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

RE: Case No. EW-97-245 - Task Force on Retail Electric Competition

Dear Mr. Roberts:

Enclosed for filing in the above-captioned case are an original and fourteen (14) conformed copies of a **REPORT BY THE LEGAL COMMITTEE OF THE MISSOURI PUBLIC SERVICE COMMISSION TASK FORCE ON RETAIL ELECTRIC COMPETITION.**

This filing has been mailed or hand-delivered to all members of the Task Force members.

Thank you for your attention to this matter.

Sincerely yours,

Dana K. Joyce

Dana K. Joyce
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DKJ/wf
Enclosure
cc: Task Force Members

A REPORT BY THE LEGAL COMMITTEE OF THE MISSOURI PUBLIC SERVICE COMMISSION TASK FORCE ON RETAIL ELECTRIC COMPETITION

APRIL 3, 1998

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TAX REPORT
INTRODUCTION

The purpose of this Report is to identify state and local tax issues relating to the restructuring of the electricity industry in Missouri. In addition to taxes, the Report will address franchise fees that some utilities pay to municipalities[1] and payments in lieu of taxes ("PILOTs") made by government-owned utilities because these payments are currently passed through to customers and thus are similar to taxes.

This Report is primarily the work product of the Tax Subcommittee of the Legal Committee, with significant input from the full Legal Committee that approved this report in its present form. The Legal Committee is comprised of individuals representing various stakeholders in the restructuring debate. This report does not necessarily reflect the views or positions of any individual stakeholder represented on the Legal Committee.

[1] Unless the context indicates otherwise, this report will use the terms "municipal" and "municipalities" to refer to counties and villages, as well municipalities.

I. STATE AND LOCAL TAX ISSUES—BACKGROUND

In the United States, investor-owned utilities, government-owned utilities and cooperative utilities historically have delivered electricity. Most electricity has been delivered by large investor-owned utilities, which traditionally have been vertically integrated, highly regulated monopolies, each of which generates, transmits and distributes electricity within a limited service territory. Under the traditional regulatory model, an investor-owned electric utility is obligated to provide all customers within its service territory with safe and reliable electricity. In return, the investor-owned utility is allowed to charge rates that are approved by one or more public service commissions and designed to recover its costs of providing the electric service (including taxes) and to provide a reasonable return on its investment. Government-owned utilities also generally have operated within the confines of defined service areas, with very little competition for customers and rates being set by local officials. Cooperative utilities are owned by their customers and charge rates designed to recover their costs. They too have specified service territories.

Because investor-owned electric utilities have not been engaged in competitive markets and because they generally have recovered their tax liabilities in rates under the traditional regulatory model, they have served as an effective and efficient tax collecting mechanism for state and local governments. Government-owned utilities also have operated in noncompetitive markets and have made PILOTs to the municipalities where they serve.

Electricity also is generated by independent power producers and commercial and industrial cogeneration facilities. They do not have specified service territories and can sell electricity only at the wholesale level.

The taxes and other similar payments that electric utilities currently pay or collect from customers and that restructuring may affect are as follows:

- Municipal business license taxes
- Municipal franchise fees
- PILOTs
- Local property taxes
- State and local sales and use taxes
- State corporate income and franchise taxes

A summary of these taxes and their applicability to the various participants in the electricity industry under current law is attached as Exhibit A.

Several states have recently addressed tax issues in connection with electricity industry restructuring. This activity is summarized in Exhibit B. Due to the requirements of the "Hancock Amendment" to the Missouri Constitution, discussed below, some solutions that other states have adopted may not be feasible here.

II. POTENTIAL IMPACTS OF ELECTRICITY RESTRUCTURING UPON STATE AND LOCAL TAXES

The introduction of competition into the electricity industry is likely to raise state and local tax issues. Most stakeholders are concerned about the impact of these issues. Several aspects of restructuring that may be particularly relevant to state and local tax issues generally are discussed in this section. Other aspects of restructuring that are more limited in impact to specific taxes are discussed later in the paper in connection with those specific taxes.

If the poolco model (as opposed to a direct access model) for industry restructuring were adopted, then the issue of the possible loss of revenue from municipal business license taxes, franchise fees and sales taxes does not arise.

A. Potential Impact on the Revenues of Missouri Utilities and Governmental Entities

Competition may affect the amount of revenues received by Missouri electric utilities (including investor-owned, governmentally owned and cooperative electric utilities) and where those revenues are earned.

Revenues received by Missouri electric utilities from the sale of generation may decrease after restructuring if:

- restructuring lowers prices for electric generation;
- existing utilities outside Missouri take market share from Missouri utilities;
- more providers enter the market while demand remains stable;
- more customers generate their own electricity in a deregulated market; and/or
- Missouri utilities are subject to a disproportionate tax burden when compared to out-of-state electricity providers.

Revenues received by Missouri electric utilities from the sale of generation may increase after restructuring if:

- existing Missouri utilities obtain market share from existing electricity suppliers outside the state;
- demand for electricity increases while generation supply remains stable;
- electricity customers now generating their own electricity decide to stop; and/or
- restructuring increases prices for electric generation.

There may be other factors that have the effect of increasing or decreasing the revenues of Missouri utilities. In addition, revenues may shift among Missouri electricity providers as a result of restructuring.

Changes in the revenues of Missouri electric utilities and non-Missouri utilities whose revenues are subject to Missouri state and local taxation may significantly affect the revenues received by state and local governments and political subdivisions. Most state and local governments and political subdivisions are concerned about the net effect of electric industry restructuring on their revenues.

If retail competition in the electric industry results in lower prices, new taxes replacing the savings are not suggested. However, finding savings in avoiding current levels of taxation rather than in lower costs for energy may not be restructuring the retail electric industry, but rather tax reform without consideration of taxes and their relationship to public obligations. The Legal Committee assumes that restructuring the electric industry is not intended to be an excuse for increasing the tax burden on any class of customers nor to unintentionally modify the tax/revenue position that has evolved since adoption of the Hancock amendment.

B. Potential Impact on Allocation of Tax Revenues among Taxing Jurisdictions

In addition, tax revenues may shift among Missouri taxing jurisdictions as a result of restructuring, particularly in the area of property taxes. Current property tax law in Missouri has the effect of allocating the majority of the value for an investor-owned electric utility's generating facilities to all taxing jurisdictions in which the utility has transmission and distribution facilities. One potential effect of industry restructuring under current law could be the lack of viability of that allocation process, which could result in the taxation of the value of generation facilities only by those jurisdictions in which the generation facilities are located, with no generation value allocated to other jurisdictions. The effect of such a revenue shift on particular taxing jurisdictions could be very significant.

C. Potential Impact on Missouri Revenues from All Businesses

If electricity industry restructuring has the effect of increasing economic activity within Missouri (*e.g.,* by increasing the income of existing Missouri businesses or by attracting new businesses to the state), then tax revenues associated with such activities may increase.

D. Potential Impact on State and Local Government Electricity Costs

State and local governments and political subdivisions as purchasers of electricity will pay higher or lower prices depending on the market price of electricity. Changes in electricity prices may affect the amount of revenues needed from taxes.

E. Potential Impact on Collection of Taxes

Lawful avoidance of taxes by nonlocal suppliers may deprive the state and local governments of tax revenue to which they would otherwise be entitled. In addition, current state and local taxes may prove difficult to collect. In the case of the local use tax, some localities that have enacted a local sales tax would need to enact a local use tax on all taxable items in order to tax all electricity sales comparably.

