPUC rules which were adopted apply to utility/affiliate transactions involving the provision of a product or service which relate to the use of the energy commodity supplied by the utility (gas, electricity or, in the case of a combined energy utility, both) and specificaly included the types of services typically provided by electrical, HVAC, mechanical, and other contractors. [16]

Thus, the California rules require that:

- a utility and its affiliate shall be separate corporate entities
- a utility and its affiliate shall keep separate books and records
- a utility shall not share space, equipment, services and systems with its affiliates
- a utility shall not allow its affiliates to access its computer or information systems (with limited exceptions related to corporate support functions) [17]

With respect to employees, the California rules seek to place strict limits on the ability of utilities to provide employees for the performance of work on behalf of the affiliate. This is in keeping with the CPUC's stated objective of separating, rather than allocating costs for, utility/affiliate operations.

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15 Id

16 Id.

17 Id, Appendix A, Affiliate Transaction Rules, Section V. A, B, C.

Other States

The normal avenue of redress for cross-subsidization is through the state regulatory commission. However, even where state commissions have found cross-subsidization to exist, their only remedy is to deny the utility all or part of its requested rate. The private sector business owner is left without any compensation for damages or lost market share since this is beyond the power of the state regulatory authority. Numerous examples of the impact of cross-subsidization are available. Among some of the more notable:

- The Washington Utilities and Transportation Commission, after reviewing the appliance operations of Washington Natural Gas Company, not only denied its requested rate increase but required the utility to effect a reduction in rates of approximately $16.9 million due to its subsidization of non-utility operation in the appliance merchandising area. [18]

- A Michigan court found that it was "... undisputed that [Consumers Power Company]... share of prepaid service contracts was very large (over 90%)". The court held that the utility violated certain state consumer protection laws but did not uphold the antitrust claim due to plaintiff's failure to properly define the relevant market.[19]

- The Minnesota Public Utilities Commission issued an order in 1995 requiring Minnegasco to stop subsidizing its appliance sales and service program due to proven cross-subsidization estimated as high as $6 million. Evidence in that case indicated that the utility controlled over 40% of the appliance service market prior to the entry of judgement. [20]

- The Maryland Public Service Commission investigated the appliance sales and services operations of Baltimore Gas and Electric and uncovered a subsidy over $500,000.[21]

Again, while these examples indicate that such activity can be uncovered eventually and addressed at the state regulatory level, the sanctions imposed do not compensate the affected businesses for damages, lost customers or lost markets. Rather the sanctions are designed to prevent ratepayers from incurring higher utility bills than would otherwise be the case. For the small business driven out of the market, the prospect of a lower monthly utility bill is no redress for the loss of business.

Cost Allocation

Many states have begun to address the challenge of assuring fair competition in competitve energy commodity and energy service markets. Among the actions taken is that of establishing proper cost allocation rules to assist in preventing cross-subsidization.

One state which recently established rules regarding the non-regulated activities of gas and electric services is Colorado. Although Colorado has not yet deregulated or restructured its utility industry, it has adopted cost allocation rules which require transfers involving services from a utility to a non-regulated affiliate to be priced at the higher of fully distributed costs (FDC) or the market price. In setting this formula, the Commission specifically rejected arguments offered by utilities that using market price would amount to a subsidy flowing from the affiliate to the utility and would be tantamount to confiscation of non-regulated business funds.

The Colorado rules provide, with respect to transfers from the utility to an unregulated division, subsidiary, or affiliate, that:

- if the transaction involves a service provided by tariff, the terms of the transaction shall be, for the purpose of FDC analysis, the tariffed rate.

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18 WUTC v. Washington Natural Gas Company, Docket No. UG-920840, Fourth Supplemental Order, Sept. 27, 1993

19 *Day and Night Heating & Cooling Company, et al v Consumers Power Company*, Michigan Court for the County of Ingram, 3-9-95, File no. 88-62001-CP)

20 Re: Competitive Impact of Appliance Sales and Service Practices of Minnesota Gas and Electric Utilities, 126 PUR 4th 207, 1991 (Aug. 28, 1991).

