REGULATING AFFILIATE TRANSACTIONS IN ELECTRIC RESTRUCTURING: HOW AND HOW MUCH

by

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I. INTRODUCTION

The topic that I've been asked to treat — whether and how to regulate intracorporate transactions between incumbent electric companies and their affiliates in the course of industry restructuring — surely fits the panel title “Old Issues in New Guises.” Public utility regulation has for many decades wrestled with the host of problems that parent/affiliate transactions present when a regulated entity deals with a subsidiary (or sister entity), regulated or not. Most of these problems have had to do with cost shifting, risk shifting, and profit shifting of one kind or another. Proper pricing of certain inputs, like coal from a company affiliate or common services from the service company, are familiar examples. On the telephone side, AT&T dealings with Western Electric and Bell Labs were always a worry for regulators. The concern, of course, was whether ratepayers (all were essentially captive then) were paying too much and bearing improper risks, while providing profits actually higher than the allowed rate of return and which were masked by accounting mischief between the utility and its non-jurisdictional affiliate.

What is new now is the potential for these practices to become strategic weapons available to incumbent utilities in resisting competitive inroads and raising barriers to entry by favoring their affiliates and actively disadvantaging others. The use and leveraging of established brand names and utility logos by prominently extending them to affiliates is an important special problem arising in the new context. Accordingly, my remarks will go to the efficacy of “Codes of Conduct” that commissions are embracing to minimize anti-competitive behavior by incumbent utilities, including particular commentary on the branding issue. In preparing the presentation I scanned both the economic and marketing literature on these subjects, examined our experiences in the natural gas and telecommunications sectors with the advent of some competition, and checked the approach taken by commissions in some sixteen states where the subjects have come up.

So the order of events is: 1) reporting on what the academic literature seems to tell us; 2) reporting on what states have done so far in facing the issues; and 3) offering my own conclusions of where I think the broad public interest lies in policies toward parent/affiliate dealings in the emerging environment of the electrics.

II. THE GIST OF THE LITERATURE

Virtually all streams and schools of economic thought recognize the existence of market power. At the extremes it can probably be said that all markets have some degree of competition to them and that all have some degree of monopoly in them. Economic theory is most sure-footed in explaining the operation of markets at both ends — perfect competition and full monopoly — and less certain (and useful) in
calculations about what’s in between. What's in between, of course, is where reality is and what policymakers face — very imperfect markets often characterized by dominant firms, tight oligopolies, high barriers to entry, and the accompanying tactical behavior by incumbents to keep them that way.

Neoclassical economics — especially as practiced by those who currently dominate the profession — sees the broad range of market imperfections as worthy of analysis, but generally views the matter in fairly sanguine terms, not sustainable over time and therefore a temporary aberration that will solve itself — surely not requiring social intervention. Moreover, that whatever disbenefits accrue to market imperfections they are more than balanced by actual benefits in terms of efficiencies, innovation, and the like.

That part of the economics field of a more institutional bent sees it quite another way. Here the abuse of economic power is the focus and the view is that all the anticompetitive behavior of incumbent firms that one can imagine will, in fact, occur unless government actively intervenes. Market imperfection is seen as long term, always tending toward monopolistic or collusive bad behavior requiring constant vigilance, difficult to expose and correct, and involving high costs to society. Fairness and equity are basic themes.

Sketched this way it is not too great a stretch to see the current debate and controversy over PUC policy toward incumbent utilities in their dealing with affiliates and would-be competitors as framed in these two visions of the economy and corporate behavior within it.

Turning to the specific case of branding, the economics literature is again divided, and the marketing literature takes a still different tack. Free market economists see branding, logos, and trademarks as hard-won and deserved assets flowing from superior performance and properly resulting in a stream of returns to this particular category of advertising investment. Creation of “brand equity” is the current term. As such, branding is either neutral or procompetitive.

To the industrial organization economists of institutional persuasion, branding is an impediment to market entry by others, raises start-up and penetration costs for rivals, and perpetuates meritless dominance by the incumbent. This is seen as particularly unfair if an undifferentiated product or service is the subject.