Some Missouri Department of Revenue ("DOR") officials believe that it would be extremely difficult for DOR to collect municipal business license taxes on behalf of municipalities because of the lack of consistency in these taxes among the various municipalities (*e.g.,* different rates and exemptions). The Department believes that it could collect these taxes efficiently only if the taxes are consistent. Such a change would seem to require local votes under the Hancock Amendment.

Governments are concerned about the effect on their revenues of potentially uncollected taxes. Missouri utilities are similarly concerned about the competitive effect of potential uncollected taxes.

III. POLICY ISSUES

The following tax policy issues have been identified by the Legal Committee members, although there is not unanimous agreement as to the desirability of each one:

- Level playing field: whether the legislature should seek equal tax treatment of competing energy suppliers in a restructured electricity market.
- Revenue neutrality: whether the legislature should seek to maintain revenues received by state and local governments and other political subdivisions at the same level as before electricity restructuring. If this objective is adopted, a benchmark for revenue neutrality should be established. The benchmark could be revenue levels before restructuring, revenue levels reduced by any decrease in the price of electricity, revenue levels reduced by lost customers and increased by new customers, or some other measure. If revenue neutrality is not desirable, then the legislature should determine which tax system should be implemented.
- Customer tax burdens: whether any modifications to the tax laws should be structured to minimize the shifting of tax burdens among customer classes or among customers within a particular class.
- Collectibility: whether any modifications to the tax laws should be structured to maximize the ability of governments and political subdivisions to collect them.

- Compliance: whether compliance requirements on taxpayers and government should be minimized.
- Interstate competitiveness: whether the state and local tax system should be structured to enhance the competitiveness of Missouri businesses, including both businesses that consume electricity and businesses that provide electricity.
- Avoidance of litigation: whether the legislature should seek to design tax legislation that is unlikely to be subject to court challenges in order to avoid delays in obtaining certainty in tax treatment and to avoid potentially significant tax refunds.

IV. CONSTITUTIONAL LIMITATIONS

A. Missouri Constitution.

Limit on state taxes. Article X, section 18 (the "Hancock Amendment") prohibits the state from increasing taxes above a constitutionally established revenue limit. In recent years, the state has exceeded the revenue limit and, as a result, has been obligated to refund the excess collections to Missouri taxpayers.

Limit on local taxes. Article X, section 22 (also part of the "Hancock Amendment") requires that any new tax or any increase in an existing tax by a local government or political subdivision be approved by a majority vote. In addition, a local government cannot broaden the base of an existing tax unless the rate is reduced to yield the same estimated gross revenues as under the prior base. For this purpose, taxes do not include PILOTs or franchise fees that are in the nature of rental for the use of rights-of-ways, or utility rate increases.

Limit on state tax for county or municipal purposes. Article X, section 10 (a) prohibits the state from imposing taxes for municipal or county purposes. Article X, section 10(c) allows the state to enact laws for the payment of funds collected for state purposes and to provide aid to counties or municipalities. Article X, section 1 provides that the taxing power may be exercised by counties and other political subdivisions under the power granted them by the General Assembly for county, municipal, or other corporate purposes.

Limit on taxing the property of political subdivisions. Article III, section 39(10) prohibits the imposition of sales or use tax upon the use, purchase or acquisition of property paid for out of the fund of any county or political subdivision. Article X, section 6 provides that property of the state, counties, and other political subdivisions, both real and personal, is not subject to property tax.

B. United States Constitution.

1. Commerce Clause

Under the Commerce Clause of the United States Constitution, Congress has plenary power to regulate commerce between the states. Any action taken by the states to regulate interstate commerce can be preempted by Congress. The regulation of intrastate commerce is within the purview of the states.

When Congress has not regulated in the area of interstate commerce such that any state law is preempted, the United States Supreme Court has articulated a four-part test to determine whether a state or local law impermissibly burdens interstate commerce:

- Does the regulation apply to an activity with a substantial nexus to the regulating state?
- Is the regulation fairly apportioned?
- Does the regulation discriminate against interstate commerce?
- Is the regulation fairly related to services provided by the state?

See Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 287 (1977). The two most significant parts of this analysis that must be addressed are the first and third: the nexus requirement and the prohibition of discrimination against interstate commerce. If either of these two requirements is not met, the other two are irrelevant.

Nexus. A taxpayer (or tax collector) must have a "nexus" (*i.e.*, connection) with the taxing jurisdiction that is sufficient for it to be forced to pay taxes (or to be forced to collect taxes). The United States Supreme Court has held that an interstate marketer must have a "substantial physical presence" in a state before it has any obligation to collect a tax for the state. *See Quill Corporation v. North Dakota*, 112 S. Ct. 1904 (1992). The nexus principle does not preclude a marketer from voluntarily paying (or collecting) a state or local tax. There are many cases on nexus, but not in the context of electricity sales.

Discrimination. A state or local law may not unduly discriminate against interstate commerce. The United States Supreme Court recently upheld an Ohio law imposing a sales tax on purchasers from natural gas suppliers (primarily out-of-state gas producers and marketers) that were not regulated, but exempting purchasers from regulated natural gas utilities (in-state utilities). The Court reasoned that there was no discrimination against interstate commerce because the non-competitive bundled gas business and the non-regulated gas marketers were different businesses and could be taxed differently. *See General Motors v. Tracy*, 117 S. Ct. 811 (1997). It is not known how this reasoning would be applied in the context of electric industry restructuring. The Commerce Clause does not prohibit discrimination against in-state business (although the Equal Protection Clause may).

2. Equal Protection Clause

The Equal Protection Clause prohibits discrimination among taxpayers within the same classification. To pass muster under the Equal Protection Clause, state tax classifications must have a rational basis and serve a legitimate state purpose. *See General Motors, supra.*

3. Due Process Clause

The Due Process Clause requires (1) a definite link and a minimum connection between the taxing jurisdiction and the person, property, or transaction it seeks to tax, and (2) that the income attributed to the taxing jurisdiction for tax purposes must be rationally related to values connected with the taxing jurisdiction. The Due Process Clause limitation can be satisfied by "minimal contacts," as opposed to the physical presence that is required under the Commerce Clause. *See Quill, supra.* Therefore, it is possible that a taxpayer or tax collector has nexus for Due Process Clause purposes (minimal contacts), but not for Commerce Clause purposes (physical presence).

V. MUNICIPAL BUSINESS LICENSE TAXES, FRANCHISE FEES AND PILOTs

A. Current law

Some municipalities impose business license taxes upon retail sellers of electricity. These taxes are determined as a percentage of the seller's gross receipts from retail sales of electricity within the jurisdiction. Investor-owned and cooperative electric utilities are subject to these taxes, but not government-owned utilities or cogeneration facilities.

Some municipalities receive a franchise fees from utilities. These fees are generally determined as a percentage of the utility's gross receipts from retail sales of electricity within the jurisdiction. They serve as consideration for the utility's use of the municipality's rights-of-way to lay wires and erect poles pursuant to the utility's franchise.

Government-owned electric utilities are not subject to municipal business license taxes or franchise fees. However, they typically provide support for city governmental operations by making PILOTs, which may be in the form of cash payments or free or subsidized services. PILOTs are intended to provide a municipal government with cash and/or services equivalent to the tax revenue it would have received from an investor-owned utility that paid franchise fees or business license taxes, but may exceed that amount. PILOTs may be determined as a percentage of gross receipts.

Rates of investor-owned electric utilities include municipal business license taxes and franchise fees. The amount of the tax shown on the customer's bill has been "grossed up" to reflect that the collection of the tax or fee from the customer is itself subject to the tax or fee. PILOTs are also included in the rates charged to government-owned electric utility customers.

