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MISSOURI PUBLIC SERVICE COMMISSION

REGULATORY REVIEW DIVISION

UTILITY SERVICES - AUDITING

DIRECT TESTIMONY

OF

CHARLES R. HYNEMAN

KANSAS CITY POWER & LIGHT COMPANY
KCP&L GREATER MISSOURI OPERATIONS COMPANY

CASE NO. EC-2015-0309

Jefferson City, Missouri
August 2015

** ***Denotes Highly Confidential Information*** **

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KCP&L GREATER MISSOURI OPERATIONS COMPANY

CASE NO. EC-2015-0309

Q. Please state your name and business address.

A. Charles R. Hyneman, Fletcher Daniels State Office Building, 615 East 13th Street, Kansas City, Missouri.

Q. By whom are you employed and in what capacity?

A. I am employed with the Missouri Public Service Commission ("Commission"). I currently hold the position of Regulatory Auditor V, which is a senior-level professional and supervisory position in the Commission's Auditing Department. A Regulatory Auditor V performs, supervises and coordinates regulatory auditing work for the Commission Staff ("Staff").

Q. Please describe your educational background and work experience.

A. I have been employed with the Commission in various audit positions since April 1993. I earned an MBA from the University of Missouri Columbia, a dual-major Bachelor of Science degree (Accounting and Business Administration) from Indiana State University (cum laude) and Associates in Applied Science (AAS) degree in Contracts Management from the Community College of the Air Force. Please see Schedule CRH-d1 attached to this testimony for specific work experience and background information.

Q. Have you previously testified before this Commission?

A. Yes. I have testified before the Commission on numerous occasions over the past 22 years. Schedule CRH-d1, attached to this testimony includes a list of rate cases in which I have submitted testimony.

Q. In your work as a regulatory auditor with the Commission, have you obtained significant experience and developed an expertise in the areas of utility affiliate transactions and the application of the Commission's Electric Affiliate Transactions Rule, 4 CSR 240-20.015 ("Affiliate Transactions Rule" or "Rule")?

A. Yes. I have significant experience as a regulatory auditor and expert witness in the area of regulated utility affiliate transactions. I have filed testimony with the Commission on affiliate transactions and utility parent company cost allocation issues in several utility rate case audits and other proceedings. These cases include cases involving Kansas City Power & Light Company ("KCPL") and KCP&L Greater Missouri Operations Company ("GMO").

Q. Over the past several years have you been, and are you currently involved in reviews of Affiliate Transactions Rule compliance and the sufficiency of the Cost Allocation Manuals (CAMs) of all major Missouri utility companies?

A. Yes. I was the Staff expert witness in the Affiliate Transactions Staff Complaint (Case No. GC-2011-0098) against Laclede Gas Company. In that case, Laclede, Staff, and the Office of the Public Counsel ("OPC") filed a *Unanimous Partial Stipulation And Agreement And Waiver Request And Request For Approval Of Cost Allocation Manual* which, among other things, resolved certain affiliate transaction issues raised in that Staff complaint case. The Commission issued an order approving the partial stipulation and agreement on August 14, 2013.

I am also the Staff expert witness in File No. EO-2014-0189 ("0189 Case"). In the 0189 Case KCPL and GMO filed an *Application for Approval of its Cost Allocation Manual*, which is required by the Commission's Affiliate Transactions Rule. The Staff, KCPL and GMO have made significant progress in the design of a revised CAM for KCPL and GMO. The Staff has an expectation that a joint application seeking Commission approval of these revised CAMs will be filed in the very near future.

Finally, I am the Staff expert witness in File No. File No. AO-2012-0062. On August 23, 2011, The Empire District Electric Company ("Empire") and Empire Gas filed for Commission approval of its CAM pursuant to an agreement in Empire's last rate case, File No. ER-2011-0004. I am currently involved in a review of Empire's affiliate transactions policies, procedures, and internal controls and the sufficiency of its CAM policies, procedures and controls.

Q. What is the purpose of this testimony?

A. The purpose of this testimony is to provide support for the Staff's Complaint against KCPL and GMO filed on May 20, 2015 ("Staff Complaint"). The Staff Complaint concerns transactions between KCPL and GMO ("the utilities") and its affiliate Great Plains Energy Services Incorporated ("GPES"). An additional concern of the Staff is the nonregulated business relationship that currently exists between KCPL and GMO and Allconnect, Inc. ("Allconnect").

In this testimony I describe the specific KCPL and GMO Affiliate Transactions Rule violations included in the Staff Complaint as well as describe some of the Staff concerns with the current KCPL/GMO relationship with Allconnect. Although I am not one of the authors of the *Report of Staff's Investigation File No. EO-2014-0306 Allconnect Direct Transfer*

Service Agreement Between Allconnect, Inc. and Great Plains Energy Services Incorporated Respecting Itself and Its Affiliates Kansas City Power & Light Company and KCP&L Greater Missouri Operations Company ("Staff Report"), I did actively participate in the investigation which led to the Staff Report and Staff Complaint.

Q. Who is Allconnect?

A. Allconnect is a nonregulated marketing company based in Atlanta Georgia.

Corporate Structure

Q. Please describe KCPL and GMO's corporate structure.

A. KCPL is a wholly-owned subsidiary of Great Plains Energy Incorporated, ("GPE"). GPE is a public utility holding company which, in addition to KCPL, also wholly owns GMO. GMO is the former Missouri regulated operations and nonregulated properties of Aquila, Inc. GPE also has an ownership interest in Transource Energy LLC, a partnership between American Electric Power and GPE.

In addition to its two regulated utility subsidiaries (KCPL and GMO), GPE has two nonregulated subsidiaries-KLT Inc. and GPES. KLT Inc. is an intermediate holding company that has investments in affordable housing limited partnerships and KCPL Solar Inc., a solar supplier. KLT Inc. also owns various nonregulated companies that have no active operations. GPES is technically a service company, but it provides no services and has no employees.

Q. Is the basis of Staff's Complaint the business relationship between GPES (acting as an affiliate of KCPL) and Allconnect?

A. Yes. GPE's regulated utilities, KCPL and GMO have no formal contract or written agreement with Allconnect. The only contract or written agreement between any GPE entity and Allconnect is the contract entered into by GPES and Allconnect entitled

Allconnect Direct Transfer Service Agreement ("Allconnect-GPES contract" or "contract"). This contract is described in the Staff Complaint and is attached as Highly Confidential Schedule CRH-d2 to this testimony.

Q. While there is no contract or agreement between KCPL and Allconnect, nor is there a contact or agreement between KCPL and GPES related to Allconnect, does KCPL have any other formal contracts or agreements with GPES?

A. Yes. According to KCPL's 2014 Cost Allocation Manual submitted by KCPL into the Commission's EFIS System on March 13, 2015 ("2014 CAM submission"), KCPL has the following contracts with GPES:

1. Service Agreement dated September 20, 2005, by and between Kansas City Power & Light Receivables Company and Great Plains Energy Services Incorporated.

2. Service Agreement between Great Plains Energy Services Incorporated and Kansas City Power & Light Company, dated April 1, 2003.

3. Facilities Services Agreement between Great Plains Energy Services Incorporated and Kansas City Power& Light Company, dated April 1, 2003.

4. Assignment and Assumption of Contracts and Permits by and between Kansas City Power & Light Company, KCP&L Greater Missouri Operations Company and Great Plains Energy Services Incorporated and Transource Missouri, LLC Effective January 2, 2014.

5. Bill of Sale and Assignment by and between Kansas City Power& Light Company, KCP&L Greater Missouri Operations Company and Great Plains Energy Services Incorporated and Transource Missouri, LLC effective January 2, 2014.

Q. Does KCPL have contracts with GPES that govern affiliate transactions?

A. No. The Commission's Affiliate Transactions Rule for electric utilities, 4 CSR 240-20.015 at paragraph 4(b)(2) requires KCPL to "provide a full and complete list of all

affiliate transactions undertaken with affiliated entities without a written contract together with a brief explanation of why there was no contract." In its 2014 CAM submission KCPL stated that as of December 31, 2014, there was no written contract for affiliate transactions between KCPL and several of KCPL's affiliates, including GPES.

Q. In its 2014 CAM submission did KCPL provide an explanation as to why there was no contract between KCPL and several affiliates related to affiliate transactions?

A. No. In its 2014 CAM submission KCPL merely stated that transactions with these entities are governed by the costing and transfer pricing procedures in the CAM.

Purpose of Affiliate Transactions Rule

Q. What is the purpose and objective of the Commission's Rule on affiliate transactions as related to regulated electrical corporations?

A. The purpose and objective of the Rule is to prevent a regulated utility from subsidizing its nonregulated operations. The Rule, coupled with its effective enforcement, is designed to provide the public the assurance that utility rates are not adversely impacted by the utilities' nonregulated activities.

The Rule seeks to prevent this cross subsidization. By their very nature, affiliate transactions create incentives for utility management to increase costs to the regulated utility (KCPL and GMO) so higher profits can be recognized by the nonregulated operations of the company (GPES and GPE). Without ratepayer protections, such as an affiliate transactions rule, there is a high risk that ratepayers will subsidize nonregulated operations.

The Affiliate Transactions Rule by itself does not eliminate the risk of a utility subsidizing its nonregulated operations to the detriment of ratepayers. However, the Rule, coupled with effective utility oversight and effective enforcement, does somewhat lessen the

risk of inappropriate and excessive costs being charged to utility ratepayers. But even with close oversight and the affiliate transactions rule, the incentive for utility management to subsidize nonregulated operations exists and will continue to exist as long as utilities are allowed to transact business with affiliates.

If a regulator allows utilities to engage in affiliated transactions, substantive ratepayer protections must be put in place to protect ratepayers from improper utility-affiliate behavior and these substantive ratepayer protections must be fully supported by the Commission, utility management and utility Board of Directors ("Board") to minimize the risk off the utility inappropriately subsidizing its affiliates and nonregulated operations.

Q. How does the Rule attempt to accomplish this objective?

A. Whenever a regulated utility participates in a transaction with any of its affiliated entities, the Commission has in place through the Rule 1) financial standards, 2) evidentiary standards and 3) record keeping requirements in which the utility and its affiliates must comply. These Rule standards and requirements were designed, in part, to assure appropriate utility and appropriate affiliate company conduct when engaging in affiliate transactions.

Q. What are the financial standards the Commission created to prevent regulated utilities from subsidizing their nonregulated operations and provide ratepayers the assurance that their rates are not adversely impacted by the utilities' nonregulated activities?

A. Listed below are some of the Missouri Commission's financial standards as reflected in 4 CSR 240-20.015(2):

> 1. Regulated electrical corporation shall not provide a financial advantage to an affiliated entity.

> 2. Regulated electrical corporation shall make specific customer information available to affiliated or unaffiliated entities only upon consent of the customer or as otherwise provided by law or commission rules or orders
>
> 3. Regulated electrical corporation shall conduct its business in such a way as not to provide any preferential service, information or treatment to an affiliated entity over another party at any time.
>
> 4. If a customer requests information from the regulated electrical corporation about goods or services provided by an affiliated entity, the regulated electrical corporation may provide information about its affiliate but must inform the customer that regulated services are not tied to the use of an affiliate provider and that other service providers may be available.
>
> 5. Regulated electrical corporation shall not participate in any affiliated transactions which are not in compliance with this rule, except as otherwise provided in the variance section of this rule.

Q. What are the other standards, in addition to the financial standards, that the Commission created to 1) prevent regulated utilities from subsidizing their nonregulated operations and 2) provide ratepayers the assurance that their rates are not adversely impacted by the utilities' nonregulated activities?

A. In addition to the financial standards, the Rule also provides for evidentiary standards (which support the financial standards) and require the utility create and maintain sufficient records to support its decision to enter into an affiliate transaction (e.g., competitive bids, documentation, and CAM). (4 CSR 240-20.015(3).

Finally, the Rule includes record-keeping requirements that, among other things, mandate that the utility keep records identifying the basis (e.g., fair market price (FMP), fully distributed cost (FDC), etc.) to record the affiliate transaction. (4 CSR 240-20.015(5).

Q. Earlier you stated that for the Rule to be effective it must be supported by the Commission, utility management and the utility's Board. Please elaborate.

A. I believe a utility's senior management and especially its Board have a direct responsibility to effectively enforce the Rule throughout its utility operations. A utility's Board should communicate to utility management as well as management of nonregulated operations the importance of strict compliance with the Rule. While there are several ways to accomplish this, one way is for the Board to create and enforce a Company Code of Ethical Conduct. This Code of Ethical Conduct should specifically emphasize compliance with the Rule, communicate the Board's commitment to Rule compliance, and emphasize Board's lack of tolerance of Rule violations by management.

In addition to a strong and enforced Code of Ethical Conduct, utility management and the Board have an obligation to put in place effective internal controls (including an effective cost allocation manual) that will provide a high degree of compliance with, not only the specific intent of the Rule, but with the more general "spirit" of the Rule.

Q. What do you mean by the spirit of the Rule?

A. As stated above, the purpose of the Rule is not only to prevent regulated operations subsidizing nonregulated operations, but also to provide regulated customers with the assurance that the regulated utility, acting as a monopoly, is not taking advantage of its monopoly positon and subsidizing its nonregulated operations. By the spirit of the Rule, I mean that utility management and members of the utility's Board should strive to provide the assurance to utility customers that the utility is giving the rule a reasonable reading and application.

Customer assurance through the utility's continuous focus and emphasis on Affiliate Transactions Rule compliance is very important. Continuous improvement in internal controls and policies and procedures and, simply by making the Rule a focus of utility management, instead of an afterthought (as it currently is with KCPL/GMO and other Missouri utilities), will go a long way in assuring regulated utility customers that the utility is not subsidizing the utility's nonregulated operations or otherwise not complying with the Affiliate Transactions Rule.

Q. Do you believe it is a fact that KCPL, in its affiliate transactions with GPES and Allconnect, is taking advantage of its monopoly position and subsidizing its nonregulated operations?

A. Yes, it clearly is a fact and this is very troubling to the Staff. The Staff has provided in this docket and will continue to provide to the Commission in this docket and in other dockets substantial evidence of KCPL's Rule violations with its transactions with GPES and Allconnect. I will describe the basis of this Staff belief, as it relates to the Rule violations outlined in the Staff Report, in this direct testimony.

Q. You have described the purpose of the Rule above. Is there an explicit Purpose statement embedded in the Rule itself?

A. Yes. The Rule's Purpose Statement is as follows:

> PURPOSE: This rule is intended to prevent regulated utilities from subsidizing their nonregulated operations. In order to accomplish this objective, the rule sets forth financial standards, evidentiary standards and recordkeeping requirements applicable to any Missouri Public Service Commission (commission) regulated electrical corporation whenever such corporation participates in transactions with any affiliated entity (except with regard to HVAC services as defined in section 386.754, RSMo Supp. 1998, by the General Assembly of Missouri). The rule and its effective enforcement will provide

> the public the assurance that their rates are not adversely impacted by the utilities' nonregulated activities.

Q. When reviewing the evidence put forth in Staff testimony on KCPL and GMO's Rule violations, does a presumption of prudence that the Commission has, in the past, applied in some circumstances, apply to utility management when they engage in transactions with utility affiliates?

A. No. While I am not an attorney, I have been advised that the law on this is very clear. Transactions between affiliates cannot be reviewed through the lens of the presumption of prudence. In *Office of Public Counsel v. Public Serv. Commn,* 409 S.W.3d 371 (Mo.banc 2013; *reh. denied; op.mod.* Sept. 10, 2013) the Supreme Court of Missouri unanimously ruled ("Atmos Opinion"):

> When a regulated gas corporation such as Atmos Energy engages in a business transaction with an affiliated entity, it is required to abide by the affiliate transaction rules set forth in the Missouri Code of State Regulations. 4 CSR 240-40.015-40.016. Due to the inherent risk of self-dealing, the presumption of prudence utilized by the PSC when reviewing regulated utility transactions should not be employed if a transaction is between a utility and the utility's affiliate. 409 S.W.3d at 372.
>
> * * * *
>
> . . . the application of a presumption of prudence to a transaction with an affiliated company is inconsistent with the PSC's statutory and regulatory obligations to review affiliate transactions. Accordingly, the presumption of prudence is inapplicable to affiliate transactions. 409 S.W.3d at 379.

In its Atmos Opinion the Missouri Supreme Court also cited an article by Judy Sheldrew, entitled *Shutting the Barn Door Before the Horse Is Stolen: How and Why State Public Utility Commissions Should Regulate Transactions Between A Public Utility and Its*

Affiliates, 4 NEV. L.J. 164, 195 (2003). A copy of this article is attached as Schedule CRH-d3 to this testimony.

Q. Does the Staff Complaint assert that the contractual transactions between KCPL and Allconnect are transactions between affiliated entities?

A. Yes. As noted above, there are no actual contractual transactions between KCPL or GMO and Allconnect. The actual business transactions are between GPES and Allconnect. It is GPES, and not KCPL or GMO that has a contract with Allconnect. It is GPE management (KCPL and GMO's nonregulated parent company) who made the decision to use KCPL and GMO's regulated utility assets (without compensation) to engage in nonregulated transactions with Allconnect. It does not appear that KCPL management (KCPL management acts on behalf of both KCPL and GMO as GMO has no employees), acting on the behalf of its customers, had a choice not to participate in the arrangement entered into between GPES and Allconnect.

KCPL and GMO's only involvement in these transactions is to facilitate Allconnect's (a nonregulated Georgia-based marketing company) access to KCPL and GMO's regulated customers and to provide Allconnect with customer information specifically without those customers' consent. KCPL and GMO are servicing the contract between GPES and Allconnect by providing the use of regulated utility physical assets (computer equipment, software, office equipment, buildings, etc.) regulated utility employees (customer service, IT support and management overhead) and regulated utility intangible assets (such as access to customer phone calls and customer information).

Q. Are you stating that KCPL and GMO employ the use of regulated plant in service assets, such as buildings, office equipment, software, computer hardware, and communications equipment in its transactions with Allconnect?

A. Yes, the assets of both utilities are used to service GPES' contract with Allconnect.

Q. Does KCPL or GMO's regulated utility operations receive any revenue or compensation for the use of the utility's regulated plant assets, intangible assets such as customer information and access, the services provided to GPES and Allconnect by KCPL's regulated customer service employees?

A. No. GPE's nonregulated company management has taken specific and direct action to deny any compensation to KCPL or GMO for the use of their utility assets and employees. KCPL and GMO, despite significant investments in time and resources devoted to serving Allconnect and serving GPES, receive no compensation. GPES's relationship with Allconnect is strictly a nonregulated business relationship, but it uses only regulated utility assets and regulated utility employees. In substance and in effect, KCPL and GMO are transferring, at no cost, regulated utility assets and regulated utility personnel with the sole intention to generate additional nonregulated revenue and additional profits for GPE.

By allowing this relationship to exist, as structured, KCPL management is clearly acting imprudently and against the interests of KCPL and GMO customers. KCPL management is not only acting imprudently it is also committing a significant violation of the Rule's Paragraph 2(A)(2) affiliate pricing standards.

Q. What is the nature of the Allconnect-GPES contract?

A. As noted at Paragraph 17 of the Staff Complaint, in early May 2013, Allconnect and GPES executed the Allconnect-GPES contract to transfer "Eligible Customers" and their "Customer Data" to Allconnect for monetary compensation per "Transferred Customer" call. The Allconnect-GPES contract specifically states that the agreement is "by and between" Allconnect and GPES and GPES' affiliates "referenced herein." KCPL and GMO are identified in the Allconnect-GPES contract as affiliates of GPES, and KCPL and GMO are collectively referred to as KCPL.[1]

Q. Does KCPL admit that it and GMO are affiliates of GPES?

A. Yes. KCPL and GMO filed an *Answer of Kansas City Power & Light Company and KCP&L Greater Missouri Operations Company* to Staff Complaint ("KCPL and GMO's Answer to Staff Complaint") on June 22, 2015. At Paragraph 39, KCPL and GMO admit that GPES is an affiliate of KCPL/GMO, that GPES is a separate and distinct corporate entity registered with the Missouri Secretary of State and doing business in Missouri and that the Agreement is between GPES and Allconnect.

Q. Did any employee or officer of KCPL sign the contract with Allconnect as a representative of KCPL's regulated utility operations?

A. No. The contract with Allconnect was signed on May 6, 2013, by Mr. Charles Caisley acting as Vice President, Marketing and Public Affairs of Great Plains Energy Services, Inc. As noted in the contract, all communications with Allconnect related to these transactions were to take place between Julie Tyrell, Manager- Non-regulated Products & Services. Ms. Tyrell is listed as the "GPES Authorized Contact".[2]

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[1] KCPL response to Staff Data Request No. 0071 in File No. EW-2013-0011, p. 1.

[2] *Id.* at 9.

Q. What is the Rule's definition of an "affiliated entity"?

A. Paragraph (1)(A) of 4 CSR 240-20.015 *Affiliate Transactions* defines an "affiliated entity" as any entity which directly or indirectly controls, is controlled by, or is under common control with the regulated electrical corporation. GPES is an entity, which, along with KCPL and GMO are under the control of GPE, the parent public utility holding company of KCPL, GMO and GPES, as well as other affiliated entities.

