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Missouri Public
Service Commission

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VIA OVERNIGHT DELIVERY

Mr. Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge
Missouri Public Service Commission
P.O. Box 360
Jefferson City, MO 65102

RE: Case No. EX-99-442

Dear Mr. Roberts:

Enclosed for filing with the Commission in the above-referenced matter are the original, and 15 copies of Kansas City Power & Light Company's Reply Comments regarding the Staff's proposed rules to govern affiliate transactions. In addition, I have enclosed a return envelope whose postage is prepaid. Please time stamp one of the copies and return it to KCPL.

Please bring this filing to the attention of the Commission.

Thank you for your attention to this matter.

Sincerely yours,

Gerald A. Reynolds

Enclosures

cc: Office of the Public Counsel

STATE OF MISSOURI
PUBLIC SERVICE COMMISSION

REPLY COMMENTS
OF KANSAS CITY POWER & LIGHT COMPANY

Proposed Rule 4 CSR 240-20.015
Electric Utilities Affiliate Transactions
Case No. EX-99-442

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REPLY COMMENTS
OF KANSAS CITY POWER & LIGHT COMPANY

I. Introduction

Kansas City Power & Light Company ("KCPL" or the "Company") welcomes the opportunity to reply to the comments submitted by various parties pursuant to the Commission's proposed affiliate transaction rules for Missouri electric utilities. KCPL appreciates the chance to respond to these comments in this important proceeding. KCPL believes that the comments submitted by a number of parties in response to the proposed rules improperly go far beyond the scope of the proposed rules, in focusing their comments on a hypothetical future deregulated electricity marketplace.

On the contrary, the proposed Missouri rules do not address a restructured market. The Missouri electricity market likely will not undergo restructuring for several years. Consequently, KCPL believes that the parties to whom KCPL is responding have gone beyond the appropriate scope of the rules by discussing deregulated electricity markets and referencing states that have gone through deregulation as exemplary models for Missouri. In this proceeding, these broader issues are both premature and unnecessary for the Commission to address. KCPL nonetheless will address a number of the points dealing with deregulation in these comments to illustrate to the Commission that such proposals are premature and unnecessary.

KCPL believes it is important for the Commission to adopt affiliate transaction rules that are carefully designed to promote competition and maximize consumer welfare. In this regard, KCPL is concerned that some of the commentators in this proceeding are urging the Commission to adopt rules that would selectively handicap incumbent utilities' ability to use their legitimate competitive strengths in their affiliates' unregulated markets. Although such rules are advocated under the banner of "leveling the playing field," they are, in fact, based on a misperception of the concept of "market power." As we will show, Missouri consumers will ultimately be the losers if the Commission yields to such proposals.

Restrictions designed to prevent Missouri utilities from utilizing ordinary economies of vertical integration and scope only serve to increase the costs of the incumbents -- not promote competition. Efficiency-enhancing activity on the part of firms is something the Commission should encourage. In fact, the aims of competition are only achieved when firms are encouraged to be as efficient as possible. Only then are society's scarce resources allocated to their highest valued uses. This principle clearly applies to vertically integrated utilities. As the noted economist and former chair of the New York Public Service Commission, Alfred Kahn, has recently said (in discussing electricity deregulation at the FERC), "economies of scale or scope are precisely the kind of efficiencies ... that we want firms to take advantage of in competing and that we want to prevail in competition."[1] When firms are efficient, costs are minimized, and consumers ultimately benefit from lower prices and quality service. This position was endorsed in testimony regarding electricity deregulation presented on July 28, 1999 on behalf of the Federal Trade Commission ("FTC") by FTC Commissioner Thompson, opposing divestiture requirements because of the "sacrifice of potentially important economies of scope and vertical integration."[2]

As the Company noted in its Initial Comments (July 1, 1999), KCPL fully supports the proposition that vertically integrated incumbent utilities should not be permitted to pass on to their customers costs that should properly be attributed to the operations of non-regulated affiliates. Such

1/ *Inside F.E.R.C.*, February 23, 1998 at 4.

2/ Prepared Statement of the Federal Trade Commission, Presented by Mozelle W. Thompson, Commissioner, Before the Committee on the Judiciary United States House of Representatives, July 28, 1999, p. 5.

cross-subsidization would not only be unfair to electricity customers, it would hinder the development of a fully competitive environment in the provision of non-utility products and services. Therefore, the Commission's adoption of affiliate transaction rules designed to prohibit inappropriate cost shifting is proper. The Company believes, however, that the affiliate transaction rules that have been proposed by the Commission go beyond their stated purpose in several respects. First, the rules impose unnecessary and burdensome record keeping and reporting requirements. Second, the rules define an inappropriate and unduly low threshold of "control" of an affiliate. And third, the rules provide for asymmetric pricing requirements that prohibit a vertically integrated company from exploiting legitimate economies of scale and scope to the detriment of consumer welfare. KCPL discussed each of these concerns in detail in its Initial Comments.