21 Ernst & Young audit required by the Maryland Public Service Commission for Case #8577.

- if the transaction involves a service that is not provided pursuant to a tariff, the terms of the transaction for purposes of an FDC study shall be the higher of the utility's fully distributed cost or market rate. The market rate shall be either (a) the rate charged by the utility if the utility sells a significant quantity of the service to unaffiliated persons, or (b) if the condition cannot be met in (a) the lowest rate charged by other persons in the market for a comparable service.

- if the transaction involves an asset, the terms of the transaction for the purposes of an FDC study shall be the higher of net-book cost or market rate. [22]

In addition to establishing cost allocation rules, the Colorado Commission also required each utility to file for Commission approval for its own cost allocation manual. The Commission then went on to establish required contents for such cost allocation manuals.

Other states have acted similarly. In Minnesota, the Public Utilities Commission directed electric and natural gas utilities to file cost separation methods and data for regulated and unregulated operations[23]. The Commission's investigation in that case followed complaints that Minnegasco offered preferential utility hook-ups for customers who also purchased and appliance from the utility.

In a subsequent docket, the PUC found that the utility did not have adequate cost allocation procedures to properly identify the costs associated with unregulated non-utility operations with precision, failed to deal equitably fixed utility costs, and did not reflect a unified approach to cost allocation. Thus, the Commission required the adoption of the Federal Communications Commission's cost allocation formula. The PUC noted that the FCC's separation formula provided a just and reasonable cost allocation procedure for Minnegasco

> "Most important, they [the FCC's cost separation principles] do not allocate unregulated costs on the basis on incremental cost, i.e., costs over and above those necessary to operate the regulated utility. They ensure that regulated and unregulated operations share equally in any cost savings realized due to joint operations." [24]

In an action arising in Michigan, that state's Public Service Commission held that Consumers Power was using its fleet of vehicles and its service employees to conduct non-utility operations (the repair of furnaces and water heaters as part of the utility's heating security plan) and such activities were an improper subsidy since the revenues generated by the program were insufficient to cover costs under a fully allocated cost methodology.[25] The Commission held that a cross-subsidy could occur even if the utility started a non-utility operation after the last rate case, so that the costs of the new program are not included in current rates.

The imposition of cost allocation rules or procedures to address cross-subsidization has been used by

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22 Attachment A, Decision No. C97-1068, October 15, 1998. Colorado Rules, 4 CCR 723-47; Docket No. 96R-096EG, at pp 6-7

23 Re: Competitive Impact of Appliance Sales and Service Practices of Minnesota Gas and Electric Utilities, 126 PUR 4th 207, 1991 (Aug. 28, 1991).]

24 Re: Minnegasco, Docket No. G-008/C-91-942, p7 (Nov. 10, 1992)]

25 Michigan Coalition Against Unfair Utility Practices v. Consumers Power, PUR Slip Copy, Michigan PSC 1990.

several other state utility regulatory authorities. In Maryland, that state's Public Service Commission required Baltimore Gas and Electric to adopt cost allocation principles and prepare a new cost allocation manual to remedy subsidies in its gas appliance programs.[26]

Among the principles to be adopted were:

- a fully distributed cost allocation methodology,
- asymmetric pricing for the transfer of assets,
- full costing of services, including direct and indirect costs, for services provided by the utility to the subsidiary, and
- the fair market value of services which could reasonably be marketed by the utility to be allocated as the imputed cost to the subsidiary for services received from the utility.