> Affiliated entity means any person, including an individual, corporation, service company, corporate subsidiary, firm, partnership, incorporated or unincorporated association, political subdivision including a public utility district, city, town, county, or a combination of political subdivisions, which directly or indirectly, through one (1) or more intermediaries, controls, is controlled by, or is under common control with the regulated electrical corporation. (4 CSR 240-20.015 Affiliate Transactions, Para. (1)(A))

Thus, KCPL, GMO and GPES are affiliated entities.

Q. Please describe how the relationship between GPES and Allconnect and between GPES and KCPL results in an "affiliated transaction."

A. As defined by the Commission's Affiliate Transactions Rule, 4 CSR 240-20.015(1)(B), an "affiliate transaction" means any transaction for the provision, purchase or sale of any information, asset, product or service, or portion of any product or service, between a regulated electrical corporation (KCPL and GMO) and an affiliated entity (GPES). The Rule also states that affiliated transaction shall include all transactions carried out between any unregulated business operation of a regulated electrical corporation and the regulated business operations of an electrical corporation.

Affiliate Transactions Rule Violations

Q. Please provide a brief history of KCPL and its previous commitment to comply with the Missouri Commission's Affiliate Transactions Rule.

A. In Case No. EM-2001-464 KCPL committed that all KCPL affiliates, after its reorganization as a holding company under Great Plains Energy, Inc. would comply with the Commission's Affiliate Transactions Rule. At paragraph 2 in the First Amended Stipulation and Agreement to Case No. EM-2001-464, KCPL committed to the following:

> 2. State Jurisdictional Issues
>
> In Re Western Resources, Inc./Kansas City Power & Light Company, Case No. EM-97-515, and Re Union Electric Company/Central Illinois Public Service Company, Case No. EM-96-149, the Commission approved settlement agreements designed to ensure the protection of customers of Missouri utilities that were to possibly become or became a subsidiary of a Registered Holding Company. KCPL and GPE hereby agree to those same conditions as set forth below. KCPL further commits that it and its affiliates will continue to comply with the provisions of 4 CSR 240-20.015 and 20.017 after the reorganization is completed. [Emphasis Added]

Q. Is GPES using its affiliation with KCPL as a regulated utility to gain access to regulated customer information inconsistent with other commitments made by KCPL to the Commission in Case No. EM-2001-464?

A. Yes, KCPL noted under Section III. Benefits of Restructuring, page 7 of its Case No. EM-2001-464 Application that Section 393.140(12) RSMo. requires an electric, gas, water, or sewer utility engaged in conducting a business other than a utility business subject to the jurisdiction of this Commission conduct those operations so as "to be substantially kept separate and apart" from its Missouri jurisdictional utility business. In its Case No. EM-2001-464 Application, KCPL stated that the provisions of the Commission's

Affiliate Transactions Rule (4 CSR 240-20.015 and 20.017) detail the requirements the Commission deemed necessary to ensure such separation:

> Sec. 393.140(12) permits electric utilities operating non-jurisdictional businesses to keep those businesses "separate and apart" from their jurisdictional utility businesses. The provisions of 4 CSR 240-20.015 and 20.017 detail the requirements the Commission has deemed necessary to ensure such separation. The proposed reorganization will further separate KCPL's retail electric customers from the Company's other business interests. In the future, those competitive businesses will be conducted in subsidiaries of HoldCo – not in subsidiaries of KCPL. Depending upon the nature of the transaction, and considering the commitments made in the next section of this Application, any significant business dealings between KCPL and its affiliated companies will be subject to review and documentation, and to the approval and/or ratemaking authority of this Commission, the SEC and/or the Federal Energy Regulatory Commission ("FERC"). In addition, KCPL's GSA and CAM, Exhibits 3 and 4, contain accounting procedures that ensure a proper allocation of costs between KCPL and its affiliates.

KCPL/GMO are presently not adequately separated from GPE's other business interests such as GPES.

KCPL - Allconnect Affiliate Transactions Rule Violations

Q. Please state the specific violations of the Rule that have occurred and are currently occurring as a result of the KCPL/Allconnect business relationship.

A. As a result of the transactions that KCPL and GMO have been engaging in with Allconnect since 2013, KCPL and GMO are violating at least nine specific or general standards of the Commission's Affiliate Transactions Rule. The Staff did not raise all of these violations as Counts in its Complaint case because the Staff deemed various of these issues as being more conducive for being addressed in a rate case and the Staff's number one priority in this case is to try to get addressed by the Commission the Allconnect solicitation of KCPL

and GMO's customers and transfer of customer information without the customer's consent.

The Affiliate Transactions Rule violations that are currently taking place are as follows:

> 1. Paragraph (2)(C) Standards - Transfer of specific customer information.
>
> 2. Paragraph (2)(A)(2) Standards – Transfer Pricing
> (2)(A) A regulated electrical corporation shall not provide a financial advantage to an affiliated entity. For the purposes of this rule, a regulated electrical corporation shall be deemed to provide a financial advantage to an affiliated entity if—
>
> * * * *
>
> 2. It transfers information, assets, goods or services of any kind to an affiliated entity below the greater of—
>
> A. The fair market price; or
>
> B. The fully distributed cost to the regulated electrical corporation.
>
> 3. Paragraph (2)(B) Standards – A regulated electrical corporation should not provide any preferential service, information, or treatment to an affiliated entity over another party
>
> 4. Paragraph (2)(D) Standards – Noncomplying Transactions
>
> 5. Paragraph (2)(F) Standards - Marketing Materials
>
> 6. Paragraph (3)(C) Evidentiary Standards
>
> 7. Paragraph (4)(B) Record Keeping Requirements
>
> 8. Paragraph (4)(C) Record Keeping Requirements
>
> 9. Paragraph (5)(A) Record Keeping

Q. Is Staff aware of any contract or agreement where KCPL gave the right to GPES to use any of KCPL's regulated utility assets and employees in transactions with Allconnect?

A. No. Staff does not believe that such an agreement exists. Among the several other concerns about GPES using KCPL and GMO's regulated assets and employees without

a contract or agreement, a major concern is that KCPL is providing a "preferential service" to GPES in violation of Paragraph (2)(B) of the Rule. The Staff is not aware of any contract that between KCPL and GPES or GMO and GPES that allows GPES to use KCPL's or GMO's regulated utility assets and personnel for nonregulated operations. If such a contract exists, it would be required to be submitted each year with KCPL and GMO's affiliate transaction reports. No such contract has been submitted.

Q. In Item No. 3 above you mention "preferential service". What is a "preferential service" and how are KCPL and GMO providing its affiliate GPES with preferential service?

A. Rule Paragraph (1)(H) defines a preferential service as "information or treatment or actions by the regulated electrical corporation which places the affiliated entity at an unfair advantage over its competitors." Rule Paragraph (2)(B) prohibits a utility from providing preferential service to an affiliate.

KCPL and GMO have not allowed, and certainly KCPL and GMO would not allow an unaffiliated business entity use its regulated electric utility assets and utility employees without a written contract or agreement. By allowing GPES to use KCPL and GMO's regulated utility assets and employees, and access to regulated utility customers, especially without a contract or written agreement, KCPL and GMO are providing GPES with preferential service in clear and direct violation of Rule Paragraph (2)(B), which states:

> Except as necessary to provide corporate support functions, the regulated electrical corporation shall conduct its business in such a way as not to provide any preferential service, information or treatment to an affiliated entity over another party at any time.

Q. Why are you not addressing the other Rule violation numbers 4 through 9 in this testimony?

A. Staff believes that Rule violation numbers 4 through 9 above directly result from KCPL management's failure to recognize that the transactions between KCPL and GMO's regulated operations and GPES are affiliated transactions. I have addressed that in part above. Also, Staff believes that once the Commission finds that the KCPL/Allconnect transactions are in fact affiliate transactions as defined by the Rule, KCPL's management should bring its actions, as it relates to these affiliate transactions, into compliance with the Rule. If that does not occur, Staff will address outstanding issues in a future proceeding.

Q. Does GPES using its affiliation with KCPL as a regulated utility to gain access to regulated customer information and assets a serious concern and is contrary to commitments made by KCPL to the Commission in the past?

A. Yes, I believe it is. KCPL and GMO's retail electric customers should be separated from the Company's other business interests, such as GPES. This is a separation that KCPL told that Commission in the past that it will maintain.

Q. Please explain.

A. KCPL noted under Section III page 7 of its EM-2001-4464 Application that Missouri law permits electric utilities operating non-jurisdictional businesses to keep those businesses "separate and apart" from their jurisdictional utility businesses. In its Case No. EM-2001-464 Application KCPL went on to note that the provisions of the Missouri Commission's Affiliate Transactions Rules (4 CSR 240-20.015 and 20.017) detail the requirements the Missouri Commission had deemed necessary to ensure such separation:

> Sec. 393.140(12) permits electric utilities operating non-jurisdictional businesses to keep those businesses "separate and

> apart" from their jurisdictional utility businesses. The provisions of 4 CSR 240-20.015 and 20.017 detail the requirements the Commission has deemed necessary to ensure such separation. The proposed reorganization will further separate KCPL's retail electric customers from the Company's other business interests.

Transfer of Customer Call and Information

Q. Please describe KCPL Rule Violation No. 1, which involves the transfer of the customer call and information without customer consent.

A. Staff Complaint at Paragraph 43 stares that "KCP&L-GMO have violated the Commission's Affiliate Transactions Rule, 4 CSR 240-20.015(2)(C), each time that it transferred a customer's call and information to Allconnect without customer consent."

The Commission's Affiliate Transactions Rule (4 CSR 240-20.015) Paragraph (2)(C), Standards, contains the following three specific requirements related to customer information:

> 1. Specific customer information shall be made available to affiliated or unaffiliated entities only upon consent of the customer or as otherwise provided by law or commission rules or orders.
>
> 2. General or aggregated customer information shall be made available to affiliated or unaffiliated entities upon similar terms and conditions.
>
> 3. The regulated electrical corporation may set reasonable charges for costs incurred in producing customer information.

Q. Do KCPL and GMO provide Allconnect with customer information?

A. Yes, it does. ** _____

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_____ ** Although there is provision for the transfer of an e-mail address from KCPL to Allconnect, apparently, the KCPL customer

NP

service representative does not do so, but the Allconnect representative does attempt to obtain an e-mail address from the new or moving KCPL or GMO customer.[3]

Q. As it relates to the sharing of customer information, it is abundantly clear that 4 CSR 240-20.015 Paragraph (2)(C) imposes the identical requirement on KCPL's management, regardless if the transaction is with an (1) affiliated entity or (2) an unaffiliated entity?

A. In my opinion, yes. The Rule makes these requirements abundantly clear with no room for misinterpretation or utility creativity in interpretation. The requirement applies to transactions or communications that KCPL and GMO, as regulated utilities, engage in with any entity, whether the contact is business, social, civic or charitable in nature. If KCPL and GMO do not obtain the consent of a customer to release customer information, KCPL and GMO are expressly prohibited by the Rule from making that customer information available to any entity – affiliated or unaffiliated.

Q. Despite the clarity of the Rule's Paragraph (2)(C) customer information requirements being applicable to both unaffiliated and affiliated entities, has KCPL and GMO taken the position that the Rule's Paragraph (2)(C) customer information requirements do not apply to unaffiliated entities?

A. Yes. At Paragraph 40 of KCPL and GMO's Answer to Staff Complaint, KCPL admits that the unique customer identifier (confirmation number), customer name, service address, service commencement date and service confirmation number is provided to Allconnect employees. However, in Paragraph 44 KCPL expresses its position that the "Affiliate Transactions Rule was not designed to prohibit utilities from using customer information in utility operations." Appended to the Staff Report, as Attachment 6, is, in part,

[3] *See* Staff Complaint, Appendix 1 Report of Staff's Investigation, footnotes 4 and 62.

a "History of Commission Affiliate Transactions Rule" researched and written by Staff counsel. The adoption of the prohibition regarding the provision of customer information to affiliates and non-affiliates alike without customer consent, was suggested by Union Electric Company, d/b/a Ameren UE/Ameren Missouri in the rulemaking process.[4]

Q. Does the Rule make any distinction between utility or non-utility operations?

A. No. As noted above, the Rule requires specific customer consent before KCPL releases customer information to any entity, whether that entity is not affiliated with KCPL or whether that entity is affiliated with KCPL. The nonregulated/ regulated distinction created by KCPL is not only not mentioned in the Rule, it is clearly not a distinction contemplated by the Rule.

Q. Do you agree with KCPL's assertion that the "Affiliate Transactions Rule was not designed to prohibit utilities from using customer information in utility operations?"

A. No. There are only two types of possible entities with whom KCPL has the potential to share regulated customer information. Those two types of entities are 1) affiliated entities and 2) unaffiliated entities. No other types of entities exist. The Commission's Affiliate Transactions Rule prohibits sharing customer information with both types of entities unless consent is obtained from the customer or unless otherwise allowed by law or Commission rules or orders.

KCPL and GMO have provided nothing to date that would counter the clear meaning of the requirement that KCPL and GMO are specifically prohibited from transferring any specific customer information to any entity, without specific customer consent or as otherwise provided law or Commission rules or orders.

[4] Staff Report, p. 20; See Attachment 6, paragraph at the bottom of p. 3 and pp. 4-5.

Q. Does KCPL state its belief that its transfer of customer information to Allconnect without the customer's consent is consistent with Paragraph (2)(C) of the Affiliate Transactions Rule?

A. Yes. In KCPL witness Darrin Ives' surrebuttal testimony in the 0189 Case, page 8, lines 4-6, he states, "Customer information is transferred to Allconnect by KCP&L and GMO in a manner that the Company believes is consistent with section 2(C) of the affiliate transactions rule."[5]

Q. Did Staff ask KCPL to provide all documentation Mr. Ives relied upon to support his opinion that KCPL's transfer of customer information to Allconnect without the customer's consent is consistent with section 2(C) of the affiliate transactions rule?

A. Yes, in Staff Data Request No. 0024 ("Staff DR 24") in the 0189 Case.

Q. Was KCPL able to provide any documentation to support this position?

A. No.

Q. How did KCPL rationalize that its transfer to Allconnect is in compliance with the rule?

A. In response to Staff DR 24, KCPL reasoned that since it has been providing customer information to non-affiliated entities, such as bill collectors, for a long time and it believes other utilities have done the same, such sharing of customer information without consent is acceptable and in accordance with the Rule. KCPL rationalized that because no other Missouri utility has sought Commission approval to share customer information with non-affiliates, this lack of action and lack of Rule compliance establishes a "past practice". Given this "past practice, under what Mr. Ives refers to as a "common sense" reading of the

[5] Staff Report, p. 21.

Affiliate Transactions Rule, the "limited" customer information provided to Allconnect does not violate the Rule.

Q. Is this argument by KCPL as to why providing customer information to non-affiliates, without customer consent, is not a Rule violation a reasonable argument?

A. No, it is clearly an unreasonable attempt by KCPL to circumvent the clear meaning of the specific provision of the Affiliate Transactions Rule. This is an example why the Rule is so difficult to enforce as the incentives to the utility, KCPL in this case, cause the utility to resort to creative ways to circumvent the requirements of the Rule and to subsidize its nonregulated operations. Basing this interpretation of the clearly-written requirements of a Commission Rule on a history of Missouri utilities' noncompliance with and Staff and Commission non-enforcement of that same Rule paragraph, is, while creative, entirely unreasonable.

Q. In the Staff Complaint filed on May 20, 2015, and the Staff Report appended to it, the Staff provided a detailed description of the transactions between KCPL and GPES under GPES' contract with Allconnect. In summary, when a customer makes a call to KCPL to request new electric service or transfer electric service, A KCPL employee (also acting for GMO) inputs customer information into its customer information system. A KCPL customer service representative then informs the customer that he/she is being transferred to Allconnect in order for the customer's information to be verified and so the customer can be given the confirmation number for the new or transferred electric service. When the customer is told that he/she is being transferred from the KCPL/GMO customer service representative to the Allconnect customer service representative, the impression given to the customer is that the start service / transfer service process is incomplete, as it is the Allconnect customer service

representative that will verify the customer service information and provide the service confirmation number.

The customer is not asked if he/she consents to being transferred to the nonregulated, unaffiliated marketing company, Allconnect. The indication to the customer is that he/she must be transferred to Allconnect to have his/ her information verified and to receive his/her confirmation number for connection of service. The affiliate transaction has in essence already occurred between GPES and KCPL/GMO regarding KCPL/GMO's commitment to GPES to transfer customer calls and customer information to Allconnect.

The Allconnect – GPES contract shows on page 1 that the "Date of Agreement" is April 30, 2013 which is to be deemed the "Effective Date." The Allconnect – GPES contract relates at on page 3, section 3.4 that the Parties are to work together to "ensure that their respective systems will be available and functional to accept testing by April 12, 2013 and for implementation by June 18, 2013." On page 2, the Allconnect – GPES contract states at section 2.7 that the "Implementation Date" means "the date on which KCP&L begins transferring Eligible Customer calls to Allconnect pursuant to the [Allconnect – GPES contract]." It is at the time of the beginning of the transferring of Eligible Customer calls to Allconnect that Allconnect has a financial liability under the Allconnect – GPES contract to compensate KCPL because GPES has no employees.[6]

Q. How does KCPL characterize the service Allconnect provides to KCPL's customers?

[6] Staff Report, pp. 1-2, fn. 3.

A. KCPL said "Allconnect helps customers connect or transfer other services for their homes including home phone, internet, cable and satellite television and home security all in one call by the customer."

Q. Even if these services were needed or even desired by KCPL's customers, can these services be characterized as regulated utility services?

A. No. They are clearly nonregulated services.

Q. What resources does KCPL use to provide these services?

A. As noted above, KCPL uses regulated plant and equipment, such as office space, office equipment, and computers, software, and telecommunications facilities to provide these so-called services. KCPL also uses its regulated utility call center employee to interact with KCPL's regulated customers as a part of the process to provide nonregulated electric utility services. Finally, KCPL devotes highly compensated management resources to oversee KCPL's affiliate transactions with GPES and Allconnect. These highly compensated management employees who are employed specifically and primarily to provide regulated utility services are being tasked by GPES, a nonregulated affiliate, to provide nonregulated services for a nonregulated affiliated marketing company.

Q. When KCPL engages in nonregulated transactions, as it is doing here with GPES, and associating with marketing firms such as Allconnect, does this take away or result in a decreased level of KCPL management focus on its regulated retail customers?

A. Yes. That is clearly a concern with utility ventures into nonregulated operations and an additional concern with utility affiliate transactions. Utility companies, including KCPL have historically ventured into nonregulated activities only to have

unsuccessful experiences and ultimately return to their core competencies, which is the operation of a regulated utility.

KCPL has had several failed nonregulated ventures and GMO, under its former ownership, had major non-utility business failures when it ventured away from core utility operations and into nonregulated utility operations.

One of Kansas' largest electric utilities, Western Resources, Inc. ("WRI" or "WR") has also failed when it ventured into nonregulated operations. After the Kansas Corporation Commission ("KCC") got involved with investigations on the impact of WRI's nonregulated business failures on regulated customers, WRI eventually agreed to return to its core utility roots.

When a regulated utility gets involved in nonregulated operations and in a business where its management has no expertise, bad things usually happen. One of the main bad things that often, if not always, happen is that the regulated utility customers receive less or not as good customer service and are leveraged (as in the case with GPES and Allconnect) for nonregulated operations. Things do not usually improve for the utility customer until the utility realizes its mistakes and returns to its core operations. This concept of returning to core utility functions and focus on utility customers and operations is explained in the testimony of Dr. Charles J. Cicchetti in his direct testimony in KCC Docket No. 01-WRSE-949-GIE, WRI filed on June 19, 2001. As discussed by Dr. Cicchetti, this concept is not unique to regulated utilities but to competitive firms as well.

Q. Who is Dr. Cicchetti?

A. Dr. Cicchetti is a co-founding member of Pacific Economics Group. He is also a Professor of Economics at the University of Southern California. Dr. Cicchetti is a

former Chairman of the Wisconsin Public Service Commission and former director of the Wisconsin Energy Office. Dr. Cicchetti appeared in KCC Docket No. 01-WRSE-949-GIE on behalf of the utility, WRI.

Q. What point did Dr. Cicchetti make with regard to the impact of a utility's nonregulated ventures on regulated customers?