In this submission, we focus our comments on why the Commission should not adopt the even more over-reaching regulatory measures urged by other commentators, specifically the Office of Public Counsel (the "OPC"), the Missouri Industrial Energy Consumers ("MIEC"), and Mountain Energy.[3] We begin by setting out the basic principles that should guide the Commission in formulating appropriate affiliate transaction rules. With these basic principles as a backdrop, we then discuss why rules that place unwarranted competitive handicaps on incumbent utilities ultimately will injure the competitive process and result in very real harm to Missouri consumers.

II. The Commission Should Adopt Rules that Are Opportunity-Based, Impartial, and Forward-Looking

Supreme Court Justice Stephen G. Breyer, when he was an appeals court judge, in an extensive discussion of deregulation of telecommunications and airlines, noted that: a "special

3/ The proposals advanced by the OPC substantially encompass the proposals advanced by the MIEC and Mountain Energy. Therefore, this discussion replies principally to the OPC's Initial Comments (July 1, 1999).

policy risk of deregulation is that government policy makers will protect competitors instead of protecting competition."[4] He cautioned that, "[e]ither the regulatory system or the antitrust laws may be used [ill-advisedly, in his view] to protect new competitors rather than to serve the ends of competition."[5] Justice Breyer specifically considered, and rejected, alleged justifications for "competitive handicapping" such as the "considerable name recognition and other historical advantages" of the incumbent. He concluded that, "long-term, handicapping is wasteful even if deregulation itself was wrongly conceived," because the handicapping would either "deprive consumers of the benefits of lower costs" or simply interfere with the competitive process.[6] More recently, Justice Breyer reiterated this analysis in the context of a challenge to the Federal Communication Commission's implementation of the Telecommunications Act of 1996. He noted that:

> . . . given the Act's basic [deregulatory] purpose, it requires a convincing explanation of why facilities should be shared (or "unbundled") where a new entrant could compete effectively without the facility, or where practical alternatives to that facility are available. ... Moreover, a sharing requirement may diminish the original owner's incentive to keep up or to improve the property by depriving the owner of the fruits of value-creating investment, research, or labor. ... Rules that force firms to share every resource or element of a business would create, not competition, but pervasive regulation, for the regulators, not the marketplace, would set the relevant terms. ... Regulatory rules that go too far, expanding the definition of what must be shared beyond that which is essential to that which merely proves to be advantageous to a single competitor, risk costs that, in terms of the Act's objectives, may make the game not worth the candle.[7]

Justice Breyer's analysis is equally applicable to Missouri's treatment of vertically integrated utilities and the proposed handicapping of their unregulated affiliates. Specifically, the Commission

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4/ Breyer, Antitrust, Deregulation, and the Newly Liberated Marketplace, 75 Calif. L. Rev. 1005, 1018 (1987).
5/ *Id.* at 1022.
6/ *Id.* at 1024-26.
7/ *AT&T Corp., et al. v. Iowa Utilities Board, et al.*, __ U.S.__, 119 S.Ct. 721, 753-54 (1999) (J. Breyer concurring in part and dissenting in part).

must focus on promoting competition and not try to manage the outcome of competition by handicapping incumbent utilities and their affiliates in ways that harm consumers and undermine efficiencies.

Most parties in this proceeding, including KCPL, agree that, to protect competition, affiliate transaction rules should (1) protect against cross-subsidization between the competitive and regulated operations of an integrated utility, and (2) assure that business decisions made by unregulated affiliates of utilities be based solely on business conditions in the unregulated markets, without transfers of competitively significant information that would otherwise be unavailable to non-owners of transmission or distribution lines.

Agreement breaks down, however, over the question of whether it is necessary, to protect competition and enhance consumer welfare, that the rules also limit a vertically integrated utility's ability to use competitive advantages that are not traceable to its continued ownership of the distribution system. The OPC, for example, asserts that attributes that an incumbent utility acquired by virtue of its history as being the only electricity provider in its service territory, *i.e.*, attributes such as its brand name recognition, reputation with consumers, and current customer base, give the utility advantages in a deregulated marketplace that its competitors do not have. The OPC thus urges the Commission to restrict Missouri vertically integrated utilities' ability to use these attributes in conjunction with their non-regulated affiliates.

Restrictions of the type the OPC favors are backward-looking, detrimental to competition, and merely call for more regulation in the name of deregulation. The OPC's proposals are, thus, anti-consumer welfare. KCPL submits that, instead of placing handicaps on incumbent utilities, thus increasing their costs and weakening their ability to compete, the Commission should adopt competition-enhancing rules that are opportunity-based, impartial, and forward-looking.

Opportunity-based rules are rules designed to guarantee open access to *all* unregulated markets for *all* firms, including affiliates of utilities. *Impartial* rules are rules that treat all competitors the same and do not impose discriminatory, cost-raising burdens on any competitor -- either the vertically integrated incumbent utility or any new entrant -- and do not constrain the legitimate competitive conduct of any firm. *Forward-looking* rules are rules that disregard historical market conditions that are irrelevant to future competition and, rather, provide a framework for maximizing consumer benefits during the transition to restructured markets and thereafter.