Municipal business license taxes, franchise fees and PILOTs on electricity account for a significant portion of municipal budgets in Missouri.

B. Effect of industry restructuring on these taxes under current law

As noted above, industry restructuring may significantly affect the revenues received by utilities and therefore by local governments from municipal business license taxes, franchise fees and PILOTs. Moreover, under current state law and local ordinances, if nonlocal electricity suppliers[2] are allowed to sell electricity to Missouri consumers, those nonlocal electricity suppliers will not be required to pay municipal business license taxes or franchise fees. This

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2 For purposes of this paper, the term "nonlocal electricity supplier" refers to an electricity supplier that does not have tax nexus with the municipality within which it has customers. In other words, a nonlocal supplier, who does not have property or employees within the municipality, sells electricity to customers by structuring transactions so that the sale of electricity occurs outside the municipality. Out-of-state suppliers will not necessarily meet this definition; some may structure their operations so as to have nexus with Missouri for purposes of a state tax.

would significantly impact the revenues of local governments and political subdivisions, as well as the ability of Missouri electricity providers to compete.[3]

C. Potential Solutions

There are many possible potential solutions to the issues involving municipal business license taxes, franchise fees and PILOTs. They include, but are not limited to, the alternatives listed below, each of which has advantages and disadvantages. Attached are summary evaluations of the alternatives in terms of the principal policy issues discussed above in sections III of this report (Exhibit C) and in terms of the principal constitutional issues discussed above in section IV of this report (Exhibit D). The Legal Committee considers the first three alternatives to be viable solutions and the remaining seven alternatives to be less viable solutions.

1. Repeal the existing taxes and impose replacement taxes. This option requires consideration of the features of the replacement taxes, including the following:

    a. *Implementation options.* The legislature could enact a state law authorizing municipalities to impose the replacement taxes after Hancock votes. To effectively require municipalities to impose replacement taxes, the legislature could remove authority for the current taxes. Alternatively, the legislature could condition the implementation of electric industry restructuring upon the passage of the replacement taxes by municipalities or by the state. Another alternative would be to amend the state

3 In the case of municipal business license taxes and franchise fees, this has already become a significant issue in the partially deregulated natural gas industry. Many municipalities believe that they are losing substantial revenues. Many Missouri gas utilities believe that they have been placed at a competitive disadvantage. Legislation has been introduced in the General Assembly (SB 627 and HB 1142) to address revenue losses that are asserted to have occurred as a result of partial deregulation of the natural gas industry.

constitution to either require or authorize municipalities to impose the replacement taxes.

b. *Measure of tax*: purchase price (if the entity collecting the tax has pricing information; if the tax were calculated using an "assumed" price such as a tariffed price; or if customers were allowed to self-assess) or volume (if the entity collecting the tax holds volume information, but not pricing information).

c. *Taxpayer and tax collector*: customer, distribution company, or supplier (*e.g.*, retail electric provider, provider, seller).

d. *Base of tax*: all components of cost of electricity; transmission and distribution charges only; or distribution charges only.

2. Retain existing business license taxes, franchise fees and PILOTs and impose a compensating tax, which would be imposed on retail sales that are not taxed by the existing taxes and fees. This option requires consideration of the same "tax design" issues as the replacement tax option, above.

3. Permit municipalities to charge rental fees to local distribution companies for the privilege of using public rights of way for their wires, in lieu of business license taxes and franchise fees. The rental fees would be volumetrically based (with variable rates), with the amount attributable to some large customers determined by reference to purchase price. The distribution company would pass the cost of the rental fee through in rates to its customers.

4. Create a meter surcharge on the owner of the meter.

5. Retain existing business license taxes, and franchise fees and PILOTs and require as a condition of certification that nonlocal suppliers[4] agree to pay municipal taxes and fees.

6. Retain existing business license taxes, franchise fees and PILOTs and require as a condition of certification that nonlocal suppliers maintain a place of business in Missouri.

7. Retain existing business license taxes, and franchise fees and PILOTs and require as a condition of certification that nonlocal suppliers install and own meters at the premises of all of their retail customers.

8. Permit municipalities to adjust their taxes, fees and PILOTs to compensate for lost revenues from sales by nonlocal suppliers in order to collect the entire amount of the former tax or fee.

9. Charge suppliers a state registration fee for the privilege of selling electricity in Missouri. The fee would be structured to collect any lost tax revenues and distribute them to political subdivisions.

10. Increase some other tax to make up for the lost tax revenue.

VI. PROPERTY TAXES

A. Current law

Property taxes are imposed upon owners of property and based on a percentage of the value of property. For investor-owned utilities, real or tangible personal property used directly in the generation and distribution of electric power (but not property used as a collateral facility nor

[4] The use of the term "certification" for this purpose means the licensing or registration of a business to supply electricity to customers within the state of Missouri.

property held for purposes other than generation and distribution of electricity) is subject to central assessment by the State Tax Commission, primarily valued using the unit method of valuation with emphasis given to the income approach. Everything else (real property other than transmission and distribution realty, vehicles, office furniture, equipment, etc.) is locally assessed using comparable sale methods or original cost less depreciation. Centrally assessed values (including generation, transmission and distribution) are distributed to all counties and political subdivisions based on a wire mileage formula. Investor-owned utilities include property taxes in their rates as a cost of service.

All property of cooperative electric utilities and cogeneration facilities is locally assessed. Property owned by municipal utilities is not subject to property tax pursuant to article 10 of the Missouri Constitution. There are currently no independent power producers in Missouri, and thus, no current tax treatment to note for these entities.

B. Effect of industry restructuring under current law

1. Valuation

Restructuring may affect the value of electric generation property. The value of uneconomic electricity generation assets may decrease if the generation market is opened to competition, particularly if utilities are not able to recover all of their costs of constructing, operating and dismantling their generation facilities under market-based rates. On the other hand, generation assets that can produce electricity economically in a competitive market may increase in value. In the case of centrally assessed Missouri utilities, increased competition could result in additional revenues and income being derived outside Missouri, which would decrease the allocation of electric values to Missouri.

Changes in value resulting from competition in the electric generation segment of the industry may affect the amount of property tax revenues that political subdivisions receive from utility property taxes. Changes in property tax assessments from electric generation property within a political subdivision could result in a shifting of property tax burdens among property taxpayers within the political subdivision. Any decrease in utility property tax revenues would ultimately be borne by all other property taxpayers, recouped from other revenue sources, or lost. Substantial increases or decreases would affect budgets, levy rates (roll-ups), as well as the school foundation formula. Changes in property tax revenues could affect state revenues in connection with "hold harmless" school districts.[5] At this time, it is difficult to predict effect of competition on the market value of electric generation assets located in Missouri.

2. Assessment

If electric industry restructuring results in the separation of an investor-owned utility's electricity generation function from its transmission and distribution functions (either by function within a corporation, by transfer to an affiliated corporation, or by divestiture to an unrelated third party), its electricity generation property may or may not continue to be centrally assessed. Some stakeholders believe that electricity restructuring may call into question the State Tax Commission's authority to centrally assess the assets of electric utilities. They base their view on case law that links central assessment and distribution of property values to the "service" performed by the property. Other stakeholders believe that the plain language of the Missouri tax statutes gives the Tax Commission authority to centrally assess all "electric light and power

[5] A "hold harmless" school district receives sufficient funds from the state to achieve a certain minimum funding level in the event that its property tax revenues do not otherwise meet that minimum level.

companies," regardless of the nature of some of the assets, although the generating assets of cogenerators and cooperatives are presently locally assessed.