26 Re: Small Business Coalition for Fair Utility Practices vs. Baltimore Gas and Electric, Order No. 72107, Case No. 8577, MPSC 1995]

In addition, the Maryland PSC ruled in another case that cross-subsidization concerns be addressed through operational and managerial separation of regulated utility and unregulated affiliates. In *Re: BNG, Inc.*[27] the Maryland Commission required that Baltimore Gas & Electric Company structure its relationship with its wholly-owned subsidiary, BNG, Inc., in such a way as to assure that BNG's activities as an unregulated gas broker were financially separated from regulated operations. The PSC ordered the operational and managerial employees to be clearly identified and separated from the regulated operational staff in order to avoid cross-subsidization and to assure fairness in the competitive market.

In the State of Washington, the Washington Utilities and Transportation Commission imposed a cost allocation methodology on a utility in that state to remedy an on-going problem of cross-subsidization of the utility's unregulated appliance servicing business. Arising in the context of a rate case, the utility was not only denied its requested rate but was required to implement a rate decrease of $17 million more than half of which was associated with its unregulated appliance services.[28]

Other states in which cost allocation rules have been adopted include Connecticut *[Re: Participative Architecture Issues*, 171 PUR 4th 347, 1996]; Indiana [*Re: Northern Indiana Fuel and Light Company, Inc.*, 171 PUR 4th 530, 1990]; Kansas [*Re: Western Resources, Inc.* 171 PUR 4th 386, April 13, 1996]; Massachusetts [*Essex County Gas Company*, 88 PUR 4th 167, 1987] (a rate case setting in which cost allocation procedures applicable to the utility's unregulated appliance rental business were addressed.); North Carolina [*Re: Duke Power Company*, PUR Slip Copy, April 22, 1997.]; Oregon [see *GTE Northwest Incorporated*, Order No. 96-257, October 4, 1996]; and Washington [see *Washington Utilities and Transportation Commission v. US Ecology, Inc.*, 165 PUR 4th 384, 1995.]

In addition to state actions, the Federal Energy Regulatory Commission (FERC) and the Federal Communications Commission (FCC) have adopted transfer pricing provisions to cover the transfer of assets between utilities and their unregulated affiliates and subsidiaries. For example, FERC requires that sales by a public utility to any affiliate be at the higher of cost or market value while sales or transfers from affiliates back to their utilities be not higher than market price. Similarly, the FCC requires that for the sale of services or assets by the utility to its non-utility affiliate, the proceeds should be recorded at the higher of cost of estimated fair-market value while for services and assets transferee from the unregulated affiliate to the utility, costs should be recorded at the lower of fair market value or cost

Asset Transfers

Increasingly, utilities are resorting to means of conferring a competitive advantage upon their non-regulated subsidiary or affiliate which is not normally recognized by state regulators as falling under the traditional definition of cross-subsidization. This more modern subsidy is the transfer of intangible assets (or even some tangible assets) at very little or no cost to the non-utility subsidiary or affiliate. Typically, this would be in the form of marketing data either in the aggregate or with reference to specific customer sites.

Once again, because of its nature as a utility, the local energy provider is in a position to acquire specific information regarding a customers energy usage. This can include more than just total or average consumption, but also the type of equipment being used, its load profile, the customers frequency and type of repairs, equipment age and model, customer credit and billing history. Such information is possessed by the utility by virtue of its monopoly status and can be easily transferred to its non-utility affiliate or subsidiary for use in providing a significant competitive advantage against private sector competitors which are unable to obtain such information no matter what the cost.

The advent of fiber optic cable and advanced energy monitoring capability now make it possible for utilities to know in advance of even the customer when residential or commercial equipment may fail. Such information may

[27] 87 MD PSC 43, 172 PUR 4th 347, 1996

[28] WUTC v. Washington Natural Gas Company, Docket No. UG-920840, Fourth Supplemental Order, Sept. 27, 1993]

be turned over to the utility's service affiliate without any opportunity for private sector competitors to service even existing accounts. It is no surprise that investor owned utilities have invested billions of dollars into telecommunications in order to capture this market.