The proper approach for the Commission can be readily summarized by the decision-tree approach set out in Figure 1:[8]

8/ We note that the top portion of the chart, which refers to "Marketing Restrictions," addresses issues that will likely be particularly relevant in the context of a deregulated market. Although this issue properly ought not be of concern to the Commission unless and until the industry undergoes deregulation, KCPL provides this decision approach in response to the comments of the OPC and others. The bottom half of the chart, involving "Information Exchanges," applies both to the current situation in Missouri electricity markets as well as to any future deregulation context.

Figure 1

MARKETING RESTRICTIONS

Does the proposed marketing restriction target an alleged competitive advantage that is derived solely from a utility's ***continued*** [*i.e.*, not its historic] monopoly ownership of distribution lines?

yes → It is proper for the Commission to adopt narrowly tailored restrictions on a utility's conduct.

no → Competitive advantages that are due to efficiencies and are not derived from ***continued*** ownership of distribution lines are legitimate marketplace advantages. Restrictions on such advantages merely raise a rival's costs and reduce consumer welfare.

INFORMATION EXCHANGES

Is the information shared between a utility and an affiliate information that is advantageous ***and*** only practically obtainable by exclusive control of distribution lines?

yes → It is proper for the Commission to require that the utility share the information with non-affiliates on the same basis as it shares the information with the affiliate.

no → Intracorporate information sharing promotes economies of scope and enhances efficiency. Requiring that such information be disseminated to others reduces incentives to invest in attaining efficient scope and size to the detriment of consumer welfare.

Decision Points:

- Advantages that an incumbent utility possesses that do not derive from its ***continued*** operation of power distribution lines are legitimate competitive advantages and their use should not properly be restricted by the Commission.

- Only information that can be practically obtained only by exclusive control of distribution lines ***and*** is advantageous to marketing power is a proper concern of the Commission.

A. Opportunity-Based, Impartial, and Forward-Looking Rules Promote the Fundamental Objectives of Deregulation

Opportunity-based rules that assure open access to restructured retail markets will permit all competitors, including new entrants of varying sizes and types as well as affiliates of incumbent utilities, to win and retain customers and build their businesses on the basis of efficiencies and the provision of superior prices, quality, and reliability for products and services. This is the essence of the competitive process.

Impartial rules will ensure that the mix, prices, quality, and reliability of products and services in restructured markets reflect consumer choice and preferences, rather than any pre-determined regulatory designs. Inevitably, of course, when competitors compete under impartial rules, some are bound to do better than others in the marketplace. But an unequal outcome in the marketplace, when based on consumer choice and preference, is a desirable and proper result of the competitive process, and not the result of anticompetitive abuse of market power.

Forward-looking rules aim to maximize consumer welfare on a going-forward basis. This means that proper rules should not only allow, but encourage, all competitors and potential competitors to bring to the marketplace whatever procompetitive strengths they might possess, regardless of their historical origin. "Procompetitive strengths" are any product or service attribute that has positive net value to consumers.

The Commission should follow these principles to secure the available economies of scale and scope and to establish vigorous competition in the provision of goods and services in electric markets. By contrast, rules that would remove historical regulations in retail markets, but would simultaneously impose new regulatory burdens on vertically integrated incumbent utilities would, in the end, be counterproductive.[9] Such burdens would simply "raise a rival's costs," to the benefit of certain competitors and to the detriment of consumers.

The view that impartial, equal treatment of all competitors and potential competitors is the key to protecting the competitive process, has also been expressed by the Chairman of the Federal Trade Commission, Robert Pitofsky, in discussing competition policy in the communications industries. Chairman Pitofsky outlined "a few principles that apply across the board to newly deregulated industries," including:

> Serious regulatory problems arise where some players in an industry are regulated and some are not, with the unregulated free to raise or cut prices in pursuit of various competitive strategies. It is difficult and often unfair to try to maintain a system for long where direct competitors are subject to radically different regulatory rules. . . . In a deregulatory environment, we should always be looking for ways to equalize treatment by reducing regulatory burdens on incumbents rather than by increasing them on new entrants.[10]

In testimony presented on behalf of the FTC by FTC Commissioner Thompson on July 28, 1999, this position was reiterated:

> . . . the transition from regulation to competition is never instantaneous or complete. Market participants may find themselves subject to inconsistent requirements. Some participants may become subject to market forces while others remain regulated, or