A. His point was simple and clear. When a utility strays away from regulated operations it decreases its focus on regulated customers. This is what is referred to as a detriment. It is almost impossible for utility management to engage in more and more nonregulated operations and maintain the necessary and appropriate focus on utility customers. At pages 11-13 of his direct testimony in KCC Docket No. 01-WRSE-949-GIE, Dr. Cicchetti explains:

> Q. DO TRANSACTIONS WITH SIMILAR CHARACTERISTICS OCCUR IN THE UNREGULATED SECTOR OF THE ECONOMY?
>
> A. Yes. Often, corporate restructuring in the United States involves corporate spinoffs or asset sales. Such corporate restructuring often reverses previous attempts to combine diverse businesses under one highly diversified corporate form of ownership. Often, the strategic purpose is to focus on core competencies.
>
> In effect, WR's restructuring and proposed combination of its electric utility business with PNM is a plan to focus and concentrate exclusively on the electricity needs of its retail electric consumers. I find similarities here with decisions made in the unregulated sector of our economy, where some businesses decide to change past diversification strategies and concentrate on a single core business. In Kansas, I conclude that this is precisely what WR is proposing to do. The beneficiaries of this action will be the Kansas retail electric customers.
>
> Q. ARE THERE ANY OTHER EXAMPLES OF CORPORATE RESTRUCTURING THAT ARE SIMILAR TO WR'S PROPOSALS?

A. Yes. Spin-offs are rather common. Some of the more famous ones in the past decade have also involved a reduction in the degree of corporate diversification. Four come quickly to mind:

* Sears Roebuck spun off its insurance subsidiary in 1995 to its shareholders. This change meant that Sears could concentrate on its core retail business.

* AT&T spun off Lucent and NCR in 1996. These changes meant AT&T could concentrate on its core retail consumers.

* General Motors spun off its consulting and computer services business EDS in 1996 to concentrate on its retail automobile business.

* Southern Company spun off Mirant, a worldwide electric generating entity, after an IPO for Mirant in 2001. This spilt-off means that Southern can concentrate on meeting its retail customers' electricity needs in the southeast.

In each example, diversification was reduced, core competency was elevated in importance **and retail consumers received more direct and universal attention.**

In addition to spin-offs, there are also carve-outs or sales in public offerings, rather than distributing shares to existing shareholders. For example, businesses sometimes create different classes of stock or sell shares held in other businesses to reduce their diversified holdings and raise cash to focus on core competencies. (Emphasis added).

As I discuss below, UtiliCorp sold a portion of Aquila, an energy trading company, to the public in 2001. Alliant Energy is doing this with shares it holds in a telecommunication company. Georgia Pacific has also done this for its Timber Group.

This proceeding need not concentrate on U.S. corporate financial history. Instead, the Commission should realize that WR's proposals are not unique or overly complex. **There are many precedents for such transactions, and they often yield**

significant benefits for the ultimate customer by refocusing on the core business. (Emphasis added).

Q. Do KCPL and GMO's nonregulated business ventures with GPES and Allconnect distract KCPL management from providing quality customer service and full attention to regulated customers?

A. Yes. KCPL does not need to be providing regulated electric utility customers with non-utility goods and services such as home security, Cable TV and internet services. It needs to focus on providing the best electric utility service it can. Staff witness Lisa A. Kremer addresses this issue of customer services in her direct testimony.

Q. When KCPL contracts with other companies to provide goods and services that are, in fact, goods and services necessary for the provision of utility services, does it sign contracts itself, as a regulated utility?

A. Yes. I have reviewed many contracts entered into by KCPL and signed by KCPL management over the years. These contracts were to obtain goods and services necessary to provide regulated utility service. With the dozens of contracts I have reviewed over the past almost 10 years, I do not recall ever viewing a contract signed by GPES or any GPE affiliate that seeks to obtain regulated goods or services for KCPL. KCPL is a regulated utility that is more than capable of entering into contracts and agreements for it to obtain regulated goods and services.

Q. Does your experience with KCPL as a regulated utility contradict the assertion made by KCPL that its relationship with Allconnect is related to regulated operations?

A. Yes. In my opinion this is just an effort to have the regulated utility subsidize nonregulated activities.

Q. The Staff Report and the Staff Complaint address, and you make the point in this testimony that the Allconnect-GPES contract is not directly between the regulated utilities KCPL/GMO and Allconnect but between KCPL/GMO and GPES in GPES's contractual arrangement with Allconnect. Is that correct?

A. Yes. The relationships are first between KCPL/GMO and GPES, and GPES and Allconnect, and then second between KCPL/GMO and Allconnect. Although the Allconnect-GPES contract involves GPES and Allconnect, there is also a transaction between the affiliates KCPL/GMO and GPES, and, as a consequence, there is an affiliate transaction as defined in the Affiliate Transactions Rule.

Q. Is there another Missouri statutory section that is relevant to KCPL and GMO's Allconnect activity?

A. Yes, Section 393.190.1 RSMo. The Missouri retail customer phone calls and the Missouri retail customer information are part of KCPL/GMO's works or system necessary or useful in the performance of KCPL/GMO's duties to the public, pursuant to Section 393.190.1. The Commission determined in *Re Kansas City Power & Light Co., Order Establishing Jurisdiction And Clean Air Act Workshops*, Case No. EO-92-250, 1 Mo.P.S.C.3d 359, 362 (August 26, 1992) that SO2 emission allowances under the federal Clean Air Act Amendments of 1990 are necessary and useful in the performance of KCPL's duties to the public and are part of KCPL's "system," and any sale or transfer of these allowances is void without prior Commission approval, pursuant to Section 393.190.1 RSMo. The Commission stated that "a utility's system is greater than the physical parts which would be its 'works.' A utility's system is the whole of its operations which are used to meet its obligations to provide service to its customers."

The Staff Complaint concerns the transfer from KCPL/GMO to Allconnect of Missouri retail customer phone calls and Missouri retail customer information without the prior authorization of the Commission, as required pursuant to Section 393.190.1. Allconnect is willing to pay for access to each new or transferring residential service KCPL/GMO customer and his/her customer information, which for a fee is transferred by a KCPL/GMO customer service representative to an Allconnect customer service representative. This fee is regardless of whether or not the customer purchases any Allconnect services.

Q. Is the compensation received from Allconnect for the use of regulated assets and regulated utility employees reflected in KCPL or GMO's regulated books and records?

A. No. This revenue is recorded outside KCPL/GMO's regulated costs to serve its customers and provides no value to its regulated operations for the call and customer information transferred to Allconnect. The revenue generated solely by the regulated utility and its regulated electric customers does not benefit the regulated utility. That arrangement, as discussed above, is improper, imprudent on the part of KCPL management for allowing it to occur, and a very significant violation of the Affiliate Transactions Rule's pricing standards.

Q. Given that the transactions – the provision of goods and services to Allconnect by KCPL/GMO through GPES - are affiliate transactions, how do the affiliated transaction pricing requirements reflected in the Affiliate Transactions Rule paragraph (2)(A)(2) apply to these transactions?

A. As I noted earlier in this testimony, KCPL and GMO's dealings with GPES in GPES' fulfillment of its contract responsibilities with Allconnect results in several Rule violations. One of these Rule violations is a violation of the affiliate transaction pricing

(also known as "transfer pricing") standards reflected in Rule's Paragraph 2(A)(2). By KCPL's management decision to not apply these pricing standards to affiliate transaction; they are, by definition providing GPES with a "financial advantage" that is expressly prohibited by the Rule.

Rule Paragraph 2(A)(2) requires that regulated electrical corporation shall not provide a financial advantage to an affiliated entity. For the purposes of this rule, a regulated electrical corporation shall be deemed to provide a financial advantage to an affiliated entity if it transfers information, assets, goods or services of any kind to an affiliated entity below the greater of the a) fair market price; or b) fully distributed cost incurred by the utility to produce the good or service for itself. The Commission deems that a financial advantage occurs when a utility engages in a transaction with an affiliate in which it does not employ the Rule's affiliate transaction pricing standard.

The Rule is designed to prevent a regulated utility from providing a financial advantage to a nonregulated affiliate because there is a great risk of affiliate subsidization inherent in affiliate transactions and because agreements between a public utility and its affiliates are not "made at arm's length" or on an open market. Arm's length transactions are defined as "dealings between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power."

Paragraph (2)(A)(2) requires that whenever KCPL transfers any kind of information, asset, good, or service to its affiliate GPES, in order not to provide GPES with a prohibited financial advantage, it must charge GPES the greater of the FMP or its FDC to produce the good or provide the service. The "information" is the customer information that is provided to Allconnect. Customer information, such as a customer list, is considered an

intangible asset. Services include the services KCPL's regulated customer service personnel provide by promoting Allconnect to customers and making a transfer of customers' calls to Allconnect customer service representatives.

KCPL's regulated customer information has value; in fact, the value of this asset is the only reason that Allconnect partners with GPES. Allconnect pays for the asset – the ability to gain access to KCPL/GMO's receipt of regulated utility customer calls and information given that these customers are in the process of relocating and have the possibility of seeking new or different consumer services than they presently have. The phone call, relocation, and other customer information is a time-sensitive intangible asset that is owned or controlled by KCPL/GMO and is transferred at no cost to GPES, a nonregulated affiliate.

Phone Access, Customer Information/ Are Intangible Assets

Q. What is an intangible asset?

A. An intangible asset is an asset that generally lacks physical substance; you cannot touch an intangible asset. Some examples of intangible assets are copyrights, patents, mailing lists, customer lists, trademarks, brand names, domain names, and so on. Accounting principles require that intangible assets be reported on a company's balance sheet at cost or less. Because of the Missouri Telemarketing and/or No-Call Statutes GPES is selling access to KCPL/GMO's customers and their information. However, since many intangible assets, such as access to KCPL/GMO's customers and their information generally are not purchased, they do not have a reportable cost and are not officially reported as assets on KCPL or GMO's balance sheet.

Q. Is regulated utility customer access and regulated utility customer information, such as name and address, email address, future mailing addresses, relocation dates, etc., of KCPL/GMO customers considered assets of KCPL/GMO?

A. Yes, they are assets. Technically they are intangible assets and have considerable value. These assets -- regulated customer access and regulated customer information -- are the essential assets that are "exchanged" between KCPL and GPES and provided by GPES to Allconnect in return for cash.

Q. What is the definition of an asset?

A. The most commonly accepted definition of an asset in the accounting profession can be found in the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements ("CON 6"). In CON 6, assets are defined as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."

In an October 20, 2008 Joint Meeting of the FASB and the International Accounting Standards Board (IASB), FASB and IASB tentatively adopted the following working definition of an asset as a part of their joint project on the Accounting conceptual framework:

> Definition of an Asset
>
> "An asset of an entity is a present economic resource to which the entity has a right or other access that others do not have."
>
> 1. Present means that on the date of the financial statements both the economic resource exists and the entity has the right or other access that others do not have.
>
> 2. An economic resource is something that is scarce and capable of producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources. Economic resources that arise from contracts and other binding arrangements are unconditional promises and other abilities to require provision of economic resources, including through risk protection.

> 3. A right or other access that others do not have enables the entity to use the economic resource and its use by others can be precluded or limited. A right or other access that others do not have needs to be enforceable by legal or equivalent means.

Q. Based on FASB's definition of an asset and the proposed joint FASB/IASB definition are KCPL/GMO's customer information and customer access intangible assets?

A. Yes. A simple reading of these definitions is all that is needed to easily conclude that access to the regulated utility customer and the customer information that are being sold by GPES to Allconnect are regulated utility assets owned and controlled by KCPL/GMO. These are regulated utility assets that are necessary for KCPL/GMO to operate as public utilities and provide customer service and customer relocation services to its regulated customers. These assets are not owned or controlled by the nonregulated business operations of GPE.

Prudency of KCPL Management's Decision to Associate its Regulated Utility Operations with Allconnect

Q. Does GPES as an unregulated affiliate company of KCPL/GMO have any obligation to look at the interests of KCPL's ratepayers?

A. I am not an attorney so I am not able to speak on any legal responsibilities. However, I am aware that the Missouri Court of Appeals in *State ex rel. Public Counsel v. Public Serv. Commn*, 274 S.W.3d 569, 582 (Mo.App. W.D. 2009) held forcing the unregulated affiliate's Board to lose out on profits by selling its electricity to the utility at cost instead of selling it on the open market likely would have resulted in the Board violating its fiduciary duty under state law to manage the unregulated corporate business solely in accord with the unregulated corporation's interest. The nonregulated corporation's interest is to

maximize its profit and the inference here by the Missouri Court of Appeals is that it had no responsibility to regulated utility ratepayers.

Unlike KCPL and GMO, GPES or GPE, as unregulated affiliates, do not have a fiduciary responsibility to KCPL and GMO's ratepayers. GPE and GPES certainly reflect this lack of responsibility in how they treat KCPL and GMO's regulated operations in this Allconnect relationship. However, the issues in this Staff Complaint are not with GPES or GPE but with KCPL's management of its and GMO's regulated operations. By allowing its involvement in the present GPES-Allconnect contractual relationship, it is acting in manner that is detrimental to KCPL and GMO's customers, both from a customer service standpoint in unsolicited and forced transfers of regulated customers and their information to an unregulated marketing company and the use of regulated rate base plant in service assets and regulated utility employees in the process.

Q. Do you believe that it would be imprudent for utility management to not charge affiliated or unaffiliated entities for the use of regulated utility assets and for services provided by regulated utility personnel?

A. Yes. In this case, KCPL is not charging either its affiliate GPES or its affiliate's business partner, Allconnect, for the use of regulated utility assets and for the services provided by regulated utility employees. Therefore, KCPL's management is imprudent in this regard.

Q. Do you also believe that it is imprudent for utility management to make a conscious decision not to request any compensation for the use of the rate base assets and the services provided by utility personnel?

A. Yes, I do. To the extent that KCPL management (as opposed to GPE management) do not charge nonregulated operations a fair market price for the use of KCPL's and GMO's regulated rate base assets and the services of regulated utility employees, they acted in an imprudent manner by subsidizing nonregulated operations. There is no question that the primary role of utility management is to provide safe and reliable utility service at reasonable utility rates. Utility rates that reflect the provision of utility goods and services to an affiliated or an unaffiliated entity at no charge violate the role and obligation of utility management not to subsidize nonregulated operations.

Q. Are you suggesting that KCPL management was imprudent for entering into the 2013 relationship with Allconnect?

A. To the extent utility management had any influence in the decision, and supported GPES entering into an agreement with Allconnect on behalf of KCPL and GMO, then yes, KCPL's management was imprudent in this decision. In my opinion, if KCPL's management had a serious concern about the treatment of its customers, it would not mislead its customers into thinking the transfer to Allconnect is a necessary regulated operation, it would not force its customers to be subject to Allconnect's high-pressure marketing techniques, and it would not act in a detrimental manner to its customers by subsidizing its nonregulated affiliate – GPE by not seeking any compensation for the use of utility assets and personnel.

Q. Does this conclude your direct testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

Staff the Missouri Public Service Commission, Complainant, vs. Kansas City Power & Light Company and KCP&L Greater Missouri Operations Company, Respondents	)))))	Case No. EC-2015-0309

AFFIDAVIT OF CHARLES R. HYNEMAN

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

COMES NOW CHARLES R. HYNEMAN and on his oath declares that he is of sound mind and lawful age; that he contributed to the foregoing Direct Testimony; and that the same is true and correct according to his best knowledge and belief.

Further the Affiant sayeth not.

Ch. R. Hyn

CHARLES R. HYNEMAN

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 21st day of August, 2015.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

D Suzie Mankin

Notary Public

Charles R. Hyneman

Educational and Employment Background and Credentials

I am employed as a Utility Regulatory Auditor V for the Missouri Public Service Commission (Commission). Prior to serving with the Commission I served 12 years on active duty in the United States Air Force in the Defense Contracting (Procurement), Missile Operations and Training career fields. My experience in defense contracting included the contract administration of construction and services contracts in accordance with the Defense Acquisition Regulation (DAR) and the Federal Acquisition Regulation (FAR). I was commissioned as an officer in the United States Air Force (USAF) in May 1985 and promoted to the rank of Captain in 1989. I was honorably discharged from the USAF in December 1992 and joined the Commission Staff in April 1993.

I have 20 years of experience in the field of utility rate regulation. During my tenure at the Commission I have been involved in and testified before the Commission in numerous utility rate cases involving all aspects of utility cost of service revenue requirements. In addition, I have served as a Commission Staff expert witness in mergers and acquisitions cases focusing on the areas of acquisition premium calculations and acquisition adjustment rate recognition.

I have also served as a Staff expert witness in the areas of natural gas hedging activities, including reviews and analyses of utility hedging programs, and prudence issues related to hedging costs in Commission Fuel Adjustment Clause (FAC) cases and. More recently I have been the lead Staff auditor and expert witness in major electric utility construction projects and Commission Infrastructure System Replacement Surcharge (ISRS) cases.

I graduated with distinction from Indiana State University in 1985 with a dual major Bachelor of Science degree in Accounting and Business Administration. In 1988, I received a Masters in Business Administration from the University of Missouri—Columbia. For the past 20 years I have been a licensed Certified Public Accountant (CPA) licensed in Missouri.

CHARLES R. HYNEMAN

CASE PARTICIPATION

Date Filed	Case Name	Case Number	Issue	Exhibit
7/07/15	Kansas City Power & Light Company	ER-2014-0370	La Cygne Construction Audit	True-Up Direct
6/05/15	Kansas City Power & Light Company	ER-2014-0370	Corporate Allocation Affiliate Transactions	Surrebuttal
5/07/15	Kansas City Power & Light Company	ER-2014-0370	Regulatory Lag	Rebuttal
4/03/15	Kansas City Power & Light Company	ER-2014-0370	Corporate Allocation Affiliate Transactions Officer Expenses	Staff Report - Revenue Requirement - Cost of Service
3/31/15	Missouri Gas Energy	GO-2015-0179	Infrastructure system replacement surcharge (ISRS)	Staff Recommendation
3/31/15	Laclede Gas Company	GO-2015-0178	Infrastructure system replacement surcharge (ISRS)	Staff Recommendation
11/13/14	Missouri American Water Company	WO-2015-0059	Infrastructure system replacement surcharge (ISRS)	Staff Recommendation
9/23/14	Laclede Gas Company	GR-2015-0026	Infrastructure system replacement surcharge (ISRS)	Staff Recommendation
9/23/14	Missouri Gas Energy	GR-2015-0025	Infrastructure system replacement surcharge (ISRS)	Staff Recommendation
6/20/14	Kansas City Power and Light Company, Kansas City Power and Light Company-Greater Missouri Operations, Transource Missouri	EO-2014-0189	Affiliate Transactions - Staff submission of Proposed Cost Allocation Manual for KCPL and GMO	Rebuttal
01/30/2013	Kansas City Power and Light Company, Kansas City Power and Light Company-Greater Missouri Operations, Transource Missouri	EA-2013-0098 EO-2012-0367	KCPL/GMO Transfer of SPP Transmission Project NTCs to Transource Missouri, Waiver of Missouri PSC Affiliate Transaction Rules	Rebuttal

CHARLES R. HYNEMAN

CASE PARTICIPATION

Date Filed	Case Name	Case Number	Issue	Exhibit
10/10/2012	Kansas City Power and Light Company-Greater Missouri Operations, Transource Missouri	ER-2012-0175	Fuel Adjustment Clause Deferred Taxes, Hedge Settlements, FAS 87 Pension Plan Actuarial Assumptions, Supplemental Executive Retirement Plan (SERP), Southwest Power Pool Transmission Expenses, Regulatory Lag	Surrebuttal
09/12/2012	Kansas City Power and Light Company-Greater Missouri Operations, Transource Missouri	ER-2012-0175	Regulatory Lag	Rebuttal
08/13/2012	Kansas City Power and Light Company-Greater Missouri Operations, Transource Missouri	ER-2012-0175	Income Tax Expense, Accumulated Deferred Income Taxes, FAS 87 Pension costs, FAS 106 OPEBs, Supplemental Executive Retirement Plan (SERP), Organizational Realignment/Voluntary Separation (ORVS), Regulatory Lag, SPP Admin Fees, Transmission Expense, Hedge Settlements	Direct
10/08/2012	Kansas City Power and Light Company	ER-2012-0174	Kansas City Income Tax Expense, FAS 87 Pension costs, FAS 106 OPEBs, Supplemental Executive Retirement Plan (SERP), Southwest Power Pool Transmission Expenses Iatan 2 Advanced Coal Tax Credit	Surrebuttal
09/05/2012	Kansas City Power and Light Company	ER-2012-0174	Regulatory Lag	Rebuttal

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Date Filed	Case Name	Case Number	Issue	Exhibit
08/02/2012	Kansas City Power and Light Company	ER-2012-0174	Income Tax Expense, Accumulated Deferred Income Taxes, FAS 87 Pension costs, FAS 106 OPEBs, Supplemental Executive Retirement Plan (SERP), Organizational Realignment/Voluntary Separation (ORVS), Regulatory Lag, SPP Admin Fees, Transmission Expense	Direct
03/21/2012	Kansas City Power and Light Company-Greater Missouri Operations	EO-2011-0390	GMO Hedging Rate Case History, Accounting for Hedging Activities	Rebuttal
05/12/11	Laclede Gas Company	GC-2011-0098	Affiliate Transactions	Surrebuttal
04/28/11	The Empire District Electric Company	ER-2011-0004	Iatan 2 Project Construction Disallowances	Surrebuttal
04/19/11	Laclede Gas Company	GC-2011-0098	Affiliate Transactions	Rebuttal
03/22/11	Laclede Gas Company	GC-2011-0098	Affiliate Transactions	Direct
02/25/11	The Empire District Electric Company	ER-2011-0004	Iatan 1 and Iatan 2 and Common Plant Construction Audit and Prudence Review	Staff's Construction Audit And Prudence Review Of Iatan Construction Project For Costs Reported As Of October 31, 2010
02/23/11	The Empire District Electric Company	ER-2011-0004	Generally Accepted Auditing Standards (GAAS)/ Iatan 1 and Iatan 2 and Common Construction Audit and Prudence Review/Plum Point Construction Audit and Prudence Review	Direct
02/23/11	The Empire District Electric Company	ER-2011-0004	Staff's Construction Audit and Prudence Review of Plum Point	Cost of Service Report
02/22/11	Kansas City Power and Light Company-Greater Missouri Operations	ER-2010-0356	Iatan Construction Audit and Prudence Review	True-Up Direct