Name and Trademark

Another asset of substantial value which is conferred upon non-regulated affiliates and subsidiaries is the ability to trade upon the utility's goodwill (name and logo). Having been conferred a monopoly franchise for decades during which their existing captive customer base became acquainted with a utility's name and trade marks, utilities now routinely provide their non-utility subsidiaries and affiliates with all the good will previously acquired. Although, the owners of the utility have a right to permit usage of their identifying marks to those they deem fit, they should not be permitted to do so without recovering the fair market value of such an asset since failure to do so represents a subsidy from the utility side of operations to the non-utility side.
While ratepayers may not be entitled to ownership rights in the asset, they have a beneficial interest in it and have certainly contributed to its value. Failure to compensate them not only unduly drives up rates by foregoing revenues which could otherwise accrue to the utility but also conveys a substantial unfair competitive advantage over private sector competitors.

Self-dealing

Closely related to the problem of asset transfers is utility self-dealing or discriminatory treatment of competitors. In such circumstances, information possessed by a utility by virtue of its being a utility is made available exclusively or on more favorable terms to a utility's affiliate or subsidiary than to competitors. Such information may be customer lists, or customer referrals obtained by virtue of the utility's relationship to customers. As an example, customers calling to report power outages or to obtain access to electric or gas connections may be steered to an affiliated or subsidiary operation for equipment purchases or repair services available from competing merchants. Once again, it is the monopoly enjoyed in one market which provides the means to penetrate other non-utility markets.

Discriminatory self-dealing and informational advantages are recognized as problems not only from the standpoint of inhibiting competition but also as giving rise to added possibilities for cross-subsidization and cost shifting. The link between an unregulated affiliate or subsidiary and its utility creates the potential for purchases at inflated prices and sweetheart deals discourage new market entrants as well as harming existing ones. Again, consumers are worse off when self-dealing raises prices or reduces competition. Furthermore self-dealing can violate a utilitys obligation not discriminate against its ratepayers in the provision of services.

In Minnesota, actions by Minnegasco in the provision of discriminatory conduct regarding gas hook-ups for customers who purchased appliances from the utility, the Minnesota Commission directed each gas and electric utility to develop, in cooperation with the Commission's staff, customer information which would serve to clearly delineate the services offered by the utility from those offered by unregulated subsidiaries or affiliates. Each potential customer of an unregulated service or product was to be clearly informed that such services and products were available from sources other than from the utility affiliate or subsidiary. The objective was to lessen confusion, reduce the potential for discriminatory conduct, and to promote competition. [29]

In Maryland, the Public Service Commission adopted standards of conduct for Baltimore Gas & Electric and its proposed gas marketing affiliate, BNG, Inc. Those standards provided that neither BG&E nor BNG could represent that nay advantage would accrue to customers or others in the use of BG&E services as a result of dealing with the marketing affiliate. [30]

The Massachusetts DPU has consolidated its rulemaking for gas and electric utilities and the proposed standards of conduct include a prohibition on a distribution company (a) giving any appearance of speaking on behalf of its competitive affiliate, (b) engaging in joint advertising or marketing programs, and (c) promoting or marketing any product or service offered by the non-regulated, competitive affiliate. [31]

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29 See, In the Matter of an Investigation into the Competitive Impact of Appliance Sales and Service Practices of Minnesota Gas and Electric Utilities, Docket No. G,E-999/CI-90-1008.