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9/ This important conclusion was made by Professors Paul W. MacAvoy, Daniel F. Spulber, and Bruce E. Stengle in discussing natural gas restructuring. *See* MacAvoy, Spulber, and Stengle, *Is Competitive Entry Free? Bypass and Partial Deregulation in Natural Gas Markets*, 6 *Yale Journal on Regulation* 209 (1989): "Efforts by various regulatory authorities to establish a 'level playing field' may create what we call 'incumbent burdens.' These are regulatory constraints that limit an established firm's ability to compete. Under partial deregulation, then, incumbents cannot compete freely with entrants." *Id.* at 210. They also note that "Partial deregulation can lead to more administrative intervention in markets. As regulators seek to manage competition or to level the playing field, regulatory activities can increase. To counter perceived entry barriers, incumbent burdens are imposed, limiting the established firm's ability to compete. Disguised subsidies to entry may be provided. To the extent that regulatory activities persist after entry controls are lifted, it is impossible to make predictions about the market outcome using models of competitive markets. Managed competition can lead to distorted prices, inefficient product quality, and insufficient or excess investment levels. Therefore, although competition is desirable, that goal need not lead to the conclusion that all entry barriers in the utility industry should be removed." *Id.* at 231.

10/ Remarks of Robert Pitofsky, Chairman, Federal Trade Commission, "Competition Policy in Communications Industries: New Antitrust Approaches," at Glasser Legal Works Seminar, Washington, D.C. (March 10, 1997).

different participants may be subject to different regulatory rules. It may be inefficient and unfair to have different regulatory rules apply to direct competitors.[11]

These views have been presented by other officials of the FTC[12] and are consistent with the position of the Department of Justice's Antitrust Division[13] in dealing with transitions to deregulation.

B. The Commission Should Not Be Concerned with the Particular Mix of Strengths and Weaknesses Possessed by Competitors

Inherent in the competitive process is the fact that different competitors will always have differing mixes of strengths and weaknesses in vying for consumers. This is a strength of the process, and redounds to the benefit of consumers. In market-based competition, there are no artificial "handicaps" placed on competitors to attempt to render all competitors equal in strengths and weaknesses. To the contrary, market competition embodies incentives for each competitor to utilize its unique mix of attributes to the fullest to serve consumers well because, in a competitive market, serving consumers well is the only way a firm is rewarded. To foster the competitive process in Missouri electricity markets, proper policy rules need only ensure that there is sufficient opportunity for viable competition by providing for open access to distribution systems and by preventing cross-subsidization; policy rules should not be concerned with the particular mix of

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11/ Prepared Statement of the Federal Trade Commission, Presented by Mozelle W. Thompson, Commissioner, Before the Committee on the Judiciary United States House of Representatives, July 28, 1999, p. 3.

12/ *See* Remarks of Debra A. Valentine, General Counsel, Federal Trade Commission, "Antitrust In a Global High-Tech Economy," before the American Bar Association, Law Practice Management Section, Women Rainmakers and The Women's Bar Association of the District of Columbia, Washington, D.C. (April 30, 1999).

13/ *See* Letter of Joel I. Klein, Acting Ass't Att'y Gen'l, Antitrust Division, to Reed Hundt, Chairman, FCC, Re: Access Charge Reform, CC Docket No. 96-262, et al. (April 24, 1997). Representing the Antitrust Division, AAG Klein advocated that the Federal Communications Commission ("FCC") grant ILECs [incumbent local exchange carriers] increasing flexibility in pricing access services during the transition to competitive markets and that the FCC rely on emerging competition to reduce access prices, even though "market forces that will pressure access charges towards economic costs are likely to take some time to materialize for most customers in most areas."

strengths and weaknesses possessed by each competitor, and should not, accordingly, impose asymmetric "corrective" handicaps on any competitor.

Of course, the competitive process results in some competitors being injured insofar as they lose customers and suffer diminished profits when rivals serve consumers better. But such loss of customers is desirable and proper, and not the result of anticompetitive conduct. As Justice Breyer further noted during his time as appeals court judge, anticompetitive actions are not those "that merely injure competitors, but [are] actions that harm the competitive process, a process that aims to bring consumers the benefit of lower prices, better products, and more efficient production methods."[14]

III. Adoption of the Specific Proposals Advanced by the OPC Would Be Detrimental to Consumer Welfare

Among the specific handicapping proposals that the OPC has advanced in this proceeding are that the Commission prevent a competitive affiliate of an incumbent utility from (1) using its parent utility's brand name and mark, (2) engaging in joint marketing with the utility, and (3) hiring a utility employee except under severe time limitations and with compensation. The OPC's arguments for such restrictive codes rest on assertions that incumbent utilities will possess market power in retail markets because of their name recognition and reputation with consumers, as well as because of the historic role of the incumbent as the sole provider of electricity in its region. The argument is made, therefore, that regulatory handicapping of the incumbent is necessary in order to facilitate and ensure the successful entry of new providers into the market. This argument fails on two important counts. First, as is demonstrated in states where restructuring is underway,

14/ *Interface Group v. Massachusetts Port Auth.*, 816 F.2d 9, 10 (1st Cir. 1987).

incumbents are facing numerous new competitors, many of whom possess substantial reputational strengths and other resources of their own. Second, reputation and goodwill are procompetitive in that they convey important information to consumers.[15]

A. Evidence from Other States Shows that Deregulated Retail Power Markets Attract Numerous Entrants

An examination of what is actually happening in the deregulated electricity markets around the country demonstrates the dynamic character of these markets. With open access to distribution and transmission lines, incumbent utilities in states that have already implemented retail restructuring are facing new and significant competition from alternate suppliers of power, *including* other utilities that are expanding their geographic reach. Incumbents are also competing with other kinds of energy companies such as natural gas companies, oil companies, and joint ventures of energy companies with complementary expertise, such as energy trading and risk management. Entities already competing on the wholesale level include power marketers, power brokers, independent power producers, co-generators, and suppliers of enhanced energy services.