For its part, the marketing field, not surprisingly, celebrates branding in unequivocal fashion. Three excerpts from the trade press support the point. From a consultant report to Allegheny Power: "... it was recommended that Allegheny Power develop a continuity strategy which would link the services together and tie back into the corporate identity. A common word part would be created to carry throughout:"
Allegheny's new and future services." From a 1997 telephone publication: "This year's results suggest that the companies that do not have a strong brand image on a local or national basis are going to have a major challenge in the new competitive environment." And from an Internet pronouncement: "Airlines, natural gas, financial services, and telecommunications have all gone down the road of deregulation that the utility industry now faces. The victors of the capitalistic battle that ensued as a result of deregulation all share one common denominator, a clear recognizable brand."

Finally, in this context, a well-known marketing professor told me, "You have to remember that what we do in marketing is just what you policy economists worry about. The goal is to make markets less perfect so that a premium can be extracted."

III. SO WHAT'S GONE ON SO FAR?

A. Before surveying what regulatory commissions have done so far in the course of restructuring the telephone, natural gas, and electric sectors with respect to branding and codes of conduct, two other related subjects are worth mentioning. One is the diversification experience that PUCs went through earlier, and the other is why regulators generally prefer structured versus accounting safeguards.

On the first count both regulators and utility companies should remember that their experiences with diversification in the 1980s and early 1990s were mixed at best. PUCs grudgingly acquiesced to allowing utilities under their jurisdiction to diversify into both germane and non-germane businesses. Holding companies were elaborated and conglomerates were formed. PUCs were concerned then about problems of cross subsidy, risk shifting, and cost shifting and particularly the potential for injury to ratepayers resulting from bad investments.

While the worst fears of regulators did not generally eventuate, the glowing expectations of utility companies didn't either. The result often was the pulling back into the core business and the selling off of subsidiaries, much the way that non-utility companies did over time (e.g., Sears disposing of Caldwell Banker, Dean Witter, Discover Card, and Allstate).

As to the general preference for structural separation of affiliates from the parent utility (as opposed to only accounting separation), proponents of strict consumer protection weigh the following pros and cons. Structural separations (with physical separation):

1) reduce the likelihood of X-subsidization and anticompetitive behavior;
2) make easier identification and assignment of costs, revenues, and plant investments to various services;
3) allow easier enforcement of arms-length transaction rules;
4) provide easier control of information flows;
5) may result in a more competitive environment overall.

The downside is that insisting on structural separations:

1) may allow the syphoning off of profits from the regulated to the non-regulated segment of the enterprise;
2) may limit regulatory access to needed information; i.e., control is reduced, unless additional provisions are made;
3) may hinder realization of economies of scale and maybe scope that can come from not building a wall between activities.

Of course, abuses can still occur because the business units are not fully financially independent of each other. For example, regulators still have to judge whether a utility paid too much for services provided by an affiliate or a utility charged too little for services provided to an affiliate.

B. The Scoreboard

A look at the scoreboard of commission actions around the country on these subjects in the telephone and natural gas sectors as well as the electric is informative. Outcomes vary, but some patterns emerge.

(1) Telephone

Regarding branding and telephone industry restructuring, the issue has been prominent and very contentious. The companies interconnecting for sale and resale of services frequently are unable to voluntarily resolve the issues. Branding appears as a major obstacle in over one-third of the roughly ninety arbitration decisions in the NRRI data bank on the subject.

The central question in the branding debate is what company's name and logo will appear on the resold service, the incumbent carrier which is providing the service or the competitor (new entrant) carrier that is reselling it. Understandably, the competitor that is looking for a toe-hold in the market wants to "rebrand" everything (get its own name used) or at worst make the incumbent "unbrand" it. They all argue that to do otherwise would allow the incumbent to foreclose viable entry. As of last fall, in 73 arbitration decisions that AT&T was involved in, commissions allowed them to use their brand name in 45, the incumbent local exchange carrier was allowed to use their name in 3 instances, and in 13 cases both carriers were prohibited from doing so.
In telephone, the branding issues have been of two types: 1) operator and directory assistance services and 2) direct customer contact services, like installation and repairs. Vermont and New Hampshire commissions have taken a strict line requiring NYNEX to unbrand all these services (including its own). New York, however, decided that unbranding all services is not desirable, saying it would lead to confusion. Michigan said unbranding would violate certain FCC rules. Kentucky requires Bell South to unbrand or rebrand only those services it brands for itself. Ohio adopted a case-by-case approach with Ameritech. Colorado and Montana do not require branding vehicles or employees that are out serving customers, but employees must tell the customer that they are appearing on behalf of the competitor carrier. Florida requires that unbranded information (e.g., repair slips) be left with customers. Missouri and Texas allow Southwestern Bell employees to identify themselves that way but require that they say on which company’s behalf they are there and that they leave generic documentation with space to fill in the competitor’s name.