If a Missouri independent power producer and a Missouri electric utility's property tax assessments are distributed differently, the resulting tax burden may or may not be comparable. Such a disparity will affect the competitive balance of market participants. There are also questions regarding what would constitute the electric company's "unit" for assessment purposes. Currently, the Missouri Constitution places business and utility property in the same class.

3. Distribution of Revenue

If electric generation property that presently is centrally assessed becomes subject to local assessment, then a significant amount of property tax revenues from electric generation assets will shift among local government entities and political subdivisions.

4. Consequences if Current Law Is Not Changed

If current law is not changed, restructuring presents issues of changing values of electric generating property, potential differences in assessment methods applicable to different owners of electric generating property and shifts in property tax revenue distribution. There are questions of the scope of the State Tax Commission's statutory authority to assess electric generation property in a restructured environment. There also are questions as to what constitutes the electric company's "unit" for assessment purposes. In addition, uniformity questions would arise, as well as revenue neutrality and level playing field issues.

C. Solutions

There are several potential solutions to the property tax issues presented by electric industry restructuring, including, but not limited to, the alternatives listed below.

1. Eliminate unit valuation for generation assets in favor of local assessment. This alternative would (1) eliminate any question of intangible taxation argued in the unit valuation methodology; (2) subject all taxable generation assets to the same valuation methodology; (3) result in an additional assessment burden on local assessors to value special use property some of which may have limited expertise in this area (although under current law cooperative and cogeneration generating facilities are locally assessed, as are other manufacturing facilities); (4) initiate uniformity concerns as numerous assessors statewide apply independent knowledge and judgments in these assessments; and (5) result in substantial revenue losses for all counties and political subdivisions without electric generating facilities located within their jurisdiction.

2. Adopt unit valuation for all generation assets, but clarify that it applies to all electricity generation property, regardless of ownership, to the extent possible. This alternative could potentially result in uniform valuation of all taxable generation assets statewide, but could prove difficult to apply to cooperative and cogeneration facilities, given their nature. It would require a formula to distribute these values, which would presumably be devised to mitigate tax revenue shifts from the current formula. For example, the value of all electricity generation assets could be assigned to taxing jurisdictions throughout the state based on wire miles.

3. Eliminate unit valuation for generation assets, but employ the State Tax Commission to value all generation assets, regardless of their ownership. This alternative would ensure uniformity in valuation thereby promoting a level

playing field with respect to Missouri-based generation assets, but would require a formula for assigning that value among taxing jurisdictions.

4. Repeal the property tax on electric generation property and enact a replacement tax. This alternative could be structured to provide revenue neutrality, a level playing field and economic development opportunity for competitively priced Missouri generation. It also would require votes under the Hancock Amendment and would require the development of a methodology to distribute the replacement tax revenues to the counties and political subdivisions equitably.

VII. SALES AND USE TAXES

A. Current law

The state and local sales taxes are imposed upon retail customers' nondomestic purchases of electricity and are determined as a percentage of sales price. The taxes are collected by the utility and remitted to the state. Electricity purchased for domestic uses and some other purchases are exempt from the state and local tax. Local governments may reimpose their own local sales tax on domestic electricity use. A compensating use tax is imposed by the state and by some localities.

B. Effect of industry restructuring under current law

If restructuring results in Missouri customers being able to purchase electricity from nonlocal electricity suppliers, current use taxes would apply to those purchases. The principal effects of restructuring relevant to sales and use taxes are (1) potential changes in electricity prices on tax revenues, (2) potential disparity in taxation of electricity in localities that have enacted a sales tax but not a use tax, (3) potential difficulties in collecting use taxes from either the customer or the nonlocal electricity supplier, and (4) potential shifts of tax revenue among jurisdictions if the location of the electricity sale changes in a competitive environment (*e.g.*, from the meter to the seller's place of business). If current law is not changed, these issues will be left unresolved.

C. Solutions

There are a number of potential solutions to the sales and use tax issues, including, but not limited to, the following:

1. Repeal the sales/use tax on electricity and enact a replacement tax. This alternative presents issues similar to those addressed above in the context of the municipal business license taxes and franchise fees.
2. Require disclosure of sufficient information to the Missouri Department of Revenue to enable it to collect applicable use taxes.
3. Remove authorization for localities to tax domestic uses and enact a replacement tax.

VIII. <u>STATE CORPORATE TAXES</u>

The state income tax is imposed upon corporations having Missouri taxable income and determined as a percentage of Missouri taxable income. The state franchise tax is imposed upon the portion of the value of a corporation's outstanding shares and surplus (or, alternatively, the assets) allocated to Missouri. If the revenue impact of industry restructuring is deemed significant by policymakers, generally applicable income tax and franchise tax rates could be adjusted.

IX. <u>COMPREHENSIVE REPLACEMENT TAX</u>

One potential solution to the state and local tax issues raised by electric industry restructuring would be to repeal some or all of the above taxes as they relate to electricity income, transactions and property and/or to enact a single statewide replacement tax, designed to satisfy those policy concerns that the legislature deems appropriate. This solution would present Hancock Amendment implications.

X. <u>PROCESS ISSUES</u>

A. <u>Timing of tax legislation</u>: should state and local tax legislation be passed before, concurrent with, or after legislation implementing electricity industry restructuring?

B. Scope of tax legislation: Should tax legislation (whether tied to restructuring legislation or not) address all tax issues or just some tax issues?

C. Relationship of tax legislation to restructuring legislation:

1. Given that some solutions of the tax issues presented by electricity restructuring would require a statewide vote, should the entire restructuring issue (including taxes) be put to a statewide popular vote?

2. Should restructuring legislation be contingent on the approval of voters for changes in taxes (state and/or municipal)?

3. Should restructuring legislation be contingent upon the courts' upholding the constitutionality of restructured taxes? If so, what would be the mechanism?

4. Should the participation of a supplier in an open access model of electricity restructuring be contingent on its agreement to pay/collect state and local taxes?

5. Should there be no relationship at all between the tax issues and the substantive restructuring issues?

EXHIBIT A
MISSOURI STATE AND LOCAL TAXES UNDER CURRENT LAW

Tax	Investor-owned Utility	Municipal Utility	Cooperative Utility	Cogeneration Facility	Out-of-state Supplier without Nexus
Municipal business license taxes and franchise fees	Yes	No	Yes	No*	No
PILOTs	No	Yes	No	No	No
Property tax	Centrally-assessed (most property)	No	Locally-assessed	Locally-assessed	No
Customer purchases of taxable electricity					
Sales tax	Yes	Yes	Yes	No*	No
Use tax	No	No	No	No	Yes (on customer)
Sales/use tax on purchases by electricity provider	Yes	No	Yes	Yes	N/A
Corporate income tax	Yes	No	No (unless sells more than 15% to non-members)	Yes	No
Corporate franchise tax	Yes	No	No	Yes	No

*cogeneration facilities are permitted to sell only at wholesale. Therefore their sales are not subject to municipal business license taxes and sales/use taxes. If they are permitted to sell at retail, then these taxes would apply.