To give just one example, in Pennsylvania, where retail competition began to be phased in on January 1, 1999, over forty companies have filed applications to provide electric service. Many of these companies are subsidiaries of large energy companies and other corporations with substantial resources and marketing capabilities, including, significantly, their own name recognition and goodwill. In addition, many are affiliates of utilities from neighboring service territories or other states. For example, PECO Energy and Pennsylvania Power & Light -- two significant Pennsylvania incumbents -- will compete in each other's historic service territories. Other Pennsylvania applicants

15/ KCPL notes that the OPC's arguments are relevant in the context of a deregulated marketplace, which is not the structure currently proposed by Missouri Public Service Commission; however, KCPL provides reply comments to this issue nonetheless in order to respond to the OPC's proposals.

include Duke Energy Trading & Marketing, a co-venture between Duke Energy and Mobil Corporation; mc^2 (*i.e.*, "m c squared"), a unit of MidCon Corp., a subsidiary of Occidental Petroleum; DuPont Power Marketing, a subsidiary of DuPont Energy, a unit of E.I. du Pont de Nemours and Co.; and Enron Power Marketing, a unit of Enron Corp. It stretches credibility to assert that these companies would not be able to enter the retail market and compete effectively without first handicapping the incumbent utility.

This dynamic market setting makes clear that, although retail electric power markets historically have been confined to state-determined franchised territories and have been confined to a relatively narrow set of product offerings, such historical geographic and product boundaries will soon disappear. Indeed, supply-side competition in restructured markets will be virtually on a national scale. Even if some entrants initially decide not to enter all regions or localities, they are poised to do so whenever profit opportunities arise. Missouri incumbents certainly will not be immune from such significant new competition. Thus, for the Commission to base its public policy decisions on the historical retail market shares of incumbent utilities would not be well-founded, as it is plain that those historic market shares will be analytically obsolete in a restructured supply market.

B. Reputation and Goodwill Are Procompetitive Attributes That Benefit Consumers

Arguments for marketing restrictions on vertically integrated utilities also fail because such arguments are grounded in a misperception of the nature of market power. The arguments attribute market power to advantages of incumbency, such as brand name recognition and the goodwill that utilities have developed with consumers, and to asserted "consumer inertia" within utilities' customer bases. But rather than being impediments to competition, these factors are, from a consumer welfare perspective, legitimate procompetitive advantages that successful incumbent firms possess in any market.

Reputation, goodwill, and brand loyalty are procompetitive because they are customer determined, and add net value to the product or service. For example, a reputation for reliability and good service in one market provides valuable information to consumers about a firm that is expanding its products and services to new markets. Thus, to limit an integrated firm's ability to compete using its established reputation and goodwill in new markets necessarily harms consumers by removing valuable information from the marketplace.

Proponents of handicapping, such as the OPC, say, however, that in the case of a deregulated marketplace, a utility was able to acquire its brand name recognition and goodwill during a time when it was the only legal provider of electricity. In fact, however, if a given utility has a positive brand name recognition and goodwill, the time when it acquired those attributes is irrelevant to forward-looking affiliate transaction rules. Any positive reputation, goodwill, and brand loyalty that a utility might possess would only be sustainable if these factors continue to produce net positive value for consumers in the marketplace. If they do so, they should be viewed as procompetitive and consumer-welfare enhancing, and not as improper abuses of market power. If, in contrast, a utility's initial attributes derive only from the fact that the utility has been the historical incumbent and the attributes otherwise have no real sustaining value to consumers, or if consumers perceive them negatively, the utility's historical position will quickly dissipate in the face of new competition.[16] Thus, the origin of an incumbent's attributes should not be of concern to the formulation of forward-looking rules, for consumers themselves will signal the marketplace appropriately.

Furthermore, restrictions that discriminatorily foreclose a competitive affiliate from using its parent utility's name and mark would also be the functional equivalent of an economic subsidy to new entrants, many of whom will have substantial brand name recognition and goodwill of their own. In effect, such restrictions would simply raise the utility's affiliate's costs of establishing itself in the marketplace. The Commission should reject such efforts to use the regulatory process to impose costs on rivals. It would only mean that new entrants would not have to make the full investment necessary for successful and sustained entry -- that is, they would not have to bear the full economic cost of winning consumers away from a brand that consumers value, at least at the outset of restructuring. Although the direct cost of the subsidy would be borne by the incumbent, the real cost of the subsidy would be borne by consumers in the form of a more limited product and service mix, providing less value per dollar spent than would be the case if the utility's name and mark were an available choice among competitive services.