30. Re: BNG, Inc., 172 PUR 4th 347, [April 11, 1997.]

31 Re: Electric Industry Restructuring Notice of Inquiry/Rulemaking, Mass. DPU 96-44, [Nov. 27, 1996.]

Those standards also include the following limitations:

- A distribution company shall not give its competitive affiliate preference over non-affiliated suppliers in matters relating to any product or service, whether through tariffs or otherwise,

- If the distribution company offers its competitive affiliate any product or service other than those of a general corporate nature, it shall simultaneously offer the same to all non-affiliated suppliers,

- If a distribution company offers its competitive affiliate any discount or fee waiver for any product or service, it shall simultaneously offer the same to all non-affiliated providers of such products or services,

- If a distribution company provides a competitive affiliate with information not readily available or generally known to any other marketer or supplier, then it shall simultaneously make such information available, to the same extent, to all suppliers and marketers transacting business in the service territory, and

- A distribution company shall not release any proprietary customer information without the prior written authorization of the customer.

Additional requirements are contained in the standards, including operational and managerial separation of the distribution company and its affiliates, a prohibition on the shared use of employees, maintenance of separate books, accounts and records all subject to review by the state commission, and a requirement that the distribution , if asked by a customer, make available a list of all suppliers of services and products which may be provided by the distribution company or its affiliate, which may include but not promote the affiliate's products or services.

Similarly, restrictions have been incorporated into the merger terms approved by state commissions having jurisdiction over the applicant utilities. With respect to the Duke Power/PanEnergy merger, the North Carolina Utilities Commission required the adoption of certain safeguards which included provisions paralleling those in Maryland and Massachusetts. Among other things, the restrictions prohibit access by the affiliates, subsidiaries, and third parties to customer specific information possessed by the utility unless authorized by the customer in writing, discrimination by the utility's personnel against non-affiliated entities, a requirement that customers be informed of the availability of competitors providing products and services offered by the utility's affiliates or subsidiaries, a limitation on the ability of the utility to provide information to its affiliates not otherwise available to competitors.

The development of such codes of conduct by state utility regulatory bodies has generally rested on such authorities to protect ratepayers from violations by the regulated utility entities of one or more of traditionally accepted public utility obligations, e.g., just and reasonable rates, non-discrimination. However, the advent of deregulation has brought with it a necessity to move beyond such traditional authority in order to properly and effectively police the actual and potential abuses in a deregulated, competitive environment. Thus, state commissions are increasingly basing their jurisdiction on more general grants of authority, such as the obligation to protect the public interest or promote health, safety, and welfare of the people of the state. As deregulation progresses, state regulatory authorities must recognize that this evolutionary process requires that commissions move to directly address competitiveness issues not through the guise of protecting ratepayers, under an obligation to create fair and open markets and to safeguard competition itself and competing providers of products and services.

Traditionally, public utilities were viewed as a natural monopoly and permitted to hold an exclusive market territory in which they acquired enormous advantages over future potential competitors. Such advantages include name recognition (good will), customer histories (including credit histories), customer site information (on equipment and usage), and the like. These advantages are conveyed not because of any superior management or services but because the utility has enjoyed a state-sanctioned monopoly. Such advantages will continue even after more competitive markets replace monopoly franchises in the electric power and gas supply markets. Thus, the issue of abuse of market power continues to be one which state utility commissions must address and over which they must exercise jurisdiction.

The New York Public Service Commission has addressed concerns regarding the advantage a monopoly distribution companies enjoy over competitors as a result of its monopoly franchise. In its *Order Concerning Gas Appliance and Repair Service,* [32] the Commission reached certain decisions which are instructive in the present instance.

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[32] Case 93-G-0804, [April 4, 1997]

In its Order in that case, the Commission required that appliance repair services (one aspect of the overall energy services field) only be performed by a utility through a separate, unregulated subsidiary with a complete separation of functions. According to the Commission at that time, this approach best protected against competitive abuses and would foster long-term competition. Prior to that, in Opinion No 96-26, issued in case 95-G-0761 on September 25, 1996, the Commission approved a "Stipulation and Agreement Resolving Corporate Structure Issues and Establish a Multi-Year Rate Plan" which involved The Brooklyn Union Gas Company. Therein, highly effective and strict affiliate standards were adopted which included the prohibition of the use of the utility name and trading on the utility's name.