Exhibit B

Tax Issues by States Addressing Deregulation*

State	Tax Treatment
California	Appears legislation adopted is "wait and see" on taxation (no gross receipts in CA)**
Illinois	Effective 8/1/98, electricity purchased for use or consumption (not for resale) will be taxed via a declining block structure (i.e., at a lower rate in each additional increment of monthly usage). The initial tax rate block is 0.33 cents per kWh for the first 2.000 kWh used in a month (or, for noncompeting munis or coops, the lesser of 0.32 cents per kWh or five percent of the purchase price.). The tax will be collected by the entity that actually delivers the electricity to the end-use consumer. Existing taxes on distribution, supply, or sales of electricity will be repealed effective 8/1/98, and taxes on invested capital of electric utilities will be repealed effective 8/1/98. A new tax will be imposed on each utility or a RES that distributes electricity in Illinois for use or consumption. Effective 8/1/98, municipalities no longer have the authority to tax the business of distribution, supply, or sales of electricity within the municipal boundaries. The law caps the taxes that a municipality may impose on electricity use or consumption. A trailer bill to H.B. 362 provides for an Electric Utility Property Assessment Task Force to assess the effect of the restructuring law on the value of the real property component of utilities' generation plant, and in turn, on state and local government revenues. The task force must file a report by 1/1/99 regarding whether Illinois taxing districts are likely to suffer "significant sustained erosion of their property tax bases" because of restructuring.
Maine	Deregulation being handled at the PUC level.**
Maryland	The PSC did not take a position on the various tax reform proposals, citing its lack of expertise in taxation matters, but agrees that tax reform is needed in order to: 1) create a level playing field between utility and non-utility suppliers; and 2) avoid a revenue loss to Maryland and its subdivisions.
Massachusetts	DPU recommends that the legislature: 1) exempt electric companies from paying property tax to municipalities, but require them to make payments in lieu of taxes to their host municipalities during the transition period; and 2) address possible reclassification of electric companies as manufacturers.
Michigan	Deregulation being handled at PUC level.**
Montana	Revenue oversight committee must review effect of restructuring on state and local tax revenues and, by 11/30/98, recommend legislation to ensure comparable tax burdens on all market participants. During 4-year transition, utilities may accelerate amortization of accumulated deferred investment tax credits related to transmission, distribution, and general plant as an adjustment to earnings if electric earnings fall below 9.5% ROE. Utility may include flow-through of investment tax credits so that utility maintains 9.5% ROE. Co-ops offering service competitively over the distribution lines of a public utility shall create an affiliated for-profit entity that allows the entity to be taxes at the same level as other for-profit suppliers.

Exhibit B

Tax Issues by States Addressing Deregulation*

New Hampshire	Recommend that taxes be competitively neutral. Legislature should explore need for legislation to address restructuring-related changes in tax receipts.
New Mexico	Deregulation being handled at the PUC level.**
New Jersey	Gross receipts and franchise taxes which only utilities pay are to be replaced with two taxes applicable to all energy suppliers (corporate business tax and 6% sales tax on all retail sales of energy services), as well as a transition tax paid by all distribution users over a 5 year period.
New York	Deregulation being handled at PUC level.**
Oklahoma	OK Tax Commission must: 1) evaluate impact of restructuring on state tax revenues and structure at state and local levels; and 2) assess feasibility of setting a uniform consumption tax or similar tax. Tax commission must report to Joint Electric Utility Task Force by 12/31/98. If uniform tax policy for all competitors is not established by 7/1/2002, retail access date will be extended until such a tax policy is in effect. OTC prohibited from promulgating any rule or order relating to methods of taxation in a restructured industry w/o the express consent of Oklahoma legislature.
Pennsylvania	Gross receipts tax (GRT) continues, supplemented by revenue neutral reconciliation formula to maintain tax revenues at 1995/96 levels. GRT applies to all new entities in the industry, as well as competing co-ops and munis. In order to obtain a license, all suppliers, including those from out of state, must commit to paying GRT. Co-ops who serve outside their service territory must pay tax on sales of electricity. Revenue Neutral Reconciliation –to recoup revenue losses resulting from restructuring. 1/1/99 tax imposed on gross receipts of Electric Distribution Companies and Electric Generation Suppliers and municipal systems serving outside their municipal limits, or co-ops outside their service territory. Report required to describe dynamic economic effect upon affected taxes due to restructuring.
Rhode Island	Retail electric licensing commission must file by 1/1/97 a recommendation to tax discos, nonregulated power producers, and transmission companies.

*Primary source of information: Edison Electric Institute

**Conclusions drawn from conversation between Frances Goetz of Pieper, Martin, Gary Myers and Greg Nelson.

EXHIBIT C
MUNICIPAL UTILITY TAXES
POTENTIAL SOLUTIONS: POLICY IMPLICATIONS

		Does the Proposal Promote a Level Playing Field?	Is the Proposal Revenue Neutral?	Does the Proposal Retain the Current Customer Tax Burdens?	Does the Proposal Provide for a Collectible tax?	Other Issues
1	**Enact a replacement tax**	Only if muni imposes (i.e., Hancock vote passes) or if imposed by state constitutional amendment	Only if muni imposes (i.e., Hancock vote passes) or if imposed by state constitutional amendment	Only if purchase price based or volumetric based with variable rates	Risk of noncollection increases to the extent that municipalities must collect directly from customers	
2	**Retain existing taxes and fees--enact a complementary tax**	Only if muni imposes (i.e., Hancock vote passes) or if imposed by state constitutional amendment	Only if muni imposes (i.e., Hancock vote passes) or if imposed by state constitutional amendment	Only if purchase price based or volumetric based with variable rates	Risk of noncollection increases to the extent that municipalities must collect directly from customers	Whether a municipality with a PILOT can enact a tax that is compensating to a PILOT
3	**Permit municipalities to charge rental fees to distribution companies for use of right of way**	Only if muni imposes (and Hancock vote, if required passes).	Only if muni imposes (i.e., Hancock vote passes).	Yes	Risk of noncollection increases to the extent that municipalities must collect directly from customers	
4	**Impose a meter surcharge on the distribution company**	Only if the courts sustain the surcharge; it is equal to the muni tax and fee burden of local suppliers; and it is passed through to customers	Only if the courts sustain the surcharge and if it is equal to the muni tax and fee burden of local suppliers	Only if the courts sustain the surcharge and if it is equal to the muni tax and fee burden of local suppliers	Yes, if the courts sustain the surcharge	
5	**Retain existing taxes and fees--require nonlocal suppliers to agree to pay them as a condition of obtaining certification to sell**	Only if courts determine that an agreement to pay taxes is sufficient for nexus over nonlocal supplier or if all nonlocal suppliers voluntarily pay	Only if courts determine that an agreement to pay taxes is sufficient for nexus over nonlocal supplier or if all nonlocal suppliers voluntarily pay	Only if courts determine that an agreement to pay taxes is sufficient for nexus over nonlocal supplier or if all nonlocal suppliers voluntarily pay	Only if courts determine that an agreement to pay taxes is sufficient for nexus over nonlocal supplier or if all nonlocal suppliers voluntarily pay	Whether state has authority to require payment of taxes as condition of certification; not applicable to PILOTs
6	**Retain existing taxes and fees--require nonlocal suppliers to maintain office in Missouri**	Only for municipality(ies) where the supplier maintains offices (assuming that courts approve the requirement)	Only for municipality(ies) where the supplier maintains offices (assuming that courts approve the requirement)	Only for municipality(ies) where the supplier maintains offices (assuming that courts approve the requirement)	Only for municipality(ies) where the supplier maintains offices (assuming that courts approve the requirement)	Whether state has authority to require maintenance of office within the state
7	**Retain existing taxes and fees--require nonlocal suppliers to install and own meters for their customers**	Yes	Yes	Yes	Yes	Whether state has authority to require ownership of meters; not applicable to PILOTs
8	**Allow munis to adjust franchise fees to compensate for lost revenues**	Unclear	Yes	Unclear	Yes	
9	**Charge suppliers a state registration fee for the privilege of selling electricity in Missouri**	Only if the courts sustain the fee and if it is equal to the muni tax and fee burden of local suppliers	Only if the courts sustain the fee and if it is equal to the muni tax and fee burden of local suppliers	Only if the courts sustain the fee and if it is equal to the muni tax and fee burden of local suppliers	Yes, if the courts sustain the fee	Revenue distribution
10	**Increase other taxes**	Depends on specific adjustments	Depends on specific adjustments	Depends on specific adjustments	Depends on specific adjustments	Revenue distribution

FOOTNOTE: For purposes of this comparison, revenue neutrality refers to preventing municipal tax revenue losses due to customer selection of nonlocal electricity suppliers (not to any decrease that might occur if electricity prices decrease).