Restrictions on the use of name and mark make even less sense in the context of new products and services. With respect to the sale of enhanced services, such as energy management, alternative energy capabilities, or alarm or communications services, prior reputation by incumbents will not constitute a significant advantage. These are new, differentiated, non-commodity products,

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16/ A survey conducted by RKS Research & Consulting, a New York polling firm, showed that customers' opinions of their utilities have deteriorated over the past several years, particularly in the areas of service and customer interaction. "Selling Power to the People Like Soapsuds," *Wall Street Journal*, (March 17, 1998) at B-1. This suggests not only that utilities must do a better job of providing good service, but also that, at least for some utilities, current reputation and trade name recognition may actually work against the incumbent and assist the entrants. *But see* "The Name Says susceptible to different types of effective promotion by new entrants. For some of these new products and services, many utilities likely will have no prior marketing experience and would thus be new entrants themselves.[17]

C. Requiring Affiliates to Provide Disclaimers and Pay Royalty Fees to Use a Parent's Name Would Reduce Incentives to Invest in Goodwill and Distort Resource Allocation to the Detriment of Consumers

The OPC urges that if the Commission does not ban an affiliate's use of its parent's name and logo altogether, then as an alternative, the Commission should mandate that affiliates use disclaimers and pay royalty fees. There is no sound basis, however, for either of these measures.

Under the OPC's proposal, the disclaimer must state that the utility and the affiliate are not the same company, the affiliate is not regulated, and the affiliate's products need not be purchased in order to receive quality regulated services from the utility. The practical effect of these

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It All For Affiliates," *The Energy Daily*, (June 23, 1998) at 3 (reporting that 42% of a sample of consumers choosing power suppliers in anticipation of competition chose the affiliate of the local utility).

17/ There may also be Constitutional grounds that would limit the Commission's ability to tell a Missouri utility that its competitive affiliate cannot use the utility's name or logo. Recently, the Massachusetts Department of Public Utilities noted that "the corporate name and logo belong to shareholders, not ratepayers and, excessive restriction of their use could violate a company's First, Fifth, and Fourteenth Amendment rights." Massachusetts Department of Public Utilities, Order Adopting Standards of Conduct for Distribution Companies and Their Affiliates, D.P.U./D.T.E. 97-96 (May 29, 1998) at 23.

This position is consistent with the fact that, from a legal perspective, a utility's investment in goodwill and reputation is not generally considered a cost of providing utility services, and thus is not borne by ratepayers or subject to state rate making proceedings. *See, e.g., Minnegasco v. Minnesota Pub. Util. Comm'n*, 549 N.W. 2d 904, 909 (Minn. 1996). ("It is also clear that the value of a gas utility's name and reputation, as represented by good will, is generally not considered to be a "cost" of rendering utility service and that the costs associated with creating the good will have not been borne by the ratepayers. Certainly, ratepayers are involved in building a gas utility's good will when they purchase utility service. However, ratepayers are no different in that regard than any consumer who purchases a product from a business. The simple act of purchasing a product or service from a business does not mean that the consumer becomes an owner of any of the business' assets. Nor does it mean that the consumer bears the cost of creating good will. The relationship between the ratepayer, as a consumer, and the gas utility, as a business, does not change just because the gas utility provides regulated utility services. The ratepayer remains a consumer and the assets remain the property of the utility."). *See also*, Justice Marshall's observation in his concurring opinion in *Pacific Gas & Electric Co. v. Public Util. Comm'n*, 475 U.S. 1 (1986): "[A] consumer who purchases food in a grocery store is 'paying' for the store's rent, heat, electricity, wages, etc., but no one would seriously argue that the consumer thereby acquires a property interest in the store. That the utility passes its overhead to ratepayers at a rate fixed by law rather than the market cannot affect the utility's ownership of its property...." *Id.* at 22 n.1.

requirements is that the affiliates will forego using the mark because it is simply too cumbersome to comply with the mandates. This will, as discussed above, deny important information to consumers. Even if the mark is used with this disclaimer, the disclaimer, rather than informing and assisting consumers, is more likely to hinder consumers in making informed choices. It does so by confusing and obscuring the relationship between the utility and the affiliate that is relevant information to consumers.[18] Because the disclaimer largely erodes the ability of an incumbent utility to identify its goodwill and reputation with its new marketing affiliate, valuable information to consumers is lost and incentives to invest in goodwill are reduced.

The proposed royalty requirement is similarly without merit. Because customers never assumed risk associated with a utility's reputation and goodwill, there is no basis in economic analysis to require that affiliates pay a royalty for use of their parent's logo. Indeed, to do so would be welfare-reducing in that it would be a subsidy to customers. Such a transfer would distort optimal -- from a consumer welfare standpoint -- use of the logo by affiliates. Furthermore, as a practical matter, there would be no objective way to determine a "market" value of goodwill. Therefore, any required royalty payments from an affiliate to a utility would necessarily be arbitrary.