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Date Filed	Case Name	Case Number	Issue	Exhibit
02/22/11	Kansas City Power and Light Company	ER-2010-0355	Iatan Construction Audit and Prudence Review	True-Up Direct
01/12/11	Kansas City Power and Light Company-Greater Missouri Operations	ER-2010-0356	Iatan Construction Project	Surrebuttal
01/05/11	Kansas City Power and Light Company	ER-2010-0355	Iatan Construction Project	Surrebuttal
12/15/10	Kansas City Power and Light Company-Greater Missouri Operations	ER-2010-0356	Iatan Construction Project	Rebuttal
12/08/10	Kansas City Power and Light Company	ER-2010-0355	Iatan Construction Project	Rebuttal
11/18/2010	Kansas City Power and Light Company-Greater Missouri Operations	ER-2010-0356	Iatan Construction Project	Cost of Service Report
11/17/10	Kansas City Power and Light Company-Greater Missouri Operations	ER-2010-0356	Overview Iatan Unit 1 AQCS, Iatan 2 and Iatan Common Plant; GAAS	Direct
11/10/10	Kansas City Power and Light Company	ER-2010-0355	Overview Iatan Unit 1 AQCS, Iatan 2 and Iatan Common Plant; GAAS	Direct
11/10/2010	Kansas City Power and Light Company	ER-2010-0355	Iatan Construction Project	Cost of Service Report
11/04/10	Kansas City Power and Light Company-Greater Missouri Operations	ER-2010-0356	Iatan 1 and Iatan 2 and Common Plant Construction Audit and Prudence Review	Staff's Construction Audit And Prudence Review Of Iatan Construction Project For Costs Reported As Of June 30, 2010
11/04/10	Kansas City Power and Light Company	ER-2010-0355	Iatan 1 and Iatan 2 and Common Plant Construction Audit and Prudence Review	Staff's Construction Audit And Prudence Review Of Iatan Construction Project For Costs Reported As Of June 30, 2010

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Date Filed	Case Name	Case Number	Issue	Exhibit
08/06/2010	Kansas City Power and Light Company-Greater Missouri Operations	ER-2010-0356	Iatan 1 AQCS Construction Audit and Prudence Review	Staff's Construction Audit And Prudence Review Of Iatan 1 Environmental Upgrades (Air Quality Control System - AQCS) For Costs Reported As Of April 30, 2010
08/06/2010	Kansas City Power and Light Company	ER-2010-0355	Iatan 1 AQCS Construction Audit and Prudence Review	Staff's Construction Audit And Prudence Review Of Iatan 1 Environmental Upgrades (Air Quality Control System - AQCS) For Costs Reported As Of April 30, 2010
01/01/2010	Kansas City Power and Light Company-Greater Missouri Operations	ER-2009-0090	Iatan 1 AQCS Construction Audit and Prudence Review	Staff's Report Regarding Construction Audit and Prudence Review of Environmental Upgrades to Iatan 1 and Iatan Common Plant
12/31/2009	Kansas City Power and Light Company	ER-2009-0089	Iatan 1 AQCS Construction Audit and Prudence Review	Staff's Report Regarding Construction Audit and Prudence Review of Environmental Upgrades to Iatan 1 and Iatan Common Plant

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Date Filed	Case Name	Case Number	Issue	Exhibit
04/09/2009	Kansas City Power and Light Company-Greater Missouri Operations	ER-2009-0090	Transition costs, SJLP SERP, Acquisition Detriments, Capacity Costs, Crossroads Deferred Taxes	Surrebuttal
04/07/2009	Kansas City Power and Light Company	ER-2009-0089	Transition Costs, Talent Assessment Program, SERP, STB Recovery, Settlements, Refueling Outage, Expense Disallowance	Surrebuttal
03/13/2009	Kansas City Power and Light Company-Greater Missouri Operations	ER-2009-0090	Crossroads Energy Center, Acquisition Saving and Transition Cost Recovery	Rebuttal
03/11/2009	Kansas City Power and Light Company	ER-2009-0089	KCPL Acquisition Savings and Transition Costs	Rebuttal
02/27/2009	Kansas City Power and Light Company-Greater Missouri Operations	ER-2009-0090	Various Ratemaking issues	Cost of Service Report
02/11/2009	Kansas City Power and Light Company	ER-2009-0089	Corporate Costs, Merger Costs, Warranty Payments	Cost of Service Report
09/24/2007	Kansas City Power and Light Company	ER-2007-0291	Miscellaneous A&G Expense	Surrebuttal
07/24/2007	Kansas City Power and Light Company	ER-2007-0291	Miscellaneous	Cost of Service Report
07/24/2007	Kansas City Power and Light Company	ER-2007-0291	Talent Assessment, Severance, Hawthorn V Subrogation Proceeds	Direct
03/20/2007	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P	ER-2007-0004	Hedging Policy Plant Capacity	Surrebuttal
02/20/2007	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P	ER-2007-0004	Natural Gas Prices	Rebuttal
01/18/2007	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P	ER-2007-0004	Fuel Prices Corporate Allocation	Direct
11/07/2006	Kansas City Power and Light Company	ER-2006-0314	Fuel Prices	True-Up

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Date Filed	Case Name	Case Number	Issue	Exhibit
10/06/2006	Kansas City Power and Light Company	ER-2006-0314	Severance, SO_2 Liability, Corporate Projects	Surrebuttal
08/08/2006	Kansas City Power and Light Company	ER-2006-0314	Fuel Prices Miscellaneous Adjustments	Direct
12/13/2005	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P	ER-2005-0436	Natural Gas Prices; Supplemental Executive Retirement Plan Costs; Merger Transition Costs	Surrebuttal
12/13/2005	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P	HR-2005-0450	Natural Gas Prices; Supplemental Executive Retirement Plan Costs; Merger Transition Costs	Surrebuttal
11/18/2005	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P	ER-2005-0436	Natural Gas Prices	Rebuttal
10/14/2005	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P	ER-2005-0436	Corporate Allocations, Natural Gas Prices Merger Transition Costs	Direct
10/14/2005	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P	HR-2005-0450	Corporate Allocations, Natural Gas Prices Merger Transition Costs	Direct
02/15/2005	Missouri Gas Energy	GU20050095	Accounting Authority Order	Direct
01/14/2005	Missouri Gas Energy	GU20050095	Accounting Authority Order	Direct
06/14/2004	Missouri Gas Energy	GR20040209	Alternative Minimum Tax; Stipulation Compliance; NYC Office; Executive Compensation; Corporate Incentive Compensation; True-up Audit; Pension Expense; Cost of Removal; Lobbying.	Surrebuttal
04/15/2004	Missouri Gas Energy	GR20040209	Pensions and OPEBs; True-Up Audit; Cost of Removal; Prepaid Pensions; Lobbying Activities; Corporate Costs; Miscellaneous Adjustments	Direct

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Date Filed	Case Name	Case Number	Issue	Exhibit
02/13/2004	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P	HR20040024	Severance Adjustment; Supplemental Executive Retirement Plan; Corporate Cost Allocations	Surrebuttal
02/13/2004	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P	ER20040034	Severance Adjustment; Corporate Cost Allocations; Supplemental Executive Retirement Plan	Surrebuttal
01/06/2004	Aquila, Inc.	GR20040072	Corporate Allocation Adjustments; Reserve Allocations; Corporate Plant	Direct
12/09/2003	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P	HR20040024	Current Corporate Structure; Aquila's Financial Problems; Aquila's Organizational Structure in 2001; Corporate History; Corporate Plant and Reserve Allocations; Corporate Allocation Adjustments	Direct
12/09/2003	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P	ER20040034	Corporate Plant and Reserve Allocations; Corporate Allocation Adjustments; Aquila's Financial Problems; Aquila's Organizational Structure in 2001; Corporate History; Current Corporate Structure	Direct
03/17/2003	Southern Union Co. d/b/a Missouri Gas Energy	GM20030238	Acquisition Detriment	Rebuttal
08/16/2002	The Empire District Electric Company	ER2002424	Prepaid Pension Asset; FAS 87 Volatility; Historical Ratemaking Treatments-Pensions & OPEB Costs; Pension Expense-FAS 87 & OPEB Expense-FAS 106; Bad Debt Expense; Sale of Emission Credits; Revenues	Direct
04/17/2002	UtiliCorp United, Inc. d/b/a Missouri Public Service & St. Joseph Light & Power	GO2002175	Accounting Authority Order	Rebuttal

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Date Filed	Case Name	Case Number	Issue	Exhibit
01/22/2002	UtiliCorp United, Inc. d/b/a Missouri Public Service	ER2001265	Acquisition Adjustment	Surrebuttal
01/22/2002	UtiliCorp United, Inc. d/b/a Missouri Public Service	EC2001265	Acquisition Adjustment; Corporate Allocations;	Surrebuttal
01/08/2002	UtiliCorp United, Inc. d/b/a Missouri Public Service	EC2002265	Acquisition Adjustment	Rebuttal
01/08/2002	UtiliCorp United, Inc. d/b/a Missouri Public Service	ER2001672	Acquisition Adjustment	Rebuttal
12/06/2001	UtiliCorp United, Inc. d/b/a Missouri Public Service	ER2001672	Corporate Allocations	Direct
12/06/2001	UtiliCorp United, Inc. d/b/a Missouri Public Service	EC2002265	Corporate Allocations	Direct
04/19/2001	Missouri Gas Energy, a Division of Southern Union Company	GR2001292	Revenue Requirement; Corporate Allocations; Income Taxes; Miscellaneous Rate Base Components; Miscellaneous Income Statement Adjustments	Direct
11/30/2000	Holway Telephone Company	TT2001119	Revenue Requirements	Rebuttal
06/21/2000	UtiliCorp United, Inc. / The Empire District Electric Company	EM2000369	Merger Accounting Acquisition	Rebuttal
05/02/2000	UtiliCorp United, Inc. / St. Joseph Light and Power	EM2000292	Deferred Taxes; Acquisition Adjustment; Merger Benefits; Merger Premium; Merger Accounting; Pooling of Interests	Rebuttal
03/01/2000	Atmos Energy Company and Associated Natural Gas Company	GM2000312	Acquisition Detriments	Rebuttal

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Date Filed	Case Name	Case Number	Issue	Exhibit
09/02/1999	Missouri Gas Energy	GO99258	Accounting Authority Order	Rebuttal
04/26/1999	Western Resources Inc. and Kansas City Power and Light Company	EM97515	Merger Premium; Merger Accounting	Rebuttal
07/10/1998	Missouri Gas Energy, a Division of Southern Union Company	GR98140	SLRP AAOs; Reserve; Deferred Taxes; Plant	True-Up
05/15/1998	Missouri Gas Energy, a Division of Southern Union Company	GR98140	SLRP AAOs; Automated Meter Reading (AMR)	Surrebuttal
04/23/1998	Missouri Gas Energy, a Division of Southern Union Company	GR98140	Service Line Replacement Program; Accounting Authority Order	Rebuttal
03/13/1998	Missouri Gas Energy, a Division of Southern Union Company	GR98140	Miscellaneous Adjustments; Plant; Reserve; SLRP; AMR; Income and Property Taxes;	Direct
11/21/1997	UtiliCorp United, Inc. d/b/a Missouri Public Service	ER97394	OPEB's; Pensions	Surrebuttal
08/07/1997	Associated Natural Gas Company, Division of Arkansas Western Gas Company	GR97272	FAS 106 and FAS 109 Regulatory Assets	Rebuttal
06/26/1997	Associated Natural Gas Company, Division of Arkansas Western Gas Company	GR97272	Property Taxes; Store Expense; Material & Supplies; Deferred Tax Reserve; Cash Working Capital; Postretirement Benefits; Pensions; Income Tax Expense	Direct
10/11/1996	Missouri Gas Energy	GR96285	Income Tax Expense; AAO Deferrals; Acquisition Savings	Surrebuttal
09/27/1996	Missouri Gas Energy	GR96285	Income Tax Expense; AAO Deferrals; Acquisition Savings	Rebuttal
08/09/1996	Missouri Gas Energy	GR96285	Income Tax Expense; AAO Deferrals; Acquisition Savings	Direct

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Date Filed	Case Name	Case Number	Issue	Exhibit
05/07/1996	Union Electric Company	EM96149	Merger Premium	Rebuttal
04/20/1995	United Cities Gas Company	GR95160	Pension Expense; OPEB Expense; Deferred Taxes; Income Taxes; Property Taxes	Direct
05/16/1994	St. Joseph Light & Power Company	HR94177	Pension Expense; Other Postretirement Benefits	Direct
04/11/1994	St. Joseph Light & Power Company	ER94163	Pension Expense; Other Postretirement Benefits	Direct
08/25/1993	United Telephone Company of Missouri	TR93181	Cash Working Capital	Surrebuttal
08/13/1993	United Telephone Company of Missouri	TR93181	Cash Working Capital	Rebuttal
07/16/1993	United Telephone Company of Missouri	TR93181	Cash Working Capital; Other Rate Base Components	Direct

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SHUTTING THE BARN DOOR BEFORE THE HORSE IS STOLEN: HOW AND WHY STATE PUBLIC UTILITY COMMISSIONS SHOULD REGULATE TRANSACTIONS BETWEEN A PUBLIC UTILITY AND ITS AFFILIATES

*Judy Sheldrew**

I. INTRODUCTION

State public utility commissions should have the authority to regulate transactions between public utilities and their parent companies, subsidiaries or other affiliated corporations. In the absence of such authority, a public utility can (1) arrange transactions with affiliated entities that result in the utility overpaying for goods or services, thereby increasing rates, or (2) take on financial burdens attributable to affiliated entities, which can threaten its solvency. In its report on Enron's fraudulent financial transactions, the staff of the United States Senate Committee on Government Affairs explained:

> [W]henever a company conducts transactions among its own affiliates there are inherent issues about the fairness and motivations of such transactions . . . . One concern is that where one affiliate in a transaction has captive customers, a one-sided deal between affiliates can saddle those customers with additional financial burdens. Another concern is that one affiliate will treat another with favoritism at the expense of other companies or in ways detrimental to the market as a whole.[1]

The root of the problem, as noted by a former California Supreme Court Justice, is that agreements between a public utility and its affiliates are not "made at arm's length or on an open market. They are between corporations, one of which is controlled by the other. As such they are subject to suspicion and therefore present dangerous potentialities."[2]

The potential dangers of interaffiliate transactions first became apparent early in the twentieth century following the formation of public utility holding

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[1] STAFF OF SENATE COMM. ON GOV'T AFFAIRS, 107TH CONG., COMMITTEE STAFF INVESTIGATION OF THE FEDERAL ENERGY REGULATORY COMMISSION'S OVERSIGHT OF ENRON 26, n.75 (Nov. 12, 2002) [hereinafter STAFF OF SENATE COMM. ON GOV'T AFFAIRS].

[2] Pac. Tel. & Tel. Co. v. Pub. Utils. Comm'n, 215 P.2d 441, 449 (Cal. 1950) (Carter, J., dissenting).

companies.[3] At that time, "[h]olding companies were taking advantage of the fact that they owned utilities in multiple states to engage in interstate, intra-company transactions that could not be controlled by state public utility commissions."[4] In response, Congress passed the Public Utility Holding Company Act of 1935, which gave the Securities and Exchange Commission ("SEC") authority to regulate interstate public utility holding companies[5] and the Federal Power Act, which gave the Federal Power Commission the authority to regulate the rates that one utility could charge another.[6] Many states also passed legislation during this time period that authorized their public utility commissions to review certain transactions between utility companies and their affiliates.[7]

Even with these state and federal attempts to oversee transactions between regulated entities and their affiliates over the years, the difficulties in controlling such transactions still persist. A recent online version of the Wall Street Journal noted that energy companies "burned by disastrous forays into commodities trading . . ." were attempting to recoup some of their losses by passing part of their financial burdens on to their affiliated utility units.[8] As a result, utilities bought assets from affiliates, made loans to their affiliates, or passed

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[3] "Holding companies are corporations organized for the purpose of acquiring and holding the stock of other corporations. Corporations that engage in business activities and only incidentally hold majority stock in another corporation are not holding companies." Joan G. Fickinger, *Jurisdiction of State Regulatory Commissions Over Public Utility Holding Company Diversification*, 15 LOY. U. CHI. L.J. 87, 87 n.3 (citing 6A W. FLETCHER, CYCOLPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2821 (1981)). "[T]he dominant characteristic of a holding company is the ownership of securities by which it is possible to control or substantially to influence the policies and management of one or more operating companies in a particular field of enterprise." *Id.* (citing N. Am. Co. v. Sec. & Exch. Comm'n, 327 U.S. 686, 701 (1945)).

[4] STAFF OF SENATE COMM. ON GOV'T AFFAIRS, at 5.

[5] James W. Moeller, *Requiem for the Public Utility Holding Company Act of 1935: The "Old" Federalism and State Regulation of Inter-State Holding* Companies, 17 ENERGY L.J. 343, 343 (1996). The Public Utility Holding Company Act of 1935 is codified at 15 U.S.C. § 79-79z-6 (2000). This note does not discuss the Securities and Exchange Commission's ("SEC") regulation of interstate public utility holding companies. Not all holding companies, however, are subject to SEC regulation. A holding Company whose interests and business are predominantly intrastate is exempt from the registration requirements of the Act per 15 U.S.C. § 79c(a)(1) as are "companies 'predominantly' engaged in public utility operations that are confined to single states and those states contiguous thereto" per U.S.C. § 79c(a)(2). *Id.* at 353 nn.80, 81.

[6] STAFF OF SENATE COMM. ON GOV'T AFFAIRS, *supra* note 1, at 5. The Federal Power Act is codified at 16 U.S.C. § 791a-828c (2000). The Federal Power Commission was the predecessor to the current Federal Energy Regulatory Commission ("FERC"). *Id.* FERC is "an independent five-member regulatory commission within the Department of Energy . . . [that] regulates the interstate transmission and wholesale sale of electricity and natural gas . . . [and] also licenses hydroelectric projects and regulates the transmission of oil by interstate pipelines." *Id.* at 4.

[7] *Legislation: The Servicing Function of Public Utility Holding Companies*, 49 HARV. L. REV. 957, 986 (1934) [hereinafter *The Servicing Function*].

[8] Rebecca Smith, *Beleaguered Energy Firms Try to Share Pain with Utility Subsidiaries*, WALL ST. J., Dec. 26, 2002, at A1 (referring to Duke Energy's transfer of expenses from its nonutility affiliates into its utilities to reduce the possibility of customer refunds as one of the "clearest examples of a lack of firewalls" between utilities and their unregulated affiliates).

more money on to their parent companies by reducing capital spending.[9] Recognizing that utilities were subject to manipulation by their parent companies, credit-rating agencies reduced the utilities' debt ratings, thus raising the costs of borrowing money or refinancing debt for the utilities, with the potential that these higher costs would eventually be passed on to electric consumers.[10]

A. *Enron and FERC*

The most notorious examples of inappropriate interaffiliate transactions are those Enron arranged shortly before its collapse in 2001.[11] In November 2001, Enron attempted to avoid bankruptcy by securing loans for $1 billion on two pipeline subsidiaries, which were secured by the pipelines' assets.[12] The proceeds of the loans were subsequently transferred to Enron as unsecured loans from the pipelines.[13] After declaring bankruptcy a few weeks later, Enron made no payments on these loans, leaving the pipelines to pay off the entire amount.[14] As noted in the Senate Government Affairs Committee staff report, "ordinarily such costs would be passed on to shippers who use the pipelines, and ultimately to retail natural gas customers."[15]

In addition, some Enron subsidiaries also had "cash management agreements" with Enron, whereby, at the end of each day, all remaining cash in the subsidiaries was transferred to Enron, which held and invested it, with no indication that the interest earnings were properly credited back to the subsidiaries.[16] Enron made "more extensive use" of this common industry practice than did other companies, holding an average of $195 million from associated companies compared to non-Enron companies holding an average of $6 million.[17] Furthermore, the average amount transferred into Enron's accounts receivable from associated companies grew from $44 million in 1997 to approximately $195 million in 2000.[18]

There was also evidence that "Enron may have used its public utility affiliate, Portland General Electric (PGE), to engage in the questionable export and reimportation of electricity from California during the Western energy crisis of 2000-2001 and disguised these prohibited interaffiliate transactions."[19] Con-

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[9] *Id.*

[10] *Id.*

[11] STAFF OF SENATE COMM. ON GOV'T AFFAIRS, *supra* note 1, at 2 (explaining that on December 2, 2001, Enron, then the nation's seventh largest company, filed for bankruptcy protection amid allegations of financial and other fraud. Enron's collapse left thousands unemployed, erased billions of dollars of shareholder value and triggered crises, not only in investor confidence in U.S. financial markets, but in consumer and investor confidence in the energy markets as well).