(2) Natural Gas

PUCs have recently faced the issues of branding and the appropriate intracorporate relations between gas utilities and their affiliates, often on the occasion of the introduction of pilot retail access programs. Their decisions have also varied, but allowing branding is common (I note only two instances where it was not — New York and Wisconsin) and Codes of Conduct or Standards of Conduct were almost always employed. These sets of rules are often modeled after FERC Order 497 but generally are more comprehensive, obligating regulated gas utilities to provide the same services, information, and pricing terms to all marketing entities — theirs and others — as well as restricting personnel deployment, establishing complaint procedures, and allowing for reporting and audit oversight.

Pennsylvania established an “interim code of conduct” for natural gas competition requiring complete separation, no staff sharing, comparability of treatment, no joint marketing, and no dealing on inside information. Staff members report that independent marketers are “complaining everywhere.”

Maryland, on the other hand, established a “generic code of conduct” prohibiting joint management for high level executives but not others; no structural separation was

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1. While “Codes of Conduct” is the term most frequently being used, I prefer the term “Standards of Conduct” as carrying perhaps less normative baggage. “Codes” may connote more lofty aspirations associated with Boy Scout oaths, self-discipline, ethics, and well placed trust.

2. One company asserted that, “Affiliate abuse has been substantial, with referrals of customers to the affiliates, ‘temporary assignment’ of utility marketing personnel to the affiliates, transfer of utility call center inquiries to the affiliate, marketing on utility Internet sites, invocation by affiliates of utility resources, advertising that muddies distinction between utility and affiliates, and use of utility capacity.”
required on grounds that certain efficiencies would be lost and that the existence of performance-based regulation would control the problem of transfer price inflation. Complaints are to come directly to the PUC, and a pattern of violations could force divestiture of affiliates. A Maryland commissioner reports that gas marketers seem to be satisfied with the arrangements.

Massachusetts created a code of conduct through a collaborative with interested parties drawing in part on experience at the Ontario Energy Board. It is considered by commission staff to be a “first stage” to be revisited after some learning takes place. Under it the marketing affiliate of Boston Gas can say, “We are an affiliate of Boston Gas” but cannot say, “We’re Boston Gas doing something for you.” Other marketers reportedly are very suspicious of the workability of the separation.

Ohio employed a Standard of Conduct approach in its pilot requiring new complaint procedures. Commission staff there say they also would look to the Office of Attorney General to participate in any necessary enforcement through the fair trade and state antitrust laws or private actions thereunder.

New Jersey requires only accounting separation of the unregulated affiliates in its two pilot programs. According to staff, there is a widely held perception among state legislators and marketers that the overlap in employees and logos has been injurious to real competition. A new collaborative on the subject may be in the offing.

New York faced these issues most recently (December 1997) in a complicated corporate restructuring between Brooklyn Union Gas and Long Island Lighting and their affiliates. Detailed requirements were set out to “protect customers from harm” and not restrict competition. One of these last is the prohibition on employee “revolving door” transfers — for no longer than 18 months at a time and not again for at least 18 more months. Furthermore, the PUC prescribed a charge (ratemaking credit) of 20 per cent of the first year of compensation for each utility employee loaned out. Another wrinkle in the Settlement Agreement was a royalty feature for gas utility customers to compensate them (in the form of a ratemaking credit) for the affiliate’s use of the name, reputation, and expertise of the company, and “to capture any ‘unquantifiable’ subsidies or misallocations resulting from affiliate transactions.” Interestingly, the parties also agreed not to challenge the PUC’s authority to levy royalties.

(3) Electrics

A number of commissions are working toward devising codes of conduct for use in electric restructuring. FERC Order 889 first raised the need for codes of conduct in competitive markets on the electric side. Also, during 1997 the NARUC Strategic Issues Committee and the Staff Subcommittee on Accounts prepared and disseminated for comment a draft paper for use by commissions addressing the relationship between
the activities of regulated and non-regulated affiliated companies in a restructured
electric industry. This document still awaits action by the parent committees, moving it
through the resolution stage.