D. Restrictions on Billing Inserts Are Not Justified by Competitive Analysis

The OPC also argues that the Commission should restrict joint marketing between a utility and its competitive affiliate. For example, the OPC believes that the competitive affiliate should not be able to include promotional inserts with the utility's monthly billing statement. The OPC contends that including such inserts would provide an unfair advantage to vertically integrated

18/ It would be economically irrational for a parent utility not to stand behind its affiliates that trade on the parent's positive reputation with consumers. This follows because, just as positive attributes associated with a logo can be transferred from a utility to an affiliate, negative attributes can be transferred back.

utilities, and therefore argues that either (1) competitors should also be allowed to include their marketing materials in the utility's billing statement, or (2) there should be no inserts by anyone.

There are, however, other practical ways to reach customers, such as direct marketing. In addition, many alternate suppliers will have established contact with electricity customers by virtue of other lines of business. A relevant case dealing with this issue was recently decided in the telecommunications industry.[19] There, the plaintiff argued that NYNEX, the incumbent utility, should have been required to include advertising inserts from companies that wished to compete with NYNEX in the wire maintenance business. The court found that NYNEX was under no obligation to include its competitors' inserts in its monthly bill, and held that the competitors could reach customers in other ways.

E. Requirements that a Utility and its Affiliate Not Share Facilities Are Unnecessary and Are Harmful to Competition

The OPC and other commentators suggest that affiliates and utilities be prohibited from sharing any facilities in the operation of their business. The extreme OPC proposals not only prohibit utilities and their affiliates from sharing office space, office equipment, services, systems and computer or information systems, but the OPC even goes so far as to propose that utilities and their affiliates' employees be required to use separate elevator banks and/or security-controlled access. These prohibitions are overreaching and unnecessary, to say the least.

On the contrary, from a consumer welfare perspective, vertically integrated utilities should be <u>encouraged</u> to utilize economies of scope by sharing office space and other facilities and services -- they should certainly not be required to enact such stringent and costly facility divisions as

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19/ Wojcieszek v. New England Telephone and Telegraph Company, 1997 WL 594723 (D. Mass. 1997).

proposed by the OPC. Such requirements would merely raise utilities' costs and would ultimately harm consumers. The only benefit would be to competitors, and not to the competitive process or consumers.

KCPL believes that if the utility and its affiliates track their costs appropriately and ensure that the costs are appropriately assigned, a utility and its affiliates should be permitted to utilize the same corporate support, as well as facilities, for both entities. (Of course, KCPL recognizes that any information shared between the entities must not be information that has been obtained solely by virtue of the utility's role as a monopoly provider of electricity service.)

This is precisely the approach that was taken by the Federal Energy Regulatory Commission ("FERC") when it considered the proper regulatory approach for both electric and natural gas marketing affiliates. KCPL respectfully suggests that the Commission review FERC Order 497 ("FERC 497")[20] as instructive in determining the proper approach to separate corporate functions and facilities consistent with consumer welfare. In the comments to FERC 497, FERC states that the employees and facilities of a company and its unregulated affiliates should not be kept separate, stating, "The Commission does not agree with the commentators who state that a complete separation of pipeline and marketing affiliate personnel and facilities is necessary to prevent unduly discriminatory conduct." Instead, FERC mandated a less restrictive method of monitoring these entities, which it concluded will achieve the same result: standards of conduct and reporting requirements, with some organizational separation if possible.[21] The rule implemented by FERC

20/ 18 C.F.R. §§ 161, 250, 284 (1988). This order deals with the relationship between interstate natural gas pipelines and their marketing or brokering entities.
21/ *See id.* at 22148-22149.

states simply: "To the maximum extent practicable its operating employees and the operating employees of its marketing affiliate must function independently of each other."[22]

The FERC's analysis and conclusions with respect to the proper regulatory approach for natural gas marketing affiliates was followed in Order 889, dealing with electricity marketing affiliates.[23] In its preamble discussion comments to the final Order, FERC recognized that its proposed standards of conduct had been "overly broad" because they "prohibited contacts between system operators and affiliate employees engaged in functions completely unrelated to a public utility's wholesale power and energy marketing functions." Thus, in response to comments by various groups, it revised its proposed standards accordingly, eliminating these restrictions.[24]

F. Onerous Employee Transfer Rules Reduce Economies of Scope and Infringe on an Employee's Freedom to Advance

KCPL opposes the OPC's recommendations for detailed rules governing employee transfers within a utility's corporate organization. The Company fully supports the notion that a utility should not share with competitive affiliates customer information that is derived solely from the provision of utility services and that, as a practical matter, cannot be duplicated by unintegrated power suppliers. Such sharing would be unfair preferential treatment. The kind of elaborate proscriptions and extensive on-going regulatory oversight respecting employee transfers that the OPC urges, however, are unreasonable and overreaching. For example, to prevent employee transfers from being a means to circumvent proscribed information exchanges, the OPC would require that utilities rebate to ratepayers a fee, imposed on affiliates, of 25% of an employee's compensation whenever an