[12] *Id.* at 3.

[13] *Id.* at 28 n.82 (explaining that the proceeds were exchanged for "promissory notes that stated they were subordinated to prior payment of all senior indebtedness upon the dissolution, liquidation or reorganization of Enron.").

[14] *Id.* at 28.

[15] *Id.*

[16] *Id.* at 29.

[17] *Id.* at 29 n.89.

[18] *Id.* at 29 n.90.

[19] *Id.* at 3.

cluding there was a "shocking absence of regulatory vigilance"[20] over Enron's activities, the Senate Government Affairs Committee reported that the Federal Energy Regulatory Commission ("FERC")[21] was "unprepared and unwilling to act against suspect interaffiliate transactions either because the Commission's rules were inadequate or because it was not able to effectively monitor whether companies were complying with the rules."[22]

B. Western Resources Inc. and the Kansas Corporation Commission

The problems encountered in policing affiliate transactions that shift financial burdens to regulated utilities – and thus to consumers – are not confined to companies regulated by FERC.[23] A recent example of a state public utility commission's attempts to regulate transactions, that would have improperly shifted costs to regulated utilities,[24] is the Kansas Corporation Commission's ("KCC") investigation into Western Resources, Inc.'s ("WRI")[25] proposal to separate its non-regulated affiliates from its public utility businesses.[26] WRI is a public utility holding company that operates Kansas Power and Light and Kansas Gas and Electric, electric utilities providing retail service to approximately 636,000 customers in Kansas.[27] WRI also wholly owns Westar Industries, Inc. ("Westar"), a subsidiary[28] that is not regulated by the KCC.[29]

The KCC, citing its "plenary authority" to supervise and control electric utilities doing business in Kansas,[30] opened its investigation into WRI's pro-

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[20] *Id.* at 2.

[21] FERC is "an independent five-member regulatory commission within the Department of Energy . . . [that] regulates the interstate transmission and wholesale sale of electricity and natural gas . . . [and] also licenses hydroelectric projects and regulates the transmission of oil by interstate pipelines." *Id.* at 4.

[22] *Id.* at 3.

[23] FERC did not directly regulate Enron (which was a holding company) as a corporation *per se,* but had jurisdiction over many of Enron's energy marketing, generation, and transmission subsidiaries ("Enron identified 24 electricity marketers, generators or transmitters, 15 gas pipelines, and 5 oil pipelines that [were] Enron subsidiaries or affiliates" that were jurisdictional to FERC and had several other independent generation facilities known as "qualifying facilities" ("QF's") and exempt wholesale generators ("EWG's"), which were subject to FERC's jurisdiction or certification requirements). *Id.* at 7.

[24] State utility commissions regulate retail rates charged to consumers for utility services provided by public utilities within their states. *Id.* at 5.

[25] WRI has since taken the name Westar Energy, Inc. For purposes of clarity, it shall be referred to here as WRI.

[26] Order In the Matter of the Investigation of Actions of Western Resources, Inc. to Separate its Jurisdictional Electric Public Utility Business from its Unregulated Businesses, No. 01-WSRE-949-GIE, at 1 (Kan. Corp. Comm'n July 20, 2001) [hereinafter July 20, 2001 Order].

[27] *Id.* at 2.

[28] *Id.* at 3 (explaining Westar Industries, Inc. is also a holding company "consisting of an 85 percent ownership interest in Protection One, Inc. [an unregulated security monitoring business], 100 percent ownership interest in Protection One Europe, a 45 percent ownership interest in ONEOK, Inc., approximately 17 percent ownership interest in its parent WRI and interests in international power plant investments." At the time of the KCC's order, WRI owned 100 percent of Westar's outstanding common stock).

[29] *Id.*

[30] Order Initiating Investigation In the Matter of the Investigation of the Actions of Western Resources, Inc. to Separate its Jurisdictional Electric Public Utility Business from its Unreg-

posals after Westar filed a Registration Statement ("Statement") with the SEC.[31] The Statement indicated that prior to the proposed split off, Westar and WRI intended to distribute the holding company's assets and liabilities among WRI's affiliated entities via an Asset Allocation Agreement ("Agreement") between the two companies.[32] The KCC staff estimated that consummation of the Agreement would result in WRI's December 31, 2000 consolidated balance sheet reflecting 113.02 percent ($2.97 billion) of WRI's long-term debt in its electric utility businesses and negative equity of 13.02 percent (approximately $300 million).[33] Staff estimates further showed that, as of December 31, 2001, WRI's proposals would result in the transfer $1.6 billion of consolidated debt from its nonutility businesses (primarily from Protection One, Inc., Westar's residential and commercial security monitoring subsidiary) to WRI's regulated utility operations.[34] If effectuated, the Agreement would cause WRI's equity to fall from approximately 50 percent of its total capital structure in 1995 ($1.7 billion) to 25 percent of its total capital structure as of December 31, 2001 ($1.8 billion).[35]

WRI's financial condition was further worsened by credit rating downgrades it received in response to an earlier split off proposal, which resulted in its debt issuances falling from investment grade to junk bond status.[36] As a result, WRI was unable to issue unsecured notes to finance its short-term capital needs and was forced to secure short-term cash by mortgaging its property

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ulated Businesses, No. 01-WSRE-949-GIE, at 5-6 (Kan. Corp. Comm'n May 8, 2001) [hereinafter Order Initiating Investigation] (citing the commission's jurisdiction under KAN. STAT. ANN. § 66-101 (2000) which provides "[t]he commission is given full power, authority and jurisdiction to supervise and control the electric public utilities . . . doing business in Kansas, and is empowered to do all things necessary and convenient for the exercise of such power, authority and jurisdiction."; KAN. STAT. ANN. § 66-101h (2000) which provides, among other things, that "[t]he commission shall have general supervision of all electric public utilities doing business in this state . . . and shall carefully examine and inspect the condition of each electric public utility . . . the manner of its conduct and its management with reference to the public safety and convenience"; KAN. STAT. ANN. § 66-101d (Supp. 2000) which authorizes the commission to investigate any act or practice of an electric public utility which affects its ability to provide efficient and sufficient service at just and reasonable rates; KAN. STAT. ANN. § 66-136 (Supp. 2000) which provides that any transaction constituting a "contract or agreement with reference to or affecting" the certificate of convenience is not valid until approved by the commission; KAN. STAT. ANN. §§ 66-1402 (2000) which provides that any "management . . . or similar contract" between a public utility and its affiliated interests shall not be effective unless approved in advance by the commission).

[31] *Id.* at 2.

[32] July 20, 2001 Order, *supra* note 26, at 3. The Agreement also established that WRI could repay Westar for cash advances made to WRI via a note receivable to Westar. To decrease the value owed on the note receivable, WRI later issued its common stock to Westar, thus allowing Westar to establish an equity ownership position in WRI as its largest stockholder with seventeen percent of WRI's voting capital stock. Further advances were to be made by Westar to WRI financed by a proposed rights offering to Westar stockholders. *Id.*

[33] *Id.* at 9.

[34] No. 51 Order Requiring Financial and Corporate Restructuring by Western Resources, Inc., In the Matter of the Investigation of Actions of Western Resources, Inc. to Separate its Jurisdictional Electric Utility Business from its Unregulated Businesses, No. 01-WSRE-949-GIE, at 6 (Kan. Corp. Comm'n Nov. 8, 2002) [hereinafter No. 51 Order].

[35] *Id.* at 4-5.

[36] Order Initiating Investigation, *supra* note 30, at 3-4.

at an interest rate of 10.5 percent[37] – costs which WRI's electric consumers were at risk of bearing.

There were other questionable interaffiliate transactions as well. For example, prior to proposing the split off, WRI advanced at least $927 million to Westar.[38] The advance was originally classified as a loan from WRI to Westar.[39] As noted during the KCC's hearings, WRI's management and board of directors made a "pivotal decision" to reclassify the loan to an investment, thus transforming $927 million of debt on Westar's books to $927 million of common equity.[40] In addition, WRI transferred stock it owned in ONEOK, a natural gas company, which it valued at $1 billion in its 2000 Annual Report, to Westar in advance of filing the split off proposal with the SEC.[41]

The KCC concluded that WRI's split off was designed so that WRI's electric businesses would hold significant amounts of debt at the time of the split off but no Westar assets, while Westar would own all of WRI's unregulated assets but would not be responsible for the long-term debt used to acquire them.[42] As a result, WRI's asset-poor and debt-laden electric businesses would likely be forced to pay off the debt either through increases in electric rates or other cost-cutting measures which would "impair WRI's ability to perform routine maintenance, retain qualified employees or make the necessary capital improvements to meet the needs of Kansas electric customers."[43] The KCC ordered WRI to stop the transactions necessary to complete the split off and found the Asset Allocation Agreement to be "contrary to the public interest and having no force and effect."[44] The KCC directed WRI to prepare a plan to restore WRI's electric utilities to financial health, achieve a balanced capital structure, and protect ratepayers from the risks of WRI's non-utility businesses.[45]

WRI requested reconsideration of the KCC's order, arguing that the Kansas affiliated interests statutes did not extend to the Asset Allocation Agreement because it had been filed by Westar, and that the commission was "not

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[37] *Id.* at 4.

[38] July 20, 2001 Order, *supra* note 26, at 7 n.2 (explaining this investment was originally classified as an intercompany receivable owed by Westar to WRI, but was later reclassified as an investment in Westar by management).

[39] *Id.*

[40] *Id.* at 8 (footnote omitted).

[41] *Id.* at 2 n.1 (noting WRI originally acquired the stock when it exchanged its natural gas business at a book value of approximately $594 million for 45 percent ownership interest in ONEOK, Inc.).

[42] *Id.* at 12.

[43] *Id.* at 12, 13.

[44] *Id.* at 41-42.

[45] *Id.* In a subsequent order, the commission (1) rejected the financial plan proposed by WRI; (2) directed WRI to reverse certain accounting transactions; (3) directed WRI to transfer its KPL utility division to a utility-only subsidiary of WRI, after review and approval of WRI's plan to do so by the commission; (4) instituted interim standstill protections to prevent harm to WRI's utility businesses as a result of their affiliation with WRI's nonutility businesses pending adoption of final requirements relating to such affiliation; and (5) instituted an investigation into the appropriate type, quantity, structure and regulation of the nonutility businesses with which WRI's utility businesses may be affiliated. No. 51 Order, *supra* note 34, at 3-4.

empowered to substitute its judgment for that of the board of directors of the unregulated subsidiary . . ."[46] The KCC denied the petition and WRI subsequently filed for judicial review.[47]

C. *State Public Utility Commission Authority and Interaffiliate Contracts*

Assertions such as those made by WRI are common battle cries used by a public utility in questioning commission authority over transactions with its affiliates.[48] Such assertions raise the question of how far state regulators can go to stop public utility holding companies, or their unregulated subsidiaries or affiliates, from harming consumers by "milking their utility units"[49] through interaffiliate transactions such as those described above.

This note will examine various court decisions involving public utility commission authority over such transactions, and distill principles from those

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[46] Order on Reconsideration In the Matter of the Investigation of Actions of Western Resources, Inc. to Separate its Jurisdictional Electric Utility Business from its Unregulated Businesses, No. 01-WSRE-949-GIE, 4 (Kan. Corp. Comm'n Oct. 3, 2001) (citing Petition of Western Resources, Inc. for General Reconsideration of July 20, 2001 Order, and Request for Clarification and for Notice or Submission of Additional Evidence, at 21 (Aug. 6, 2001)).

[47] Initial Brief of Westar Energy, Inc. (WRI), at 4-6 (Aug. 19, 2002) (citing Shawnee Co. Dist. Ct. Mem. Decision and Order, Case No. 01-C-1190, 6-7 (Feb. 5, 2002) wherein the court remanded the petition to the KCC pending the outcome of the KCC's review of WRI's mandated remedial financial plan). In its Initial Brief, WRI reasserted the arguments made in its Aug. 6, 2001 Petition for Reconsideration. *Id.* at 22.

[48] *See e.g.*, Mountain States Tel. & Tel. Co. v. Pub. Serv. Comm'n of Wyo., 745 P.2d 563, 568 (Wyo. 1987) (observing that management decisions are "entirely that of the utility" because permitting civil servants to make those determinations instead of management results in no accountability for those decisions to investors in the business); PNM Elec. Servs. v. N.M. Pub. Util. Comm'n, 961 P.2d 147, 152 (N.M. 1988) (affirming that the commission had the authority to require a public utility to provide optional utility services through an affiliate and that the exercise of such authority was not an invasion of management as argued by the utility company); Midland Cogeneration Venture Ltd. P'ship v. Mich. Pub. Serv. Comm'n, 501 N.W.2d 573, 580-81 n.3 (Mich. Ct. App. 1993) (concluding there was no statutory authority for the Michigan Public Service Commission to regulate an affiliate's accounting and bookkeeping practices, which is a managerial decision); Lone Star Gas Co. v. Corp. Comm'n of Okla., 39 P.2d 547, 553 (Okla. 1934) (holding "[t]he powers of the Commission . . . do not extend to an invasion of the discretion vested in corporate management. It does not include the power to approve or disapprove contracts about to be entered into, nor to the approval or veto of expenditures proposed.").

[49] Smith, *supra* note 8. *See also The Servicing Function, supra* note 7, at 981 (explaining how transactions between a public utility and its affiliate may negatively impact consumers. Consumers can be harmed by overpayments for affiliate services made by the utility which result in a "swelling" of the utility's operating expenses, which can (a) prevent a rate reduction when profits are reviewed to determine whether the utility is making more than a reasonable return, or (b) minimize the return so that only small profits are shown, or none at all, which then requires a rate increase. Overcharges for capital expenses, such as construction or engineering services, can broaden the rate base (the value of property used by the utility in providing service) upon which the utility is entitled to earn a return and increase costs of operations by increasing the amount annually charged to the utility's depreciation accounts, thereby increasing the rate required to yield an adequate return.); Pac. Tel. & Tel. Co. v. Pub. Util. Comm'n, 215 P.2d 441, 449 (Cal. 1950) (Carter, J., dissenting) (pointing out that if a "raid on the treasury of the operating utility" results in the utility becoming insolvent, consumers can be harmed because consumers will either have to pay higher financing costs to acquire the capital necessary for the expansion of service demanded from a utility or higher operating expenses for a receiver).

decisions regarding state commission authority to second-guess management decisions over affiliate transactions. Part II of this note examines early twentieth century Supreme Court decisions regarding state public utility commission authority over servicing contracts between public utilities and their parent holding companies. Part III reviews state judicial responses to public utility challenges made since those early Supreme Court decisions. Part IV evaluates the continuing vitality of the "invasion of management" defense, which is frequently asserted by utilities in challenging commission authority over interaffiliate transactions. The conclusion summarizes why commission authority should be construed to encompass direct regulation of interaffiliate transactions between public utilities and their parent, subsidiary, or affiliate companies.

II. EARLY SUPREME COURT DECISIONS REGARDING COMMISSION AUTHORITY TO INDIRECTLY CONTROL INTERAFFILIATE CONTRACTS

In *Munn v. Illinois,* the Supreme Court upheld an Illinois statute, that regulated public warehouses and required the inspection of grain, as a legitimate regulation of private business because that business was "affected with a public interest."[50] The Court explained that property became "clothed with a public interest" when used in a way that affected the community at large.[51] Owners of such property, said the Court, "must submit to be controlled by the public for the common good," to the extent of the interest created.[52]

Utility companies were affected with a public interest and by the 1930's most state governments had created public utility commissions to oversee them.[53] A major goal of public utility commissions is to ensure that the utility rates charged to consumers are "just and reasonable."[54] To accomplish this goal, state legislatures have generally vested commissions with broad authority to supervise and regulate public utilities within their states,[55] and courts are

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[50] Munn v. Illinois, 94 U.S. 113, 126 (1876).

[51] *Id.*

[52] *Id.*

[53] Fickinger, *supra* note 3, at 90 (citing C. WILCOX & W. SHEPHERD, PUBLIC POLICIES TOWARD BUSINESS 334, 354 (5th ed. 1975)).

[54] *See e.g.*, NEV. REV. STAT. 704.040(1) (2001) ("Every public utility shall furnish reasonably adequate service and facilities, and the charges made for any service rendered or to be rendered, or for any service in connection therewith or incidental thereto, must be just and reasonable"); 66 PA. CONS. STAT. § 1301 (2000) ("Every rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be just and reasonable . . . ").

[55] *See e.g.*, KAN. STAT. ANN. § 66-101(2002) which provides "[t]he commission is given full power, authority and jurisdiction to supervise and control the electric public utilities . . . doing business in Kansas, and is empowered to do all things necessary and convenient for the exercise of such power, authority and jurisdiction."; KAN. STAT. ANN. § 66-101h (2002), which provides, among other things, that "[t]he commission shall have general supervision of all electric public utilities doing business in this state . . . and shall carefully examine and inspect the condition of each electric public utility . . . the manner of its conduct and its management with reference to the public safety and convenience"; KAN. STAT. ANN. § 66-101d (2002) which authorizes the commission to investigate any act or practice of an electric public utility that affects its ability to provide efficient and sufficient service at just and reasonable rates; 66 PA. CONS. STAT. §§ 501(a), (b) (West 2002) ("[T]he commission shall have full power and authority, and it shall be its duty to enforce, execute and carry out, by its

frequently deferential when commissions exercise that authority in regulating public utilities.[56]

Courts, however, have been more reluctant to affirm commission decisions that attempt to directly regulate transactions between a public utility and its affiliate or parent corporation.[57] Public utility commissions began grappling with questionable interaffiliate transactions shortly after public utility holding companies emerged, early in the twentieth century.[58] Public utility holding companies were formed, among other reasons, to "satisfy more economically the needs of small operating companies for highly skilled engineering and management."[59] To meet the needs of their operating utilities, holding companies developed servicing contracts, which "refer[red] to the performance for the operating utility by another company of any operations regarded as necessary or desirable for the utility's functioning and which could be performed by a staff as part of its own organization."[60]

The most commonplace servicing contracts were those between local Bell operating companies and their parent, American Telephone and Telegraph ("AT&T").[61] AT&T's servicing contract included a guarantee by AT&T to not only furnish its subsidiary with all the instruments necessary to provide telephone service, but also (1) managerial advice regarding public relations, engi-

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regulations, orders, or otherwise, all and singular, the provisions of this part, and the full intent thereof; and shall have the power to rescind or modify any such regulations or orders. The express enumeration of the powers of the commission in this part shall not exclude any power which the commission would otherwise have under any of the provisions of this part"; "The Commission shall have general administrative power and authority to supervise and regulate all public utilities doing business within this Commonwealth."); N.M. STAT. ANN. § 62-6-4 (LEXIS 2002) ("The Commission shall have general and exclusive power and jurisdiction to regulate and supervise every public utility in respect to its rates and service regulations . . . and to do all things necessary and convenient in the exercise of its power and jurisdiction.").

[56] *See e.g.*, Fairview Water Co. v. Pa. Pub. Util. Comm'n, 502 A.2d 162, 166 (Pa. 1985) (finding the Pennsylvania Public Utilities Commission had full power in regulating utility rates and services, excluding the power of eminent domain); PNM Elec. Servs. v. N.M. Pub. Util. Comm'n, 961 P.2d 147, 150 (N.M. 1998) (recognizing that the New Mexico Public Utility Commission possesses expansive regulatory power to broadly and liberally construe the New Mexico Public Utility Act to effect legislative policies); CURB v. State Corp. Comm'n, 28 Kan. App. 2d 313, 324-25 (Kan. Ct. App. 2000) (noting that the vast powers of the commission should not be construed so narrowly as to defeat the commission's purpose but should be liberally construed to include every power that can be fairly implied from the language of the statute and necessary to enable the commission to exercise its express powers).

[57] *See e.g.*, Pac. Tel & Tel. Co. v. Pub. Utils. Comm'n, 215 P.2d 441 (Cal. 1950) (finding the California commission did not have statutory authority to prescribe terms of conditions of contracts between the utility and its affiliate and that such authority could not be implied from its general rate-making powers); Mountain States Tel. & Tel. Co. v. Pub. Serv. Comm'n of Wyo., 745 P.2d 563, 568 (Wyo. 1987) (rejecting the commission's attempt to regulate the publication of an advertising directory by a subsidiary of Mountain Bell because the "PSC is not in a position to take on any aspect of utility management. It must restrict its position to 'regulation' with management decisions being entirely that of the utility.").

[58] *The Servicing Function*, *supra* note 7, at 957.

[59] *Id.* at 958.

[60] *Id.* at 959 n.10.