To guide the transition to competition in the natural gas distribution market, the Commission on March 28, 1996, issued "Interim Standards for Transactions between LDCs and Related Companies" which were designed to ensure that effective competition would be fostered in the retail natural gas commodity market. [33]A full panoply of restrictions involving arms-length relationship between affiliates and the utility, prohibitions on the transfer of any proprietary customer information, as well as restrictions on the use of utility name were incorporated into the Commission's standards.

Legislative Remedies

Fortunately, Congress has already established a legislative precedent in rectifying a number of the potential anticompetitive aspects of deregulation faced by private sector businesses. An excellent point of departure for crafting pro-competitive law can be found in the 1995 Telecommunications Competition and Deregulation Act of 1995.

Title I, Subtitle 2, Part III, Sections 271 - 275 spell out restrictions on Bell Operating Companies as they relate to competition with small business entities in the interLATA services (section 271), electronic publishing (section 274) and alarm monitoring (section 275). In addition, provisions dealing with operations of BOC affiliates (section 272) and manufacturing (section 273) were contained in the final bill.

For example, section 272 establishes certain requirements which require BOCs to establish separate affiliates from which to provide activities which compete with certain small businesses (e.g., alarm monitoring, interLATA services, manufacturing), a BOC may jointly market certain services with its affiliate but only if competitors are treated equally and without discrimination.

Section 274 establishes restrictions on the use of name and trade marks by BOC affiliates when they compete against others in the electronic publishing business. In addition to the requirement of dealing out of a separate subsidiary, this section also requires that separate books, records and accounts be maintained. The affiliate is also prohibited from using the name or trademark of the BOC under specified circumstances; prohibited from incurring debt in a manner in which recourse may be had to the BOC; provide for the proper valuation of assets transferred from the BOC to the affiliate to prevent cross-subsidization. The BOC is also prohibited from performing a number of activities on behalf of its affiliate including hiring or training personnel, providing equipment, or engaging in research and development.

Section 275 prohibits discrimination by a telephone company in the provision of services, either by refusing to provide competitors the same services as it provides itself or by cross-subsidizing from local telephone service.

Thus, it can clearly be seen that Congress has already considered the problems of small businesses which compete with utilities and has developed meaningful remedies to the anti-competitive conduct anticipated in connection with overhauling the Nation's telecommunications laws.

Now, similar treatment should be accorded to small businesses confronted by unfair competition from energy utilities.

Suggested provisions

55 (See, Case 93-G-0932, et al., Order Concerning Compliance Filings, issued March 28, 1996, Appendix III, p, 1)

NAFC suggest the following provisions be included in any legislation deregulating the utility industry:

- **Prohibition on cross-subsidization.** Although cross-subsidization is generally impermissible as a violation of the utility's obligation to charge just and reasonable rates, it needs to be codified into law. First, it is not a statutorily-based cause of action but one which is an outgrowth of "common law" or case decisions. Second, only a handful of states actually have codified this matter and having a federal statute would go along way toward getting the states to follow suit. Third, as utility competition progresses, there is the increasing potential for small businesses to lose this legal remedy since utility monopolies will be restructured or eliminated. With the elimination of the monopoly franchise, the obligation to charge a just and reasonable rate may well disappear along with this particular legal remedy. Finally, even in those areas where regulated utility functions remain (distribution), state regulatory authorities will likely be pressed to allow utilities to bundle product (energy) and services to at least some extent. Thus, there is an increased potential for creating permissible cross-subsidizations with which utilities will compete against small businesses.

- **Adequate definition of cross-subsidization.** The present understanding of what constitutes impermissible cross-subsidization fails to adequately cover modern subsidy situations. Traditional concepts of cross-subsidization focus on money aspects and/or misallocation of joint costs between the utility and the non-utility subsidiary or affiliate. This limitation fails completely to take into account the more common problems encountered in today's market: transfer of tangible and intangible assets at less than value (book or market) or at no charge at all. This would include goodwill (name and logo issues), marketing information and customer site data, customer referrals, etc. Cross-subsidization needs to be defined to cover its traditional meanings with respect to costs, as well as those situations noted above where a utility forgoes revenues which would otherwise inure to the benefit of rate payers.