EXHIBIT D
MUNICIPAL UTILITY TAXES
POTENTIAL SOLUTIONS: CONSTITUTIONAL ISSUES

	Is Hancock Impacted?	Does Municipality Have Nexus over the Taxpayer?	Does Municipality Have Nexus over the Tax Collector	Does the Proposal Discriminate Against Interstate Commerce?
1 Enact a replacement tax	Yes	Only if imposed on customer, distribution company, or supplier having a physical presence in the municipality	Only if collected from customer, distribution company, or supplier having a physical presence in the municipality	No, unless applied to out-of-state, but not in-state, suppliers or transactions
2 Retain existing taxes and fees--enact a complementary tax	Yes	Only if imposed on customer, distribution company, or supplier having a physical presence in the municipality	Only if collected from customer, distribution company, or supplier having a physical presence in the municipality	No, unless the complementary tax discriminates against out-of-state suppliers or transactions
3 Permit municipalities to charge rental fees to distribution companies for use of right of way	Unclear	Yes	Yes	No
4 Impose a meter surcharge on the distribution company	Unclear	Yes	Yes	No
5 Retain existing taxes and fees--require nonlocal suppliers to agree to pay them as a condition of obtaining certification to sell	No	Only if agreement to pay taxes is sufficient to confer nexus over nonlocal supplier under federal constitutional law-- answer is not clear.	Only if agreement to pay taxes is sufficient to confer nexus over nonlocal supplier under federal constitutional law-- answer is not clear.	No, assuming that state can require the agreement to pay taxes
6 Retain existing taxes and fees--require nonlocal suppliers to maintain office in Missouri	No	Only for municipality(ies) where the supplier maintains offices (assuming that courts approve the requirement)	Only for municipality(ies) where the supplier maintains offices (assuming that courts approve the requirement)	No, assuming that state can require the office
7 Retain existing taxes and fees--require nonlocal suppliers to install and own meters for their customers	No	Yes (assuming that the courts approve the requirement)	Yes (assuming that the courts approve the requirement)	No, assuming that state can require the meters
8 Allow munis to adjust franchise fees to compensate for lost revenues	Unclear	Yes	Yes	No
9 Charge suppliers a registration fee for the privilege of selling electricity in Missouri	Unclear	Unclear	Unclear	No
10 Increase other taxes	Yes	Depends on specific adjustments	Depends on specific adjustments	Depends on specific adjustments

COMPETITIVE MARKET STRUCTURES REPORT
INTRODUCTION AND SUMMARY

This Report identifies and addresses legal issues that relate directly to the alternative market structures for retail competition that are being considered by the Market Structure and Market Power working group of the Missouri Public Service Commission's ("Missouri PSC") Task Force on Retail Electric Competition. Many issues discussed by this subcommittee were referred to the Legal Committee by the Market Structure and Market Power working group, and relate specifically to matters discussed in this working group's reports, "Alternative Market Structures for Retail Competition" and "Market Power and Other Competitive Issues for Retail Electric Competition" (March 6, 1998). However, a few issues have also been included by the subcommittee itself after review of the draft reports of the Market Structure and Market Power working group.

The purpose of this Report is to identify issues for discussion rather than to answer each question definitively. However, this Report is not intended to contain or refer to all applicable legal authority and is not intended to express the individual or representative views of any of the Report's authors. No attempt has been made in this Report to summarize every aspect of the market structures themselves or discuss public policy or technical issues that may be raised by various market structures that are being discussed by the Market Structure and Market Power working group. For such discussion, the reader is referred to the Market Structure and Market Power Reports.

The full Legal Committee reviewed several drafts of this report, but it did not, as a group, see the final document presented here. This final report was compiled by the subcommittee chair, James Fischer, who incorporated final comments of the Legal Committee members under the oversight of the Task Force moderator, Dan Joyce, who chaired the Legal Committee.

I. SUMMARY OF ANALYSIS OF JURISDICTIONAL ISSUES RELATED TO MARKET POWER ISSUES

This Report will discuss state and federal jurisdictional issues related to market power, including:

- Whether the state may require the operation and planning decisions regarding transmission systems within Missouri to be made by an Independent System Operator ("ISO");
- Whether the state may require the ISO to assess fees for the funding of additional transmission capacity;
- Whether the state may require the local utilities to join an ISO or regional transmission group that has a regional transmission rate that eliminates the pancaking of individual utility transmission rates;
- Whether the state may require the use of "postage stamp" transmission rates;
- Whether the state may require the strict enforcement and audit of FERC Order 889 Rules;
- Whether the state may require reasonable standards for marketer certification that differ from requirements for marketers of wholesale power.

Based upon the jurisdictional principles discussed in this Report, it is arguable that the state of Missouri (including the Missouri PSC) may have difficulty specifically mandating the adoption of mitigation measures that relate to the regulation of the transmission services and the transmission grid itself. Since the regulation of transmission services has been held to be exclusively within the jurisdiction of the Federal Energy Regulatory Commission ("FERC"), it may be difficult for the state of Missouri to require that the transmission grid in Missouri be operated exclusively by an ISO. In addition, the state of Missouri may have no authority to mandate that the ISO assess fees to be used to expand the transmission system within the state.

Similarly, the mitigation measures that relate to the rate design of transmission services (*e.g.*, no pancaking of transmission rates, and "postage stamp" transmission rates only) arguably raise significant jurisdictional and preemption issues. It may be less clear whether the state could require the strict enforcement of FERC's Order 889 Rules (*e.g.*, OASIS Bulletin Boards and Standards of Conduct rules) for legitimate state purposes. The state could adopt its own rules related to matters within the state jurisdiction which mirror provisions in Order 889. However, the state may not be permitted to adopt state rules that negate federal rules within the exclusive jurisdiction of the FERC. Similar questions arise concerning state certification requirements for retail marketers. To the extent that state certification requirements did not pose a barrier to entry for wholesale transactions, it is arguable that state certification requirements would not be preempted by federal regulations.

II. SUMMARY OF ANALYSIS OF JURISDICTIONAL ISSUES RELATED TO MARKET STRUCTURES

The Report also discusses state and federal jurisdictional issues related to market structure issues, including:

- Whether the state may regulate a power pool;
- Whether the state may require out of state suppliers to sell power only at wholesale in Missouri and only directly to instate suppliers or a power pool;
- Whether the state public service commission may review or adjust the power pool price in setting the local distribution company's retail rate.

Based on the jurisdictional principles discussed in this Report, it is arguable that the state of Missouri (including the Missouri PSC) cannot regulate any Missouri power pool (assuming that creating one is lawful). FERC has exclusive jurisdiction over wholesale sales, and it is likely that all sales to and from the power pool will be found to be wholesale sales. This exclusive jurisdiction of the FERC may also preclude direct state involvement in the governance, procedures and operations of the power pool.