[61] George W. Simpkins, *State Regulation of Contracts with Public Utility Affiliates*, 20 ST. LOUIS L. REV. 1, 19 (1934).

neering, construction, research, accounting or the law; (2) licenses under all patents issued; (3) protection against patent infringement claims; (4) representation of all suits before public utilities commissions, federal commissions or taxing bodies; and (5) financial assistance to any extent necessary.[62] In return, AT&T received four and one half percent of the gross income of the subsidiary.[63] The standard percentage charge was later reduced.[64]

Servicing contracts raised the original question of state commission authority over interaffiliate transactions, primarily when it came to setting rates.[65] The early conclusions reached by commissions were mixed.[66] At least one state high court, while concluding the commission's exclusion of servicing contract fees from the utility's operating expenses was not "against the manifest weight of the evidence," nevertheless warned "the commission is not the financial manager of the corporation, and is not empowered to substitute its judgment for that of the directors of the corporation . . ."[67] The question of whether a commission has authority to value servicing contracts when setting rates was ultimately answered as part of a series of United States Supreme Court decisions.

A. The Competitive Price Test

In 1921, Southwestern Bell sought to enjoin the city of Houston from enforcing an ordinance that, it alleged, resulted in telephone rates that were too low.[68] In deciding that Southwestern Bell could include the cost of its servicing contract with AT&T in rates, the Court noted that Southwestern Bell had shown that the contract fees were reasonable and "less than the same could be obtained for from other sources."[69] The Court also found that AT&T's control of both Southwestern Bell and the affiliate which provided Southwestern Bell with its equipment and supplies was "not important beyond requiring close scrutiny of their dealings to prevent imposition upon the community served by the Company . . ."[70] One commentator lauded this decision as recognizing that servicing contracts required close scrutiny and that state commissions had the authority to review the fees charged for such contracts using a competitive price test.[71] Another commentator observed, correctly, that the competitive price test was not a good measure of the reasonableness of such contract charges because there was no competition then existing in the telephone industry by which competitive prices could be measured.[72]

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[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *Id.* at 30.
[66] *Id.*
[67] *Id.* at 26. *See* State Pub. Util. Comm'n *ex rel.* Springfield v. Springfield Gas & Elec. Co., 125 N.E. 891, 901 (Ill. 1919).
[68] Houston v. Southwestern Bell Tel. Co., 259 U.S. 318, 323 (1921).
[69] *Id.*
[70] *Id.*
[71] Simpkins, *supra* note 61, at 31.
[72] *The Servicing Function*, *supra* note 7, at 984.

B. The Good Faith Test

Two years later, in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission of Missouri*,[73] the Court concluded that the commission had not allowed the utility to earn a fair return on its investment, which was a violation of the Southwestern Bell's due process rights.[74] The Court receded from its previous position and invalidated the commission's disallowance of over half of the servicing contract fees paid by Southwestern Bell to AT&T. It declared that the four and one-half percent charge on gross revenues was the customary charge for servicing contracts, and that there was nothing to indicate bad faith in making the contract between AT&T and its subsidiary.[75]

Finding that the utility's board of directors had exercised "a proper discretion about this matter requiring business judgment,"[76] the Court admonished the Missouri Public Service Commission not to forget that the state "is not the owner of the properties of the public utility companies and is not clothed with the general power of management incident to ownership."[77] In issuing its warning, the Court relied on the "general rule" expressed by the Illinois Supreme Court that "[t]he commission is not the financial manager of the corporation; nor can it ignore items charged by the utility as operating expenses, unless there is an abuse of discretion in that regard by the corporate officers."[78] The Supreme Court's reliance on the Illinois Supreme Court's earlier warning was ironic, given that the Supreme Court negated commission action similar to that affirmed by the Illinois high court.[79] The adoption of the Court's newly articulated good faith standard led one commentator to observe:

> [I]t would seem not to matter how excessive the prices paid were compared to the competitive cost of the services or supplies, provided only the board of directors were sufficiently stupid or inattentive not to realize that this was a fraud upon their own corporation. It gives incompetence full privilege to mismanage the property as it will and charge the cost of the folly to the consumer.[80]

Many commissions refused to follow the good faith test of *Southwestern Bell*.[81] They were able to maneuver around the Court's good faith test by finding that no valuable services had been provided in return for the contract payments. They accomplished this in one of two ways.[82] The commission either concluded that the affiliate did nothing at all to benefit the operating company[83] or that the operating company had enough executives to perform the services covered by the contract instead of relying on the affiliate.[84]

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[73] 262 U.S. 276, 287 (1923).
[74] *Id.*
[75] *Id.* at 288-89.
[76] *Id.*
[77] *Id.*
[78] *Id.* (citing State Pub. Util. Comm'n *ex rel.* Springfield v. Springfield Gas & Elec. Co., 125 N.E. 891, 901 (Ill. 1919)).
[79] *See* Simpkins, *supra* note 61, at 26.
[80] *Id.* at 35.
[81] *Id.* at 41.
[82] *Id.*
[83] *Id.* at 41 n.118.
[84] *Id.* at 41 n.119.

C. *Disallowance of Unreasonable Servicing Contract Fees*

The good faith standard put forth in *Southwestern Bell* was short-lived. In *Smith v. Illinois Bell Telephone Co.*,[85] the Illinois Bell Telephone Company appealed an order by the Illinois Commerce Commission, asserting its telephone rates were too low and violated the due process clause of the Fourteenth Amendment.[86] Despite a lower court's findings that the servicing contract was made in good faith, and the services and supplies were competitively priced, the Court noted Western Electric Company (AT&T's equipment supply subsidiary) "occupied a special position with particular advantages in relation to the manufacture and sale of equipment to the licensees of the Bell system, including the Illinois Company."[87] As a result of this special relationship, the Court, while finding AT&T had rendered valuable services, remanded the case for more specific findings regarding the cost of the services provided by Western Electric and the reasonable amount that should be allocated to Illinois Bell's operating expenses.[88]

Shortly thereafter, in *Dayton Power & Light Co. v. Public Utilities Commission*, the Court settled the question of how a commission was to obtain the information about an affiliated entity's costs of service.[89] The Court affirmed the Ohio Public Utilities Commission's valuation of property of affiliated producing and transportation companies, as though they were part of the local public utility, because the affiliated companies were not dealing at arm's length.[90] The Court concluded that, "in view of the close relation between the affiliated companies," the burden was upon the utility to sustain the fairness of a management contract between Dayton Power and Columbia Engineering and Management Company, a company affiliated with Dayton Power.[91]

1. Despite Commission Disallowance Authority, the Ambiguous Limitations of Southwestern Bell Remain

By the early 1930s, the Supreme Court's decisions had thus evolved. The Court recognized the dangers of interaffiliate contracts caused by the absence of arm's length negotiations between a public utility and its affiliates and concluded that commissions were entitled to closely scrutinize such transactions. Utility companies had the burden of showing that contracts between a public utility and its affiliates were fair, and commissions could determine the proper allocation to the utility of those costs incurred by the providing entity that were deemed to be reasonable.[92] The Court, however, left in place its ill-defined

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[85] Smith v. Ill. Bell Tel. Co., 282 U.S. 133, 143 (1930) *rev'd on other grounds sub nom.* Lindheimer v. Ill. Bell Tel. Co., 292 U.S. 151 (1934).
[86] *Id.*
[87] *Id.* at 153.
[88] *Id.* at 154, 157.
[89] Dayton Power & Light Co. v. Pub. Utils. Comm'n, 292 U.S. 290 (1934).
[90] *Id.* at 295.
[91] *Id.* at 307.
[92] This does not apply when an affiliate charges FERC-approved rates for wholesale utility services, such as wholesale electric power, because a state utility commission's regulation is preempted by FERC in such instances. *See* Nantahala Power & Light Co. v. Thornburg, 476 U.S. 953, 971 (1986); Miss. Power & Light Co. v. Mississippi, 487 U.S. 354 (1988).

limitation on commission authority over interaffiliate transactions with its warning that a utility commission was not "the financial manager of the corporation."[93]

2. *Disallowance of Unreasonable Servicing Fees is Insufficient to Prevent Payment of Excessive Fees to Affiliates*

States began to codify the doctrine of *Smith*, placing the burden on the operating company to prove the fees entered as operating expenses were reasonable in view of the cost to the service-providing entity, thus assuring that commissions had the authority to disallow those expenses determined to be unreasonable when setting rates.[94] Such provisions remain in place today, but provide, at best, indirect control over servicing contract fees, or other inappropriate charges against the operating company, because there is little a commission can do to curtail excessive interaffiliate payments outside the context of a rate hearing.[95] That is, disallowance of servicing contract fees can only contribute toward a decrease in rates if a rate case is held. This is unlikely given the time and expense of a rate case and the reality that it is up to the utility company to present a rate case to the commission. For example, in Duke Energy's recent agreement to refund $25 million to its electric customers to settle allegations that it had transferred expenses of its non-utility affiliates into its regulated utilities, the chairwoman of the South Carolina Public Service Commission reported that neither of Duke's utilities had been subjected to a rate case in more than a decade.[96] She reported that the inappropriate transactions might not have been discovered had it not been for an inside tip, which led to an independent audit that uncovered the shift.[97]

Even if a commission disallows some portion of the servicing fees or other charges, and subsequently reduces a utility's rates, the utility can still fully compensate the holding company for the agreed-upon fees by reducing other operating expenditures.[98] As observed by one commentator, "such indirect control seems a dubious method of preventing the payment of excessive fees to affiliates," which is detrimental to consumers and investors alike.[99] Nor does such authority prevent a holding company from shifting huge amounts of debt or loan repayment responsibilities to public utilities, such as was attempted by

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[93] Missouri *ex rel.* Southwestern Bell Tel. Co. v. Pub. Serv. Comm'n, 262 U.S. 276, 289 (1923).

[94] *The Servicing Function*, *supra* note 7, at 985 n.122 (the states that codified such provisions by 1936 were New Hampshire, New York, Oregon, Pennsylvania, South Carolina, Virginia, Washington, Wisconsin, and Louisiana).

[95] *Id.* at 986 (explaining that the disallowance of servicing contract fees as a method of stopping excessive payments to affiliates was unlikely to be effective unless exercised in a rate case, which was unlikely to occur solely for the purpose of reducing servicing fees because of the time and expense of litigating a rate case. If servicing fees were disallowed during a rate case, such disallowance could increase the utility's net operating revenue and improve the utility's return, thus subjecting the utility to lower rates, which would ultimately decrease income and force a comparable reduction in expenditures).

[96] Smith, *supra* note 8.

[97] *Id.*

[98] *The Servicing Function*, *supra* note 7, at 986.

[99] *Id.*

WRI. To prevent such shifts, commissions need more direct control over the transactions between public utilities and their affiliates.

III. State Law Authorizes Commissions to Directly Control Some Interaffiliate Contracts

A. *State "Affiliated Interests" Statutes*

In response to reports by the Federal Trade Commission and investigatory bodies in New York and Massachusetts that holding companies were realizing huge profits from fees on servicing contracts,[100] many states granted commissions *direct* statutory authority over interaffiliate transactions[101] through "affiliated interests statutes."[102] "Affiliated interests statutes extend public service commission jurisdiction by giving commissions authority to monitor transactions between utilities and corporations or persons who have limited authority over the utility. 'Authority' is statutorily defined; it generally means control through stock ownership."[103] These statutes varied in the degree of control over affiliate transactions provided to each state commission. Some statutes required affirmative approval prior to the contract becoming effective,[104] while others gave commissions the power to restrain payments for unapproved contracts per court order.[105] Other statutes declared unapproved contracts void[106] and some empowered the commission to inspect the affiliate's books and records.[107] Oregon enacted a statute that gave its commission the strongest possible authority, in that it considered the affiliate providing the service as a public utility for purposes of regulation.[108]

Many state commissions still rely on these affiliated interests statutes as the primary tool to regulate interaffiliate transactions. This is despite a resurgence of utility diversification activities in the 1980s that posed additional challenges to commissions in controlling inappropriate interaffiliate transactions.[109]

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[100] *Id.* (referring to Federal Trade Comm'n, Utility Corporations, S. Doc. No. 92, 70th Cong., 1st Sess. (1928-36); Report of N.Y. Comm'n on Revision of Public Service Comm'n Law (1930); Report of Mass. Special Comm'n on Control and Conduct of Public Utilities (1930)).

[101] *Id.* at 986-87 n.127 (listing statutes from New York, Alabama, Oregon, Washington, Wisconsin, New Jersey, Illinois, Indiana, Kansas, Pennsylvania, Virginia, New Hampshire, Arkansas, Maine, Vermont, Massachusetts and Connecticut).

[102] Fickinger, *supra* note 3, at 93.

[103] *Id.*

[104] *The Servicing Function*, *supra* note 7, at 987 n.130 (referencing statutes in Illinois, Maine, New Jersey, North Carolina, Oregon, Virginia, Washington, West Virginia, and Wisconsin).

[105] *Id.* at 987 n.131 (noting statutes in New Hampshire and Wisconsin).

[106] *Id.* at 987 n.132 (referring to statutes in Illinois, Massachusetts and West Virginia).

[107] *Id.* at 988 n.134 (referring to statutes in Alabama, Arkansas, Illinois, Indiana, New Jersey, New York and Oregon).

[108] *Id.* at 988.

[109] Fickinger, *supra* note 3, at 92-95 n.41 (listing possible dangers of public utility holding company diversification, such as managerial dilution as more talented managers are transferred to the more competitive non-utility operations, or profit-skimming from the utility to the holding company; wrongful charges for non-utility goods or services and risks or losses being absorbed by the utility while profits are diverted elsewhere; and diversion of retained

One commentator observed that, as of 1982, few states had amended their public utility statutes beyond the affiliated interests statutes to assure that their commissions were able to deal adequately with the consequences of diversification.[110]

New York's affiliated interests statute is representative of many state affiliated interests statutes. It provides

> [n]o management, construction, engineering or similar contract, hereafter made, with any affiliated interest . . . shall be effective unless it shall first have been filed with the commission, and no charge for any such management, construction, engineering or similar service, whether made pursuant to contract or otherwise, shall exceed the reasonable cost of performing such service . . . If it be found that any such contract is not in the public interest, the commission, after investigation and a hearing, is hereby authorized to disapprove such contract.[111]

Some commentators criticized statutes, such as New York's, for not requiring commissions to scrutinize every interaffiliate contract.[112] More expansive delegations of authority, however, have not always survived judicial scrutiny. For example, Pennsylvania's original affiliated interests statute prohibited a public utility from making or modifying any contract without getting prior commission approval.[113] The Pennsylvania Supreme Court found the statute to be an unconstitutional delegation of legislative authority, primarily due to the lack of specific statutory guidelines required for approval of an interaffiliate transaction, other than a tenuous link to the commission's authority to withdraw previously approved contracts if such withdrawal were in the public interest.[114] Even if that standard were applicable, the court concluded, "[t]he phrase 'public interest' as used in this connection is 'a concept without ascertainable criterion'" and, as such, was "too vague and elastic to furnish a standard."[115]

Despite this initial setback, Pennsylvania's statute was later amended to require the prior written commission approval of an interaffiliate contract "only

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earnings from the utility to more profitable ventures or the unequal division of assets attributable to the utility in favor of the non-regulated entity).

[110] *Id.* at 94-95 nn.39, 40 (noting that only Connecticut and Maine had enacted statutes to address diversification activity adequately. The note examined commission orders in four states dealing with proposed utility diversification activity. The Illinois Commerce Commission concluded "it lacked jurisdiction over a utility holding company's maneuver calculated to avoid the language of the Illinois regulatory statute." The Connecticut Public Service Commission, which the author believed set an example for dealing equitably with diversification *ex post*, was unable to involve itself until the diversification was complete and ratepayers had been forced to absorb the costs of the diversification efforts. The New York Public Service Commission avoided the jurisdictional question by "flatly . . . refusing to allow diversification through the holding company arrangement" while the Michigan Public Service Commission was "unable to exercise jurisdiction over a utility's pre-divestiture conduct which resulted in the displacement of valuable utility assets.").

[111] N.Y. PUB. SERV. LAW § 110(3) (McKinney 2002).

[112] *The Servicing Function*, *supra* note 7, at 987 n.129 (referencing *Legislation: Legislation Extending Control Over Public Utility-Affiliates Contracts*, 45 HARV. L. REV. 729, 733-34 (1932)).

[113] 1937 P.L. 1053 § 702, as amended by 1938 P.L. 44, 66 PA. STAT. ANN. § 1272 (1938) (since repealed).

[114] Bell Tel. Co. of Pa. v. Driscoll, 21 A.2d 912, 916 (Pa. 1941).

[115] *Id.* at 915.

if it shall clearly appear and be established upon investigation that [the contract] is reasonable and consistent with the public interest."[116] The statute also applied to a broad assortment of interaffiliate contracts for "management, supervisory, construction, engineering, accounting, legal, financial, or similar services" as well as contracts for "the purchase, sale, lease or exchange of any property, right, or thing or for the furnishing of any service, property, right or thing."[117] Notably, perhaps because of the Pennsylvania statute's specificity, little other case law regarding the commission's authority over such transactions has developed.

B. Some Courts Narrowly Construe Commission Authority Over Interaffiliate Transactions

1. General Telephone Company of Upstate New York v. Lundy

Case law regarding commission authority over interaffiliate transactions, however, has developed in other jurisdictions with less encompassing affiliated interests statutes than Pennsylvania's. In *General Telephone Co. of Upstate New York v. Lundy*,[118] the New York Court of Appeals concluded that the commission was "powerless" to impair the obligation or otherwise invalidate contracts between a public utility and its affiliated suppliers aside from those types of contracts specifically delineated in New York's affiliated interests statute.[119] However, the court upheld the commission's power to investigate prices charged by *all* affiliated suppliers, saying such power could be "fairly implied" from the commission's rate making powers, despite the absence of an express grant of legislative authority to conduct such inquiries.[120] The court explained that for such interaffiliate contracts, "the commission does not require the authority to invalidate contracts. All that is required – and, indeed, all that is given – is the authority to disregard unwarranted payments to affiliates when calculating the 'just and reasonable' rates which the telephone company will be permitted to charge its subscribers."[121] Observing that the commission's rate-making power was not "'subservient to the discretion of (a utility),'"[122] the court concluded that when dealing with transactions between affiliates, the commission not only had the right, but "the duty to scrutinize (such) transactions closely" to ascertain whether the prices charged by the affiliates were excessive.[123]

2. Pacific Telephone & Telegraph Company v. Public Utilities Commission of California

The *Lundy* court's decision relied, in some measure, on an earlier decision of the California Supreme Court in *Pacific Telephone & Telegraph Co. v. Pub-*

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[116] 1976 P.L. 1057 § 16, 66 PA. CONS. STAT. ANN. § 2102(b) (West 2002).
[117] *Id.* at § 2102(a).
[118] 218 N.E.2d 274 (N.Y. 1966).
[119] *Id.* at 278. *See also* N.Y. PUB. SERV. LAW § 110(3) (McKinney 2002).
[120] *Id.* at 278.
[121] *Id.* (footnote omitted).
[122] *Id.*
[123] *Id.*

lic Utilities Commission of California.[124] The issue in *Pacific Telephone* was whether the Public Utilities Commission of California had the authority to prescribe the terms upon which Pacific Telephone could contract with its parent, AT&T.[125] Acknowledging that transactions among affiliated entities had created "problems in regulation," the court noted that California, unlike other states, had no affiliated interests statute.[126] Consequently, the court held that the commission could treat interaffiliate contracts differently than contracts between non-affiliated entities "only to the extent the Legislature so provides or to the extent that they are used as a device to defeat the exercise of powers the commission has been granted."[127]

In so deciding, the court rejected the commission's arguments that the commission's authority over interaffiliate contracts could be fairly implied from the powers the commission had been granted.[128] The court observed that, in the absence of express statutory authority, a commission's control over contracts between affiliated corporations was generally limited to disallowing excessive payments for the purpose of fixing rates,[129] a proposition which Pacific Telephone did not contest.[130]

The court considered the commission's limit on how much Pacific Telephone could pay AT&T as an attempt by the commission to substitute its judgment for that of management as to the reasonable amount to be paid for the contract and how it was to be computed.[131] "Thus the commission [was] seeking to disregard the separate corporate entities, not to exercise more effectively its existing jurisdiction, but to extend its jurisdiction."[132]

Decisions, such as *Pacific Telephone*, that limit commission authority to disallowing excessive fees for rate setting purposes only, are, however, ineffective in preventing excessive payments to affiliates for the same reasons discussed in Part II(C)(2). Notably, the California Supreme Court revisited the conclusions it reached in *Pacific Telephone* and found that later cases "cast serious doubt on the continuing vitality of much of the reasoning in *Pac. Tel.*"[133]

C. Other Courts Rely on the Doctrine of Implied Powers to Construe Commission Authority to Regulate Interaffiliate Transactions

As demonstrated by *Pacific Telephone* and *Lundy*, courts are sometimes reluctant to find that there is commission jurisdiction over interaffiliate contracts absent specific legislative authority for the commission to police such transactions in some manner.[134] Such conclusions, however, seem to ignore