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22/ *See id.*, § 161.3(g).
23/ 18 C.F.R. § 37 (1996). This order involves public utilities that are involved in the electric energy area and their relationship with wholesale power affiliates.
24/ *See id.*, § 37.4.

employee is transferred to an affiliate, and mandate that an employee remain in the employ of the affiliate or the utility for specified periods of time before the employee can be transferred again.[25] This proposed rule is simply a punitive measure to be imposed on vertically integrated utilities who wish to take advantage of economies of scope by allowing their employees to move between a utility and its affiliate. Not only would this rule penalize a company for going to its affiliates for employees, but it would also punish the employees who work for the utility and its affiliates by impeding their advancement and forcing them to find employment elsewhere.

Moreover, the OPC's proposed restrictions are similar to employee transfer restrictions that have been struck down by Missouri courts; thus, these restrictions violate Missouri public policy. In Missouri, restrictions that purport to limit employees in the exercise or pursuit of their occupations are deemed to be "restraint[s] of trade" and are disfavored. Sturgis Equip. Co. v. Falcon Indus. Sales Co., 930 S.W.2d 14, 16 (Mo. App. 1996), Continental Research Corp. v. Scholz, 595 S.W.2d 396, 400 (Mo. App. 1980). Only those restrictions which "protect employers from unfair competition by former employees without imposing unreasonable restraint on the employees" are permitted. Sturgis, 930 S.W.2d at 17.

According to the courts in Missouri, only two "narrowly defined and well-recognized interests" may be protected by employer-employee agreement against the possible appropriation by a former employee: trade secrets and customer contacts. Id. The Missouri courts have held that matters of public knowledge or of general knowledge in an industry are not trade secrets and that "[o]nly secrecy sufficient to confer an actual or potential economic advantage on one who possesses

25/ This provision also has the consequence of severely limiting an employee's ability to advance professionally within the larger company. For instance, if a position were to open at the utility for which a transferred employee, now with the affiliate, is well-suited, the rule could foreclose that employment opportunity for the employee.

the information is sufficient." AEE-EMF, Inc. v. Passmore, 906 S.W.2d 714, 722 (Mo. App. 1995) (adopting the definition of trade secrets set forth in Restatement of Torts (1939) § 757). Further, the courts have said that noncompetition restrictions, which purport to protect against misappropriation of customer contacts, will only be enforced when the customer contacts are "substantial," Refrigeration Indus., Inc. v. Nemmers, 880 S.W.2d 912, 921 (Mo. App. 1994), and where the "quality, frequency and duration of employee's exposure to customers is of crucial importance." Continental Research Corp., 595 S.W.2d at 401.

First, in adopting rules regarding employer-employee transfers between utilities and their affiliates, there is a substantial question as to whether the Commission could or should impose employee transfer restrictions that are not the product of employer-employee agreement. Even putting aside that issue, however, the OPC's proposed rules should not be adopted, as they are not tailored to apply only to employees possessing trade secret information or having substantial customer contacts. Rather, they purport to apply across the board to all utility and affiliate employees, from the most senior official to the new hire clerk. This blanket approach is unfairly punitive to the utilities and their employees and is flatly inconsistent with Missouri law.

KCPL respectfully suggests that the Commission consider FERC 889 as instructive in this area as well. FERC 889 allows employees to transfer to or from an affiliate, "as long as such transfer is not used as a means to circumvent the standards of conduct in this section."[26]

IV. Conclusion

This Commission should reject the proposals put forward by the proponents of marketing restrictions on incumbent utilities. Rules that handicap the incumbent utility and raise its costs run

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26/ *See* FERC 889, 18 C.F.R. § 37.4(b)(2) (1996).

counter to the main goals of a competitive marketplace, which are increased consumer choice and lower prices. From a competition perspective, in order to maximize consumer welfare on a forward-looking basis, affiliate transaction rules should not only allow vertically integrated utilities to bring to the marketplace whatever procompetitive attributes they possess, but should actually encourage them to do so.

As the Commission considers the issues in this proceeding, KCPL urges the Commission to keep in mind the key principles to proper policy: (1) ensure equal opportunity to all utilities, with or without affiliates, (2) treat all competitors impartially, and (3) be forward-looking. Commission-imposed, discriminatory restraints based on the presence of historical attributes are unnecessary, anticompetitive, and distort a competitive marketplace. Proper rules should not only permit, but should encourage, all electricity competitors and potential competitors, including incumbent utilities, to bring to the marketplace whatever procompetitive strengths they might possess, regardless of the historic origin of the strengths. This will ensure that Missouri consumers enjoy the maximum benefits of competition.

Respectfully submitted,

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