Commissions in New Jersey and Pennsylvania are beginning work on fashioning
appropriate codes of conduct using working groups and collaboratives. New York
completed a negotiated agreement and settlement on a Consolidated Edison
restructuring plan for retail competition. Safeguards were similar to the above-
mentioned Brooklyn Gas-LILCO case. Branding was allowed, and a royalty payback of
2 per cent of the capital investment in the affiliate is required for use of the logo. A new
complaint system must be set up by the utility with the utility having 20 days to
informally resolve complaints on its own, failing that, to promptly refer the matter to the
PUC. The PUC has remedial authority for serious or sustained violations of the
standards of competitive conduct including ordering divestiture. The PUC can choose
an independent auditor to review utility compliance with the terms of the agreement at
its call:

As often happens, the nine-month California rulemaking to establish standards
of conduct for relationships between energy utilities and their affiliate (decided just last
month) is perhaps a classic case containing sharply delineated positions of the various
parties, contrary arguments as to the need and effectiveness of possible safeguard
provisions, and divergent philosophies of social intervention and the sanctity of
property rights. The final document can, I believe, be described as fairly strict in the
detailed provisions of the standards of conduct and as taking a middle position on the
branding question between banning their use outright or allowing their use unfettered.
The tone of the order conveyed the seriousness with which the Commission saw the
matter, underscored by the writings of three of the commissioners in the course of
deliberations and adoption.3

IV. WHAT'S BEST — ONE VIEW

Moving from fact to considered opinion, mine is that commissions should at this
time and with very immature markets for competitive utility service err on the side of
strictness in dealing with incumbent utilities. By this I mean, generally employing the
full range of prohibitions and constraints on the incumbents in dealings with their
affiliates.

Branding transfers would be prohibited for several years as would strategic
transfers of utility personnel. Structural separation is the chosen arrangement for

3I refer here to Commissioners Bilas’ and Knight’s suggested amendments and President
Conlon’s dissent.
consumer protection, and access to records should be complete. Prompt and effective complaint procedures should be established with early involvement of the PUC and informational involvement of the office of attorney general. To discourage frivolous complaints by competitors, a fee system would be imposed for use of commission time and investigatory resources. Non-compliance with the letter or the intent of the Standards of Conduct would not be tolerated, and both monetary and divestment penalties should be available.

My reasons for urging such an intrusive stance are several. One is that I judge the downsides to each of the arguments against intervention to be exaggerated and less than the benefits. Also, we should be aware that we are reframing an entire industry for years to come, and the stakes are very high for the public and not just the industry players. The need for public policy to "get it approximately right" is great, for done badly we perhaps will have frozen in place and legitimized severely flawed markets in this important sector of the economy.

While I would rather decide on the merit the question of strictness or leniency in the oversight of utility/affiliate relations, my reason for opting for the strict approach is also influenced by two external considerations. One is our experience in trying to bring workable competition to local telephone (and, to a lesser extent our experience with natural gas) service. Here public policy wildly underestimated the power (and will) of the incumbent utility to resist and frustrate change. Despite the rhetoric, it has gone badly and so far, at least, has fizzled in the case of local service.

The second is the larger context in which the discussion over brand usage and standards of conduct is taking place. The argument can be made that in the course of electric sector restructuring we have treated the incumbents rather generously already with huge concessions like transition cost recovery, and the tilt should be in the other direction on these particular aspects of market power. Moreover, PUCs now have the new mission to actively induce competition, and reducing the chances for anticompetitive practices by lowering entry barriers would seem entirely consistent with that charge. To me, managed competition at this moment is neither an oxymoron nor a bad term — it may well be what we need to do to get there.

But for all of this I'm no more than cautiously optimistic that even the promulgation of strict standards of conduct will be reasonably successful by themselves. Enforcement is a huge task and may be an overwhelming one for many PUCs. Opportunities to shade compliance are endless, and inventiveness in skirting the edges of misbehavior is boundless. Counting very much on lofty promises, self-policing, and the benign behavior of utilities on these matters may prove a slender line of defense.

Thank you for your attention.