Second, it is also arguable that the state of Missouri (including the Missouri PSC), may have difficulty mandating that wholesale sales within the state may only be made directly to an in state supplier or directly to a power pool. Because FERC has exclusive jurisdiction over wholesale sales, the state may be preempted from regulating wholesale sales by out of state suppliers in this way.

Third, it is also questionable whether the state will have jurisdiction to review and adjust the prices paid by the power exchange ("PX") or in state supplier for power purchased at wholesale. FERC has exclusive jurisdiction over wholesale sales, and the state has exclusive jurisdiction over retail sales. However, it is unclear whether the state could adjust the wholesale price in setting retail rates of the local utility under a poolco structure.

III. SUMMARY OF ANALYSIS RELATED TO CONSTITUTIONAL ISSUES

The Report also briefly addresses constitutional issues, including:

- Whether the state may prohibit the use of the name of an incumbent by a retail electric provider ("REP") affiliate;
- Whether the state may prohibit an affiliate of an incumbent utility from advertising or promoting its services for a period of time;
- Whether the state may require the Local Distribution Utility ("LDU") to exit the merchant function;
- Whether the state may require REPs or LDUs to serve customers involuntarily or otherwise designate a default provider for customers who "choose not to choose" a REP;
- Whether the state may require the involuntary divestiture of generation assets of an incumbent public utility.

As with most constitutional issues, there may be considerable controversy regarding how an appellate court may ultimately resolve such issues. This Report raises the possibility that an outright prohibition on the use of brand names or advertising by incumbent public utilities or their affiliates may raise First Amendment and Equal Protection Clause concerns. Similarly, other mitigation measures, including requiring a local distribution company to exit the merchant function, requiring a REP to serve customers or serve as a provider of last resort involuntarily, may also raise constitutional questions. Finally, the Report suggests that, depending upon how divestiture of generation assets would be accomplished, it is possible that constitutional issues could be raised by a policy of mandatory divestiture of generation assets by incumbent utilities. However, a detailed analysis of these constitutional issues was beyond the scope of the Report.

IV. SUMMARY OF ANALYSIS RELATED TO ANTITRUST ISSUES

Finally, this Report discusses antitrust issues related to market structures, including:

- Whether a PX is a price fixing mechanism that, absent an exemption, would violate federal antitrust laws;
- Whether a PX that imposes mandatory buy-sell arrangements on the market violates federal antitrust laws;
- Whether a PX with a mandatory monopoly, absent an exemption, would violate federal antitrust laws;
- Whether a state legislature may confer antitrust immunity on a PX; and
- Whether the FERC can confer antitrust immunity on a PX.

Proponents of the direct access model have argued that a PX may violate the antitrust laws. According to this view, a PX of the type contemplated by the poolco market structure model is a "horizontal price fixing mechanism" that would constitute a *per se* violation of the Sherman Act. Therefore, a poolco market structure could only be implemented if federal antitrust laws were expressly or implied repealed, or unless the "state action" doctrine was invoked by the courts. Since the PX would arguably be under the exclusive jurisdiction of the FERC, these proponents suggest that the state action doctrine could not be applied to exempt a PX from federal antitrust law.

Proponents of the poolco and hybrid models, however, disagree with this analysis. These parties argue that the purpose of a PX is not to "fix prices" but rather to bring willing buyers and sellers together, and to make a market for wholesale and/or retail power. Competitive market forces that are determined by a bidding process determine the price of the power. Since the PX will be actively supervised by the FERC or other appropriate governmental authority, these proponents argue that the state action doctrine or a similar exemption will be recognized. These proponents also point out that such power pools have existed in other states without a legal finding that the arrangements violate antitrust laws. Finally, the proponents of the poolco and hybrid models point out that in virtually every state in which restructuring of the electric market has been implemented, some form of a power pool or PX has been developed.

For a more in-depth analysis of these issues, the reader is referred to the body of this Report.

LEGAL ISSUES RELATED TO COMPETITIVE MARKET STRUCTURES

A. State and Federal Jurisdictional Issues Related to Market Power

To date, many legal issues raised in the Market Structure and Market Power Reports have related to the measures proposed for mitigating potential market power of incumbent public utilities. Several measures that are being proposed to mitigate market power raise questions related to the extent of the jurisdiction of the Federal Energy Regulatory Commission ("FERC") and of state regulatory bodies, including the Missouri Public Service Commission ("Missouri PSC"). Ultimately, many of these mitigation measures include proposals that relate to the regulation or pricing of transmission services. To the extent that the specific measures may fall within the jurisdiction and purview of the FERC, it may be arguable that the state of Missouri would be preempted from addressing such measures in legislation, or in rules or decisions adopted by regulatory bodies.

1. Mitigation Measures

The following mitigation measures are being discussed by the Market Structure and Market Power working groups and may raise jurisdictional or preemption issues:

(a) **Requiring the operation and planning decisions regarding transmission systems within Missouri to be made by an Independent System Operator ("ISO");**

(b) **Requiring the ISO to assess fees for the funding of additional transmission capacity;**

(c) **Requiring the local utilities to join an ISO or regional transmission group that has a regional transmission rate that eliminates the pancaking of individual utility transmission rates;**

(d) **Requiring the use of "postage stamp" transmission rates;**

(e) **Requiring the strict enforcement and audit of FERC Order 889 Rules;**

(f) Requiring reasonable standards for marketer certification that differ from requirements for marketers of wholesale power.

Each mitigation measure should be reviewed individually in light of the broad jurisdictional principles discussed in this report.

2. Jurisdictional Principles Related to Regulation of the Transmission Services and the Creation and Operation of an Independent System Operator (ISO)

Based upon an analysis of the relevant legislative history and case law under the Federal Power Act ("FPA"), the FERC has concluded "it has exclusive jurisdiction over the rates, terms and conditions of the unbundled transmission in interstate commerce, by a public utility, of electric energy to an end user."[1] (FERC Order No. 888, App. G, p .1). It has also held that ". . . any facilities of a public utility used to deliver electric energy in interstate commerce to a wholesale purchaser, whether such facilities are labeled 'transmission,' 'distribution' or 'local distribution,' are subject to the Commission's jurisdiction. . . ." *Id.* at 37. These conclusions were based upon Sections 201, 205 and 206 of the FPA that give the FERC jurisdiction over the rates, terms and conditions of transmission in interstate commerce, and sales at wholesale in interstate commerce, by public utilities.[2]

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[1] Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Notice of Proposed Rulemaking, 59 FR 35274 (July 11, 1994), IV FERC Stats. & Regs., Proposed Regulations (hereafter referred to as "FERC Order No. 888").

[2] *See* 16 U.S.C. 824(b)(1), 8249(d) and 824(e). *See also Public Utility Commission v. Attleboro Steam & Electric Co.*, 273 U.S. 83 (1927) (holding that assertions of jurisdiction by state regulators over "interstate" wholesale transactions were in violation of the Commerce Clause); *Jersey Central Power & Light v. FPC*, 319 U.S. 61 (1943) (holding that two indirectly interconnected public utilities owned facilities that were used to transmit electric energy in interstate commerce, therefore, were within the federal jurisdiction); *Connecticut Light & Power Co. v. FPC*, 324 U.S. 515 (1945) (holding that federal jurisdiction generally extends to transmission facilities that transmit electric energy in interstate commerce); *FPC v. Southern California Edison Co.*, 376 U.S. 205 (1964) (holding that the purchase and importation of out of

The California Public Utilities Commission ("California PUC") has also addressed jurisdictional issues related to restructuring the electric industry, including the creation of an ISO, PX and direct access.[3] In its Restructuring Order, the California PUC concluded:

> Based upon the record in this combined proceeding we concur . . . that the FERC should rule that facilities transferred to the ISO are FERC-jurisdictional and that those retained by utilities "downstream" of the ISO are local distribution facilities, if used to make retail sales, whether to retained utility customers (bundled) or to direct access customers (unbundled).