In addition, self-dealing (including the steering of customers by utility employees to utility-affiliated subsidiaries) must be closely scrutinized and should be prohibited as a form of cross-subsidization since such "steering" is usually the result of information, or marketing data initially acquired by the utility by virtue of its monopoly status and utility functions.

- **Separation of utility and non-utility functions and operations.** As utilities are restructured in a competitive environment, there will be a need to configure them in such a way as to assure that those functions, and only those functions, which are inherent to the utility monopoly franchise are not co-mingled with competitive operations. This be especially true at the distribution level (DISCO) which will lie partly within utility and partly within competitive, private sector markets.

Energy services which can be procured competitively from private sector companies can and should be distinguished from, and not bundled with, the utility functions. Non-utility operations should be legally separated from the utility and conducted through a separate, distinct entity to assist in the prevention of cross-subsidization.

- **Adoption of, and adherence to, proper cost allocation rules.** Many states do not have cost allocation rules. It should be a requirement of any deregulation proposal that states adopt such rules (the FCC's telecommunications cost allocation formulae are an example) as we move toward a competitive and restructured environment in order to prevent abuses such as cross-subsidization.

- **Protection of customer proprietary information and data.** Energy utilities are rapidly expanding their capability to exploit optical fiber and other new technologies to provide customers with energy monitoring and management services. The recent telecommunications bill contained provisions which permitted energy utilities to enter this field without restrictions --- even less than what was imposed upon telecommunications utilities -- and the permissive approach allotted to energy utilities under that bill substantially threatens small business markets.

Customer generated information and data is the property of the one generating such data. The transference of such information without the consent (or even knowledge) of the customer is an invasion of privacy as well as outright theft of valuable commercial data. Energy monitoring (a permissible utility activity since it serves the need to acquire data on present and future load demands) allows the utility to gather exactly the kind of information which would be of considerable commercial value in a competitive market. By passing this information along, either in the aggregate or with reference to specific sites, to its non-utility, competitive subsidiary or affiliate at no cost, the utility imparts an exceptional and substantial competitive advantage over private sector competitors.

Customer generated information and data should stay with the utility and be used only for utility functions. It should not be shared with a utility's subsidiary or affiliates in aggregate form unless and except it is made available to all competitors under non-discriminatory terms. With respect to specific customer sites, it should never be disclosed without the written, knowledgeable consent of the customer.

- **Equal, non-discriminatory access to incumbent architecture and systems.** This is necessary in order to permit small business competitors access to utility owned property. It is the same remedy which was applied in the telecom bill and, like the remedy there, utilities should be permitted to charge just, reasonable and non-discriminatory fees for granting such access.. Absent such a provision, substantial and significant barriers to competition and the creation of new firms and employment opportunities would exist. This is especially relevant to the emerging energy monitoring and management markets for residential and commercial sites.

Unfortunately, legislation now pending in Congress is focused almost solely on generation (or commodity) aspects and "customer choice" rather than taking a more comprehensive view toward the impact deregulation and restructuring will have on businesses which compete with utilities in the energy services markets.

NAFC strongly urges the Subcommittee and the entire Congress not to omit addressing the substantial issues which arise at the distribution stage from comprehensive legislation. Without enacting truly pro-competitive legislation, neither consumers nor competitors will reap the potential benefits from deregulation. Prices will fall only marginally to end users and new markets will be denied for small businesses at the same time that traditional markets are lost.

We hope that the Congress will choose to explore remedies such as those indicated in this testimony as well as others, such as monopoly leveraging theories, when considering legislation in this area.

Respectfully Submitted
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