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[124] 215 P.2d 441 (Cal. 1950).
[125] *Id.* at 443.
[126] *Id.* at 444.
[127] *Id.* at 447.
[128] *Id.* at 445.
[129] *Id.* at 446.
[130] *Id.* at 443.
[131] *Id.* at 446.
[132] *Id.*
[133] *See* Gen. Tel. Co. v. Pub. Utils. Comm'n, 670 P.2d 349, 353 (Cal. 1983).
[134] *See* Pac. Tel. & Tel. Co. v. Pub. Utils. Comm'n of Cal., 215 P.2d 441 (Cal. 1950); Gen. Tel. Co. of Upstate N.Y. v. Lundy, 218 N.E.2d 274 (N.Y. 1966).

the doctrine of implied powers, which has been relied upon by many other courts to broadly construe commission authority over interaffiliate transactions. As explained by one commentator, the doctrine of implied powers means that an administrative agency must have the power to put into effect the measures necessary to achieve the desired end, regardless of whether the agency is expressly delegated such power.[135] As was explained, "[t]he larger the powers conferred with regard to the ends, the larger the powers regularly to be implied as to means."[136] Since state public utility commissions have been granted sweeping powers to regulate public utility companies, direct control of interaffiliate transactions can be seen as a necessary means of accomplishing the commissions' ultimate goal of protecting consumers from the ill effects of harmful transactions. In applying the doctrine of implied powers to administrative agencies, the United States Supreme Court also recognized that "[w]ithout a doubt the [administrative agency] may not go beyond the words of the statute properly construed, but they must be read in the light of its general purpose and applied with a view to effectuate such purpose."[137]

1. International Railway v. Public Service Commission

Using the doctrine of implied powers, the New York Supreme Court broadly construed the New York commission's authority to control contracts between a public utility and its affiliates, and affirmed the commission's decision to order the cancellation of a management contract between International Railway and Mitten Management, Inc.[138] Mitten controlled International Railway's system and properties.[139] The contract in question provided that Mitten would have "complete charge and supervision of the business, system and properties" of International Railway, subject only to the supervision of the board of directors of International Railway, which Mitten also dominated.[140] The commission concluded that the contract was unnecessary for the proper management of the corporation and was an unneeded expense that was not in the public interest, and ordered it to be cancelled.[141]

The court found that the commission had not unlawfully invaded management's prerogatives or overruled management decision's regarding the company's affairs in ordering cancellation of the contract.[142] The court held that the commission had the implied authority under its public interest standard to cancel the contract, as a "necessary concomitant" of the power to disapprove, which was expressly stated in the statute.[143] The court pointed out that mere disapproval of the contract was not supported by a realistic view of the purpose of the statute, which, per the legislative history, was "to restrain contracts

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[135] Hans J. Morgenthau, *Implied Regulatory Powers in Administrative Law*, 28 IOWA L. REV. 575, 601-02 (footnote omitted).
[136] *Id.*
[137] Fed. Trade Comm'n v. W. Meat Co., 272 U.S. 554, 559 (1926).
[138] Int'l Ry. Co. v. Pub. Serv. Comm'n, 36 N.Y.S.2d 125, 128 (N.Y. App. Div. 1942).
[139] *Id.*
[140] *Id.* at 128-29.
[141] *Id.* at 135.
[142] *Id.*
[143] *Id.* at 132. *See also* N.Y. PUB. SERV. LAW. § 110(3) (McKinney 2002).

between public utilities and affiliates when such contracts were found to be contrary to the public interest."[144]

2. New York Telephone v. Public Service Commission of New York

In *New York Telephone Co. v. Public Service Commission of New York*,[145] the New York Court of Appeals also took an expansive view of the commission's authority over *management contracts* between a public utility and its affiliate. The court rejected New York Telephone's argument that the term "management contract" within New York's public service law[146] meant only "the all-encompassing power to run the local operating company's business lock-stock-and-barrel."[147] The court held that a directory publishing agreement ("DPA") between the telephone company and its affiliate was subject to the commission's approval as a management contract[148] because the affiliate had been given total control and responsibility for managing New York Telephone's directory business.[149]

The court found nothing in the statute or the legislative history that supported New York Telephone's narrow construction, nor did the statute include a precise definition for the term *management*.[150] The court explained that while the impetus for passing the legislation in the first place had been public utility holding company abuses of servicing contracts, the *primary purpose* of the legislation was to "prevent the utilities from insulating themselves from regulatory control through these contractual devices so that they could charge large fees 'at the expense of the operating company and ultimately the consumer.'"[151] The legislature's concern, the court concluded, was with enriching utility owners at the expense of ratepayers through all types of management contracts, not just the lock-stock-and-barrel type.[152] The interpretation advocated by New York Telephone, the court said, would "frustrate the very ameliorative purpose of the legislation and should be avoided."[153]

3. BellSouth Advertising & Publishing Corporation v. Tennessee Regulatory Authority

In *BellSouth Advertising & Publishing Corp. v. Tennessee Regulatory Authority*, a case with issues similar to those in *New York Telephone,* the Tennessee Supreme Court went even further and concluded the Tennessee Regulatory Authority ("TRA") had direct jurisdiction over an advertising company that had been assigned the responsibility for BellSouth's directory services.[154]

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144 *Id.*

145 N.Y. Tel. Co. v. Pub. Serv. Comm'n, 530 N.E.2d 843 (N.Y. 1988).

146 *See* N.Y. PUB. SERV. LAW § 110(3) (McKinney 2002).

147 *N.Y. Tel.*, 530 N.E.2d at 847.

148 *Id.* at 845.

149 *Id.* at 848.

150 *Id.*

151 *Id.* at 847 (quoting REPORT OF N. Y. COMM'N ON REVISION OF PUBLIC SERVICE COMM'N LAW, 1930 N.Y. LEGIS. DOC. No. 75, at 63 (Feb. 23, 1930)).

152 *Id.*

153 *Id.* at 848.

154 BellSouth Adver. & Publ'g Corp. v. Tenn. Regulatory Auth., 79 S.W.3d 506, 516 (Tenn. 2002).

The case began when the TRA ordered the advertising company, an affiliate of the regulated BellSouth Telephone Company, to provide competing telephone companies the opportunity to contract for their names and logos to appear on the telephone directory under the same terms and conditions that the advertising company had provided to BellSouth.[155]

In reaching its decision, the Tennessee Supreme Court concluded that a regulatory body, such as the Public Service Commission, was "not bound in all instances to observe corporate charters and the form of corporate structure or stock ownership in regulating a public utility" and, to obtain accurate information as to revenues and expenses for the purposes of determining rates, the commission could "consider entire operating systems of utility companies."[156] To do otherwise would allow the regulated utility, "through the device of holding companies, spin-offs, or other corporate arrangements to place the cream of a utility market in the hands of a parent or an affiliate, and to strip the marketing area of a regulated subsidiary of its most profitable customers."[157]

Applying this reasoning, the court concluded that TRA had jurisdiction over the advertising affiliate.[158] The court so concluded because BellSouth delegated its responsibility over the white pages directories to its advertising affiliate, and because the advertising affiliate had exclusive control over the directories.[159] To find otherwise would allow BellSouth to escape "the legal responsibilities [to provide the names and logos of competing local exchange telephone companies on the cover of the white page directories] thrust upon it."[160]

4. Pacific Telephone & Telegraph Company v. Public Utilities Commission of California *(Carter, J. dissenting)*

In his dissent in *Pacific Telephone*, a former California Supreme Court Justice also offered persuasive arguments for applying the doctrine of implied powers to broadly interpret commission authority over interaffiliate transactions.[161] Justice Carter correctly placed greater emphasis on the implied powers of the commission under California's Public Utilities Act for finding that the commission did have the authority necessary to regulate interaffiliate contracts, even in the absence of express statutory authority to do so.[162] The commission's power extended over interaffiliate contracts, he argued, because the commission was vested with the statutory authority to "supervise and regulate every public utility in the state and to do all things, whether herein specifically designated or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction."[163]

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[155] *Id.* at 508.
[156] *Id.* at 516 (quoting Tenn. Pub. Serv. Comm'n v. Nashville Gas Co., 551 S.W.2d 315, 319-20 (Tenn. 1977)).
[157] *Id.* (quoting Tenn. Pub. Serv. Comm'n, 551 S.W.2d at 321).
[158] *Id.* at 516.
[159] *Id.*
[160] *Id.*
[161] Pac. Tel. & Tel. Co. v. Pub. Utils. Comm'n of Cal., 215 P.2d 441, 445 (Cal. 1950).
[162] *Id.* at 450 (Carter. J., dissenting).
[163] *Id.* (citing 1915 CAL. PUB. UTIL. ACT § 31; 2 DEERING'S CAL. GEN. LAWS, Act 6386).

Justice Carter argued that if a commission is authorized to take indirect action through its subsequent disallowance of costs (i.e., disallow payment of some or all of an interaffiliate contract's fees during a rate case as the majority had concluded), the commission could surely take precautionary measures to stop the contract in advance of it incurring the fees.[164] He pointed out that a commission must have the authority to stop "a 'raid on the treasury of the operating utility'" before it happened because customers would be negatively affected if the utility became insolvent,[165] explaining:

> an insolvent utility has no credit with which to obtain the capital necessary for the continuous expansion for service demanded from a utility under modern conditions and that operation of a utility by receivers seems usually to be thought to result in higher operating expenses than would ordinarily be incurred.[166]

He urged that the commission be allowed to "of necessity . . . lock the door before the horse is stolen."[167] Such preventive action was justified with interaffiliate contracts because the contracts were not made at arm's length or in an open market. Instead, "[t]hey are between corporations, one of which is controlled by the other. As such they are subject to suspicion and therefore present dangerous potentialities."[168]

5. Arizona Corporation Commission v. State ex rel. Woods

Other courts have been in agreement with Justice Carter's reasoning on the question of a public utility commission's implied authority to regulate interaffiliate contracts. The Supreme Court of Arizona found the constitutionally established Arizona Corporation Commission had the authority to promulgate regulations that required public service corporations to report information about, and obtain permission for, transactions with other affiliated organizations under its general ratemaking authority.[169] The court explained:

> The Proposed Rules arguably prevent utilities from endangering their assets through transactions with their affiliates. If such transactions damage a utility company's assets or net worth, the company will have to seek higher rates for survival. Thus, transactions with affiliated corporations could have a direct and devastating impact on rates . . . . we believe the Commission's regulatory power permits it to require information regarding *and* approval of, all transactions between a public service corporation and its affiliates that may significantly affect economic stability and thus impact the rates charged by a public service corporation.[170]

The court found that the commission must be given the authority to prevent a utility from engaging in activities that "so adversely affect its financial position that the ratepayers will have to make good the losses," and concluded that giving the commission the authority to approve or disapprove of such transactions in advance was the only "common-sense" way to do that.[171] The

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[164] *Id.* at 449.
[165] *Id.* (citing Simpkins, *supra* note 61, at 58).
[166] *Id.*
[167] *Id.*
[168] *Id.*
[169] Ariz. Corp. Comm'n v. State *ex rel.* Woods, 830 P.2d 807, 818 (Ariz. 1992) (en banc).
[170] *Id.* at 816.
[171] *Id.* at 818.

Court put it simply, saying: "the Commission was given the power to lock the barn door before the horse escapes."[172]

D. The Arguments for Implying Commission Authority to Effectuate Measures Necessary to Protect Consumers

The willingness of many courts to broadly construe a commission's authority over interaffiliate contracts correctly recognizes such agreements are "potent with possibilities adverse to the interests of the consumers"[173] caused by the absence of arm's length dealings between the parties on either side. The almost boundless statutory power granting commissions broad authority to supervise and regulate every public utility under their jurisdiction[174] should also be read as giving commissions the implied powers to directly regulate the potentially dangerous transactions between a public utility and its affiliates. This is especially true since many transactions, like those engaged in by Enron and WRI, can impair a utility's financial stability or adversely affect consumers' rates. Broadly construing a commission's authority to encompass such transactions addresses the "realities of administrative problems"[175] inherent in modern interaffiliate transactions and is consistent with the principle that "[t]he larger the powers conferred with regard to the ends, the larger the powers regularly to be implied as to means."[176] In so doing, courts can acknowledge the realities of modern holding company transactions and allow commissions to effectuate those measures necessary to achieve the desired legislative end of protecting consumers from the negative effects of self-serving deals which otherwise would evade regulatory detection.

Given the realities of infrequent and utility-driven rate cases in the regulatory process, the only common sense way by which a utility commission can prevent a public utility from engaging in transactions that will adversely affect its financial position is through the authority to approve or disapprove such

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[172] *Id.*

[173] Pac. Tel & Tel. Co. v. Pub. Utils. Comm'n, 215 P.2d 441, 450 (Cal. 1950) (Carter, J., dissenting).

[174] *See e.g.*, N.Y. PUB. SERV. LAW § 66(1) (McKinney 2002) ("The commission shall: [h]ave general supervision of all gas corporations and electric corporations under any general or special law . . ."); N.Y. PUB. SERV. LAW § 66(2) (McKinney 2002) ("The commission shall: . . . investigate and examine the methods employed . . . in manufacturing, distributing and supplying electricity . . . and have the power to order such reasonable improvements as will best promote the public interest, preserve the public health and protect those using such gas or electricity . . ."); N.Y. PUB. SERV. LAW § 66(5) (McKinney 2002) ("The commission shall: [e]xamine all persons, corporations and municipalities under its supervision and keep informed as to the methods, practices, regulations and property employed by them in the transaction of their business. Whenever the commission shall be of opinion . . . that the rates, charges or classifications or the acts or regulations of any such person, corporation or municipality are unjust, unreasonable, unjustly discriminatory or unduly preferential . . . the commission shall determine and prescribe the just and reasonable rates, charges and classifications thereafter to be in force for the service . . . and the just and reasonable acts and regulations to be done and observed . . . ").

[175] Morgenthau, *supra* note 135, at 575.

[176] *Id.* at 601-02 (footnote omitted).

transactions in advance.[177] As Justice Carter correctly reasoned, commissions unquestionably have the authority to deal with interaffiliate transactions indirectly, (i.e., disallow costs or disapprove them for rate making purposes after-the-fact).[178] By construing commission authority to encompass approval or disapproval of interaffiliate transactions in advance, courts are simply allowing commissions to lock the door before the horse is stolen.[179]

IV. The Invasion of Management Defense Should Not Apply to Public Utilities

A second difficulty with commission authority over interaffiliate transactions is that the commission, in taking action on such transactions, has invaded the prerogatives of management.[180] As explained in one law review article on the subject, the term "invasion of management" generally means "the order is illegal because it usurps the rights of ownership" or "regulation has exceeded its proper limits."[181] The underlying question posed by such an assertion is: to what extent did the legislature intend the management of public utilities to remain with the owners of the property at issue?[182]

Unfortunately, there is little guidance to be gained from the Supreme Court cases on this question. On the one hand, *Munn v. Illinois* seems to suggest that since the owner of utility property has submitted his property to the control of the public for the common good, the legislature intended the owner of the utility property to have very little management control over it (aside from certain constitutional assurances regarding recovery of costs).[183] A commission, therefore, should be allowed to directly control those contracts between a public utility and its affiliate that it finds to be contrary to the public interest. At the other end of the spectrum lies the Supreme Court's ill-defined Lochner-era[184] admonition that, while a commission may regulate with a view to enforcing reasonable rates, it is not the owner of the public utility's property nor "clothed with the general power of management incident to ownership."[185] Under this view, the commission's authority would seem to be limited to assuring that retail utility rates are reasonable.[186]

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[177] *See* Ariz. Corp. Comm'n v. State *ex rel.* Woods, 830 P.2d 807, 818 (Ariz. 1992) (en banc).

[178] *Pac. Tel. & Tel. Co.*, 215 P.2d at 449 (Carter, J., dissenting).

[179] *Id.*

[180] *Management Invaded – A Real or False Defense?*, 5 Stan. L. Rev. 110, 111 (1952) [hereinafter *Management Invaded*].

[181] *Id.* at 110, 117.

[182] *Id.* at 117.

[183] Munn v. Illinois, 94 U.S. 113, 126 (1876).

[184] *See* Moeller, *supra* note 5, at 358-59 nn.132, 135 (citing Lochner v. N. Y., 198 U.S. 45, 61 (1905)) (finding a New York labor statute to be unconstitutional under the Fourteenth Amendment because it was "an illegal interference with the rights of individuals . . . to make contracts regarding labor upon such terms as they think best . . . "). *Lochner* "ushered in the so-called Lochner era of economic substantive due process, which, in retrospect, appeared to be hostile to state economic and social regulation." *Id.*

[185] Missouri. *ex rel.* Southwestern Bell Tel. Co. v. Pub. Serv. Comm'n, 262 U.S. 276, 289 (1923).

[186] *Management Invaded*, *supra* note 180, at 117.

One law review article suggested that generally worded grants of power to commissions clearly refer only to those services and facilities in the area of *direct utility-consumer contact* and observed that "commission orders are uniformly upheld when the managerial decision 'invaded'" is within areas of utility-consumer contact.[187] However, the article, which relied largely on the California Supreme Court's reasoning in *Pacific Telephone*, said a commission's power to regulate is properly limited by invasion of management arguments when "a regulatory body has attempted to order 'how' a service or facility is to be provided" as opposed to what kind of service is to be provided.[188] Further, it also suggested that courts limit a commission's power to regulate what services are provided when "no public necessity can be shown [for the service] and the service is losing money."[189]

A. The Invasion of Management Rationale Has Succumbed to Regulatory Realism

1. General Telephone v. Public Utilities Commission

Since *Pacific Telephone,* however, cases not only in California but in other jurisdictions as well, have "cast serious doubt[s] on the continuing vitality" of the "'invasion of management' rationale"[190] and, consequently, some of the propositions put forth in the law review article discussed above. As explained by the California Supreme Court in *General Telephone v. Public Utilities Commission,* thirty years after its decision in *Pacific Telephone,* "the *Pac. Tel.* court's observations regarding the commission's power to control the relationship between utilities and their parents or affiliates have succumbed to regulatory realism."[191] Regulatory realism means that courts approve of commission practices which refuse to recognize the distinction between public utilities and their affiliates or parents for regulatory purposes.[192]

General Telephone involved a challenge to a commission order that directed the telephone company to solicit competitive bids for new switching equipment in lieu of its usual practice of buying switching equipment from an affiliate.[193] In so ordering, the commission tied its directive to a finding that General's telephone service was unsatisfactory and that the commission's order was necessary to prevent General "from favoring GTE's manufacturing subsidiary to the detriment of the service General provides."[194] General Telephone Company, relying on *Pacific Telephone*, argued that the legislature had not granted the commission the power to regulate the company's contracts; the commission could not imply such powers under the commission's rate-making authority because "[almost] every contract a utility makes is bound to affect its rates and services"; and that "[the] determination of what is reasonable in con-

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[187] *Id.* at 118-119.
[188] *Id.* at 122.
[189] *Id.* at 123.
[190] Gen. Tel. Co. v. Pub. Utils. Comm'n, 670 P.2d 349, 353 (Cal. 1983).
[191] *Id.* at 355.
[192] *Id.*
[193] *Id.* at 351.
[194] *Id.* at 350 n.3.

ducting the business of the utility is primarily the responsibility of management."[195]

The court disagreed, noting that the invasion of management rationale "now appears to be disfavored"[196] and explained "[w]e have been unable to locate a single case since *Pac. Tel.* in which this court has annulled a commission order based on this rationale."[197] To the contrary, the court recounted its affirmation of a commission order requiring Southern Pacific Railroad to furnish a particular type of passenger service, "even specifying the particular equipment to be used, despite Southern Pacific's claim that the order was an invasion of management."[198] The court also noted "the most conspicuous example of an asserted but rejected claim of 'invasion of management . . .' – the commission's order requiring construction of a passenger station and terminal in Los Angeles . . . in *Atchison, etc., Ry. Co. v. Railroad Com* . . . In that case, the commission not only ordered the construction and specified the amount to be spent, but provided plans for the station."[199]

"[A]s the 'invasion of management rationale' has waned, [the California Supreme Court] ha[s] been more willing to permit regulatory bodies to exercise powers not expressly stated in their mandate."[200] Under its regulatory realism paradigm, the court concluded that, although the commission could not treat interaffiliate contracts differently than other contracts entered into by the utility for conducting its business, it could refuse to recognize the distinction between public utilities and their affiliates.[201] As an example, the court pointed to its previous affirmation of commission orders wherein the commission looked directly to the profits of the parent from sales to affiliates in calculating rate

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[195] Pac. Tel. & Tel. Co. v. Pub. Utils. Comm'n, 215 P.2d 441, 445 (Cal. 1950).

[196] Gen. Tel. Co. v. Pub. Utils. Comm'n, 670 P.2d 349, 354 n.10 (Cal. 1983).

[197] *Id.*

[198] *Id.* at 353-54 (citing S. Pac. Co. v. Pub. Utils. Comm'n, 260 P.2d 70, 79 (Cal. 1953)) (finding the Commission had express legislative authority to order changes in service and the type of passenger cars to be used in providing such service, observing:

> In exercising the powers . . . granted it may not be disputed that the commission to some extent invades the functions of management. But they are not necessarily unlawfully invaded. They are subjected to the exercise of the police power of the state in the regulation of the public utility. It is undoubtedly true that for the most part all lawful regulations of a public utility in the exercise of the police power are to some degree an invasion of the managerial functions of the utility. In the absence of such regulations the utility would be free to exercise all powers of management otherwise within the law.

[199] *Id. See also* Atchison Ry. Co. v. R.R. Comm'n, 209 Cal. 460 (Cal. 1931) *aff'd sub. nom* Atchison, T & S.F. Ry. Co. v. R.R. Comm'n of Cal., 283 U.S. 380 (1931) (ordering the construction of, and specifying the amount to be spent for, a railroad station).

[200] *Id.* at 354 (referring to Ralph's Grocery Co. v. Reimel, 69 Cal. 2d 172, 176 (Cal. 1968) (concluding that the sole function of a court in determining whether an administrative rule falls within the coverage of the delegated power is whether the agency "reasonably interpreted the legislative mandate"); Gay Law Students Ass'n v. Pac. Tel & Tel. Co., 24 Cal. 3d 458, 469-70 (Cal. 1979) (holding plaintiffs' allegations of arbitrary employment discrimination against homosexuals as a cause of action against the utility under the Public Utilities Code; noting the state generally expects a public utility to conduct its affairs more like a governmental entity than a private corporation; and concluding "[u]nder these circumstances, we believe the state cannot avoid responsibility for a utility's systematic business practices and that a public utility may not properly claim prerogatives of 'private autonomy' that may possibly attach to a purely private business enterprise").

[201] *Id.* at 355.

base[202] and affirmed an earlier conclusion that the "'utility enterprise must be viewed as a whole without regard to the separate corporate entities . . . .'"[203] The court also referenced a commission finding that two wholly owned subsidiaries of GT&E, "'are, in effect, different departments of one business enterprise, so there exists no incentive to real bargaining . . . .'"[204]

The court stopped short of expressly overturning *Pacific Telephone.* Instead, the court distinguished *Pacific Telephone* and affirmed the commission's order because it involved direct utility-consumer contact – that is, telephone service to consumers could only be improved if General Telephone could "be pried away from its dependence on the antiquated equipment being manufactured by [its affiliate]."[205] Despite the court's failure in *General Telephone* to specifically decide whether the invasion of management rationale survived,[206] there can be little doubt that if the rationale exists at all, it is applicable only when the commission's action has "nothing to do with the 'relationship of the utility to the customer'" or does not "affect 'the manner in which the utility provide[d] the affected services.'"[207] Consistent with the law review article's observations noted above, the "'management invaded' pejorative has little application in the area of 'direct consumer-utility contact.'"[208]

2. PNM Electric Services v. New Mexico Public Utility Commission

The California Supreme Court's view is consistent with the opinions of other state courts. For example, the New Mexico Supreme Court, in upholding a commission order denying Public Service of New Mexico's applications to provide optional electric and gas services, concluded that such denial did not constitute an impermissible intrusion upon a management prerogative.[209] Explaining that the commission's order was based upon the commission's statutory obligation to ensure that the utility did not engage in activities that could harm its ability to provide service at just and reasonable rates, the court found that the commission was well within its authority to require that the optional services be carried out through unregulated subsidiaries.[210] Although recognizing there were limits to a commission's ability to inject itself into the internal management of a utility, the court rejected that argument as a basis for reversal and found the invasion of management prohibition had "waned."[211] The court

[202] *Id. See* Pac. Tel. & Tel Co. v. Pub. Utils. Comm'n, 401 P.2d 353, 370 (Cal. 1965) (affirming the determination by the commission that Western Electric was not entitled to a return on its sales that was any higher than the return Pacific was entitled to earn on its regulated operations).

[203] *Id.* (citing L.A. v. Pub. Utils. Comm'n, 497 P.2d 785, 795 (Cal. 1972)).

[204] *Id.* (citing Decision No. 75873, 69 Cal. P.U.C. 601, 634-639 (1969)).

[205] *Id.* at 355.

[206] *Id.*

[207] *Id.* at 356.

[208] *Id. See also* Barnett Stepak v. Am. Tel. & Tel. Co., 186 Cal. App. 3d 633, 646 (Cal. Ct. App. 1986) (noting that the invasion of management rationale, while "near terminal" in the area of direct consumer-utility contact, has life in other areas, such as in fairness to disappearing minority interests when they would have no effect on rates or services) (internal citations omitted).

[209] PNM Elec. Servs. v. N.M. Pub. Util. Comm'n, 961 P.2d 147, 150 (N.M. 1998).

[210] *Id.* at 151.

[211] *Id.* at 152.

noted that commissions have "substantial latitude in protecting the public" and that "commissions are generally empowered to act in areas seemingly reserved to management prerogative where the regulated action is 'impressed with a public interest.'"[212]

3. Arizona Corporation Commission v. State ex rel. Woods

In *Arizona Corporation Commission v. State ex rel. Woods*, the Arizona Supreme Court concluded that the Arizona commission had the authority to adopt rules governing interaffiliate transactions even in the absence of regulatory authority separate from its rate-making powers.[213] The court also rejected an argument that the commission had "no authority to become involved in management issues indirectly related to rates [such as proposing rules governing interaffiliate transactions] because such involvement is not necessary in setting rates."[214] The court concluded what was necessary in setting rates must be interpreted in light of the commission's "range of legislative discretion"[215] and in accord with "the framers' intent of the Commission's function: to protect consumers from abuse and overreaching by public service corporations."[216] The court was persuaded by the California Supreme Court's pronouncements that "the utility enterprise must be viewed as a whole without regard to the separate corporate entities . . ." and "[t]he invasion of management arguments fail to recognize the special relationship between affiliated companies and the strong potential that transactions between affiliates will affect rates."[217] The court continued that the intent of the framers was to "protect our citizens from the results of speculation, mismanagement, and abuse of power" and that limiting the Commission's ratemaking power so that it could "do no more than raise utility rates to cure the damage from [unwise] inter-company transactions" would subvert that intent.[218] The court concluded that the proposed rules did

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[212] *Id.* (citing Pub. Serv. Co. v. State *ex rel.* Corp. Comm'n, 918 P.2d 733, 739 (Okla. 1996) (quoting Mo. Pac. R.R. Co. v. Corp. Comm'n, 672 P.2d 44, 44 (Okla. 1983)). It should be noted that in *Pub. Serv. Co.*, the Oklahoma Supreme Court struck down a commission regulation which required an acquiring electric supplier to pass the costs of changing suppliers onto the customer rather than allowing the company to make the decision whether to pass the cost on or to absorb the cost. The court said the regulation in question was an improper invasion of management because "how and who" should absorb the cost of a change in electric suppliers was not within the realm of the Commission's authority, absent some overall public effect. *Id.* at 740. In coming to its decision, the Court relied upon its 1934 decision in *Lone Star Gas Co. v. Corp. Commission,* wherein the Court held "[t]he powers of the commission are to regulate, supervise and control the public service companies in their services and rates, but these powers do not extend to an invasion of the discretion vested in corporate management. It does not include the power to approve or disapprove contracts about to be entered into, nor to the approval or veto of expenditures proposed." Lone Star Gas Co. v. Corp. Comm'n, 39 P.2d 547, 553 (Okla. 1934).

[213] Ariz. Corp. Comm'n v. State *ex rel* Woods, 830 P.2d 807, 818 (Ariz. 1992) (en banc).

[214] *Id.* at 816.

[215] *Id.* (quoting Simms v. Round Valley Light & Power Co., 294 P.2d 378, 384 (Ariz. 1956)) (explaining "[t]he commission in exercising its rate-making power of necessity has a range of legislative discretion . . . .") (internal cross-reference omitted).

[216] *Id.*

[217] *Id.* at 817 (citing Gen. Tel. Co. v. Pub. Utils. Comm'n, 670 P.2d 349, 355 (Cal. 1983)).

[218] *Id.*

not "constitute an attempt to control the corporation rather than an attempt to control rates."[219]

4. BellSouth Advertising & Publishing Corporation v. Tennessee Regulatory Authority

Other state courts have also endorsed the regulatory realism paradigm put forth in *General Telephone.* For example, in *BellSouth Advertising & Publishing Corp. v. Tennessee Regulatory Authority,*[220] the court concluded "the Public Service Commission is not bound in all instances to observe corporate charters and the form of corporate structure or stock ownership in regulating a public utility, and in fixing fair and reasonable rates for its operations."[221]

5. In the Matter of Rochester Telephone Corporation v. Public Service Commission *and* In the Matter of New York Telephone Company v. Public Service Commission of New York

Courts have also affirmed commission decisions, which ignored the distinction between public utilities and their affiliates when imputing benefits from an affiliate's business operations to the utility, when such benefits can be linked to contributions made by ratepayers toward that affiliate's profits. For instance, the New York Court of Appeals affirmed an order by the New York commission to impute a two percent royalty, as revenue to Rochester Telephone Corporation from unregulated affiliates, to compensate ratepayers for "improper cost-shifting" and the uncompensated use of the telephone company's name and reputation.[222] In addition, the New York Court of Appeals recently reversed the Appellate Division's annulment of a New York Commission order, which required New York Telephone Company to distribute the intrastate portion of the proceeds of the sale of its communications research facility to the telephone company's ratepayers as a credit to its customers' bills.[223]

B. An Abuse of Discretion Standard is an Ineffective Second Choice

1. Duquesne Light Company & Pennsylvania Power Company v. Pennsylvania Public Utility Commission

Not all courts, however, have been willing to eviscerate the invasion of management rationale as a defense to commission orders that are alleged to have improperly intermeddled in management prerogatives. For example, in *Duquesne Light Co. & Pennsylvania Power Co. v. Pennsylvania Public Utility Commission,* the Commonwealth Court of Pennsylvania affirmed two commission orders that established a market price-capping mechanism for the cost of

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[219] *Id.* at 818.

[220] BellSouth Adver. & Publ'g Corp. v. Tenn. Regulatory Auth., 79 S.W.3d 506 (Tenn. 2002).

[221] *Id.* at 516 (citations omitted).

[222] *In re* Rochester Tel. Corp. v. Pub. Serv. Comm'n, 660 N.E.2d 1112, 1114 (N.Y. 1995).

[223] *In re* N.Y. Tel. Co. v. Pub. Serv. Comm'n of N.Y., 731 N.E.2d 1113, 1114 (N.Y. 2000).

coal purchased from certain mines.[224] The companies argued that the commission's denial of the right to recover the cost of coal purchased from certain mines interfered with the utilities' lawful management decisions in initiating and continuing a mining project that was not found to be imprudent.[225] Acknowledging that there were limitations to the commission's authority to "inject itself in the management of a public utility," the court nevertheless concluded that a commission may regulate utilities "where their actions affect the public they serve. Of course, rates affect that public. Indeed, the Commission has an ongoing duty to protect the public from unreasonable rates."[226]

2. Pennsylvania Public Utility Commission v. Philadelphia Electric Company

The Pennsylvania Supreme Court, however, later tempered this opinion in *Pennsylvania Public Utility Commission v. Philadelphia Electric Co.*[227] In *Philadelphia Electric,* the commission and consumer advocate challenged an order of the Commonwealth Court, which reversed a commission order denying a $57 million rate increase requested by the utility.[228] In affirming the lower court's ruling in part, and reversing it in part, the court explained that an obvious corollary to the proposition that it is not within a public utility commission's province to interfere with the management of a utility unless an abuse of discretion can be shown, is that "if there has been an abuse of managerial discretion, and the public interest has been adversely affected thereby, then the Commission is empowered to intervene."[229]

Despite the Pennsylvania courts' view that the invasion of management rationale is still viable in a regulatory setting, the judicial approach to its use is worthy of consideration for those who reject the conclusions in *General Telephone.* It is arguable that the Pennsylvania approach is more closely aligned with the Supreme Court's utterance on the subject in *Southwestern Bell*, and represents a more restrained approach to regulatory activism. It is unclear, however, who would bear the burden of showing that the utility's action was an abuse of discretion, or arbitrary, or how such an approach would protect ratepayers before the damage was done. As such, the Pennsylvania approach may be no better than the well-settled principle that commissions may disallow inappropriate operating expenses generated by interaffiliate contracts, which will only result in a rate reduction if implemented as part of a rate case.

C. *The Arguments for Discarding the Invasion of Management Rationale*

On the other hand, *General Telephone* and the decisions that are supportive of it, offer numerous valid reasons for courts to disregard the antiquated invasion of management rationale when dealing with transactions between a public utility and its affiliates. As observed in *General Telephone,* the invasion

[224] Duquesne Light Co. & Pa. Power Co. v. Pa. Pub. Util. Comm'n, 507 A.2d 1274, 1281 (Pa. Commw. Ct. 1986).
[225] *Id.* at 1278.
[226] *Id.* (citations omitted).
[227] 561 A.2d 1224, 1228 (Pa. 1989).
[228] *Id.* at 1225.
[229] *Id.* at 1226-27 (internal citations omitted).

of management rationale is no longer viable in a jurisdiction where courts have routinely affirmed commission orders that have directed utilities to take actions normally reserved for management. Such is the situation in California where, for example, in *Southern Pacific*, the California Supreme Court affirmed a commission order to provide rail service to consumers by the use of a certain kind of rail car.[230] In *Atchison Railway Company*, the California Supreme Court also affirmed a commission order to construct a new rail station, complete with plans for the station supplied by the commission.[231] Thus, in jurisdictions where the invasion of management rationale has not, in the past, limited a commission's exercise of powers normally reserved for management in deciding "how" a service is to be provided, the rationale cannot be a viable defense in the future.

Further, the regulatory realism paradigm, embraced by a number of state courts, allows a commission to disregard the distinction between a public utility and its affiliates when looking at interaffiliate transactions, because there is no "incentive to real bargaining" in such instances.[232] As a result, courts have rejected the invasion of management defense when commissions have (1) looked at the profits of the parent or the affiliate in calculating rate base, (2) construed affiliates as being subject to direct commission regulation when they are performing obligations of the regulated entity, or (3) extended their authority over interaffiliate transactions in the absence of specific legislative authority to do so.

As pointed out in *General Telephone,* almost all regulations put forth by a public utilities commission can be said, in some way, to invade the prerogatives of management.[233] However, such invasions are not necessarily unlawful so long as the commission is exercising the police powers of the state in protecting the public from mismanagement and the abuse of power that could result from interaffiliate transactions negotiated in the absence of arm's length bargaining. As correctly referenced in *General Telephone*, the state generally expects a public utility to conduct its affairs more like a governmental entity than a private corporation.[234] "Under these circumstances . . . a public utility may not properly claim prerogatives of 'private autonomy' that may possibly attach to a purely private business enterprise."[235]

This concept is consistent with the proposition put forth in *Munn v. Illinois*, which provided that when a person commits property to a use in which the public has an interest, that person has granted the public an interest in that use, and must submit to be controlled by the public for the common good.[236] Legislatures have granted commissions broad supervisory powers to protect consumers from abuse and overreaching by utilities. For example, the California commission is vested with vast regulatory powers to supervise and regulate

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[230] *See* S. Pac. Co. v. Pub. Utils. Comm'n, 260 P.2d 70 (Cal. 1953).

[231] *See* Atchison Ry. Co. v. R.R. Comm'n, 288 P. 775 (Cal. 1931) *aff'd sub. nom* Atchison, T & S.F. Ry. Co. v. R.R. Comm'n of Cal., 283 U.S. 380 (1931).

[232] Gen. Tel. Co. v. Pub. Utils. Comm'n, 670 P.2d 349, 355 (Cal. 1983) (citation omitted).

[233] S. Pac. Co. v. Pub. Utils. Comm'n, 260 P.2d 70, 79 (Cal. 1953).

[234] Gay Law Students Ass'n v. Pac. Tel & Tel. Co., 595 P.2d 592, 599 (Cal. 1979).

[235] *Id.*

[236] Munn v. Illinois, 94 U.S. 113, 126 (1876).

its jurisdictional utilities and "to do all things, whether herein specifically designated or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction."[237] By implication, therefore, any action that impacts a utility's ability to provide reliable service to its customers at reasonable rates is properly within the commission's jurisdiction. This is particularly true of transactions between a pubic utility and its affiliates, because such arrangements lack arm's length negotiations and are thus "subject to suspicion and . . . present dangerous potentialities."[238]

Lastly, as observed in *General Telephone,* invasion of management can only apply to commission decisions that do not involve direct utility-customer contact or affect the utility's ability to serve the public efficiently at reasonable rates.[239] As noted by the California Supreme Court in *Pacific Telephone*, however, "[a]lmost every contract a utility makes is bound to affect its rates and services."[240] Likewise, almost every interaffiliate transaction is bound to affect a utility's rates or services. In view of broad commission authority to regulate the rates and services of public utilities, and the growing acceptance of the principle that the invasion of management rationale has little application in the area of direct consumer-utility contact, there can be very few legitimate assertions that commissions invade the prerogatives of management when directly regulating transactions between public utilities and their affiliates.

V. Conclusion

The standard established by the Supreme Court in *Smith,* which allows commissions to investigate the cost incurred by an affiliate in providing a service to a public utility and disallow any portion of it deemed to be unreasonable, provides public utility commissions indirect authority over interaffiliate transactions, but is "a dubious method of preventing the payment of excessive fees to affiliates."[241] Moreover, modern interaffiliate transactions have gone far beyond the simple act of overcharging a public utility and thus inflating its operating costs. As demonstrated by the actions of Enron and WRI, "intercorporate dealings . . . of public utilities can have disastrous consequences for the economic viability of the entire enterprise, and . . . such misfortunes are visited not only on the stockholders of the company but the ratepayers of the state."[242] As noted by one commentator, "absent regulatory oversight, it is not clear how ratepayers can be protected from holding company accounting abuses such as unrecorded cross-subsidization among subsidiaries."[243]

The challenge today is for legislatures and courts to recognize that public utility commissions must have the authority to not only disallow excessive operating expenditures caused by improper interaffiliate transactions, but to guard against other financial pressures being placed upon utilities. The call for

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[237] Pac. Tel & Tel. Co. v. Pub. Utils. Comm'n of Cal., 215 P.2d 441, 450 (Cal. 1950) (Carter, J., dissenting).
[238] *Id.*
[239] Gen. Tel. Co. v. Pub. Utils. Comm'n, 670 P.2d 349, 356 (Cal. 1983).
[240] *Pac. Tel. & Tel. Co.*, 215 P.2d at 445.
[241] *The Servicing Function*, *supra* note 7, at 986.
[242] Ariz. Corp. Comm'n v. State *ex rel* Woods, 830 P.2d 807, 817 (Ariz. 1992) (en banc).
[243] *Id.* (citing Fickinger, *supra* note 3, at 96).

"[l]egislators [to] . . . recognize that public service commission jurisdiction should extend comprehensively over public utility holding companies and their non-utility subsidiaries"[244] is as urgent today as it has been in the past.

Even in the absence of a specific statutory provision clarifying a commission's authority over interaffiliate transactions, however, the general statutes authorizing commissions to regulate the activities of public utilities can, and should, be construed to provide commissions with the necessary authority to achieve the desired legislative end of protecting ratepayers from abusive interaffiliate transactions. Such transactions have a great potential to harm ratepayers because they are formed absent arm's length negotiations and are between corporations that control one another. Public utility commissions, through the doctrine of implied powers, should be able to control interaffiliate transactions to achieve the desired legislative end of protecting consumers from the negative side effects of self-serving deals that might otherwise evade regulatory detection. As argued by Justice Carter in *Pacific Telephone,* if a commission can indirectly disapprove an interaffiliate transaction by disallowing it in rates, it should also be able to "lock the door before the horse is stolen."[245]

Courts should disregard the invasion of management rationale for nullifying a commission's order, which was first introduced during a bygone era in which the Supreme Court was hostile to state economic regulation.[246] In its place stands the regulatory realism paradigm articulated by the California Supreme Court, which allows commissions to ignore the distinctions between public utilities and their affiliates or parents when evaluating interaffiliate transactions.[247] Further, regulated utilities must be viewed much more like government entities than private entities and, as such, are not entitled to claim the prerogatives of a privately held business. They have submitted to be controlled for the public good. The commission is the body designated by the legislature to exercise the state's police power in this area and decide what is in the public interest, not utility management. The invasion of management rationale is simply inapplicable to the vast majority of decisions made by public utility commissions, because such decisions affect direct utility-consumer contact or a utility's ability to provide effective service at reasonable rates.[248] The invasion of management rationale, like a rusty old battle-axe that has seen better days, has no legitimate role to play in the judicial review of today's public utility cases.

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[244] Fickinger, *supra* note 3, at 116.

[245] Pac. Tel. & Tel. Co. v. Pub. Utils. Comm'n, 215 P.2d 441, 449 (Cal. 1950) (Carter, J., dissenting).

[246] *See* Missouri *ex rel.* Southwestern Bell Tel. Co. v. Pub. Serv. Comm'n, 262 U.S. 276, 282 (1923).

[247] Gen. Tel. Co. v. Pub. Utils. Comm'n, 670 P.2d 349, 355 (Cal. 1983).

[248] *Id.* at 355-56.