Id. at 44.

3. Analysis of Specific Mitigation Measures in Light of Jurisdictional Principles

Based upon the jurisdictional principles discussed above, it would appear that the state of Missouri (including the Missouri PSC) may have difficulty specifically mandating the adoption of mitigation measures that relate to the regulation of the transmission services and the transmission grid itself. Since the regulation of transmission services has been held to be exclusively within the jurisdiction of the FERC, it may be difficult for the state of Missouri to require that the transmission grid in Missouri be operated exclusively by an ISO.[4] In addition, the

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state electricity for resale within a state, conferred jurisdiction on the FPC); *FPC v. Florida Power & Light Co.*, 404 U.S. 453 (1972) (holding that the ability of electricity generated in one state to "commingle" with interstate electricity on interconnected transmission facilities was a sufficient predicate for the exercise of federal regulatory jurisdiction under the FPA).

[3] Order Instituting Rulemaking on the Commission's Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation, Case No. R.94-04-031 (filed April 20, 1994, and decided December 20, 1995, modified January 10, 1996).

[4] In *Re Union Electric/CIPSCO,* Case No. EM-96-149, (February 21, 1997), the Missouri PSC, however, conditioned its approval of a proposed merger of Union Electric and CIPSCO upon Union Electric agreeing to join an ISO. Union Electric subsequently accepted this condition and consummated the merger with CIPSCO.

state of Missouri may have no authority to mandate that the ISO assess fees be used to expand the transmission system within the state.

Similarly, the mitigation measures that relate to the rate design of transmission services (*e.g.*, no pancaking of transmission rates, and "postage stamp" transmission rates only) appear to raise significant jurisdictional and preemption issues. While the demarcation line between transmission and distribution services has been somewhat unsettled,[5] once it is determined that the service is "transmission," then the FERC has asserted exclusive jurisdiction. It should, however, be noted that the FERC envisions a continuing role of the states in determining which facilities are transmission and which are local distribution.[6]

It may be less clear whether the state could require the strict enforcement of FERC's Order 889 Rules (*e.g.*, OASIS Bulletin Boards and Standards of Conduct rules) for legitimate state purposes. The state could adopt its own rules related to matters within the state jurisdiction which mirror provisions in Order 889.[7] However, it may not be permitted to adopt rules that were

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[5] In FERC Order No. 888, the FERC applied a functional test in determining whether particular facilities are transmission or local distribution in the case of a vertically integrated transmission and distribution utilities. More specifically, the FERC stated that it would evaluate the following factors in making this determination: (1) Local distribution facilities are normally in close proximity to retail customers; (2) Local distribution facilities are primarily radial in character; (3) Power flows into local distribution systems, and rarely flows out; (4) When power enters into a local distribution system, it is not reconsigned or transported on to some other market; (5) Power entering a local distribution system is consumed in comparatively restricted geographical areas; (6) Meters are based at the transmission/local distribution interface to measure flows into the local distribution system; and (7) Local distribution systems will be of reduced voltage. *FERC Statutes & Regulations* at 31,770-71.

[6] FERC *Statutes & Regulations* at 31,780-81, 31,783-84 (1996).

[7] For example, the state enforces federal safety rules related to the regulation of public utilities. *See* 4 CSR 240-18.010 (adopting the American National Standard, National Electrical Safety Code for electric and telephone utilities and cooperatives); 4 CSR 240-40.020 (adopting

inconsistent with or otherwise negate federal rules within the exclusive jurisdiction of the FERC.

Similar questions arise concerning state certification requirements for retail marketers. The consumer safeguards that are necessary for retail marketers may be different than in the wholesale markets. However, many retail marketers may also be subject to FERC certification requirements for wholesale transactions. To the extent that state certification requirements did not pose a barrier to entry for wholesale transactions, it is arguable that state certification requirements would not be preempted by federal regulations. Furthermore, in the telecommunications marketplace, the various states have established specific state requirements for certification of intrastate, interexchange and local exchange companies,[8] notwithstanding that different requirements and procedures are used by the Federal Communications Commission ("FCC") for similar interstate services. Nevertheless, this area also raises possible preemption issues that the Task Force should consider in more depth.

B. State and Federal Jurisdictional Issues Related to Market Structure

Other jurisdictional issues are raised because of the unique characteristics of certain proposed market structures. For instance, the poolco model interposes an entity between the power seller and the retail customer whose sole function is to buy and sell power at wholesale and establish market prices. Thus, the following jurisdictional and preemption issues are raised:

(a) **Whether the state may regulate a power pool;**

(b) **Whether the state may require out of state suppliers to sell power only at wholesale in Missouri and only directly to in state suppliers or a power pool;**

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gas safety rules similar to Minimum Federal Safety Standards, 49 CFR part. 191).

[8] *See* Sections 392.410 and 392.450, RSMo (Cum. Supp.1997).

(c) Whether the state public service commission may review or adjust the power pool price in setting the local distribution company's retail rate.

1. Analysis of Specific Market Structure Issues in Light of Jurisdictional Principles

The following discussion is based on the jurisdictional principles as discussed in subsection A.2. With respect to Issue (a) identified in this section, it appears that the state of Missouri (including the Missouri PSC) cannot regulate any Missouri power pool (assuming that creating one is lawful). FERC has exclusive jurisdiction over wholesale sales, and it is likely that all sales to and from the power pool will be found to be wholesale sales. For example, California's PX is under the exclusive jurisdiction of the FERC after FERC issued a declaratory order that all sales into the PX would qualify as wholesale sales.[9] Thus, the state would have no jurisdiction to regulate the PX. This exclusion may preclude state involvement in the governance, procedures, and operations of the power pool.

Second, with respect to Issue (b) identified in this section, it appears that the state of Missouri (including the Missouri PSC), may have difficulty mandating that wholesale sales within the state may only be made directly to an in state supplier or directly to a power pool. Because FERC has exclusive jurisdiction over wholesale sales, the state may be preempted from regulating wholesale sales by out of state suppliers in this way.[10] In California, out of state suppliers are permitted to sell power directly to retail customers, so this issue was never addressed.

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[9] FERC Declaratory Order Concerning Sales of Electricity into the California PX, 9/10/97, Docket No. EL97-36-000.

[10] See footnote 2.

Third, with respect to Issue (c) identified in this section, it appears that the state may not have jurisdiction to review and adjust the prices paid by the power exchange or in state supplier for power purchased at wholesale. FERC has exclusive jurisdiction over wholesale sales, and the state has exclusive jurisdiction over retail sales. However, it is unclear whether the state could adjust the wholesale price in setting retail rates of the local utility under a poolco structure. A state utility commission must allow, as reasonable operating expenses, costs incurred by a utility as a result of paying a FERC-determined wholesale rate.[11] A state commission can challenge the prudence of a utility's decision to purchase power at a FERC-approved rate under what has come to be known as the *Pike County* doctrine.[12] Currently, the state can also perform a "prudence review" of the price paid for natural gas at wholesale by the local utility in setting the local gas company's retail rate.[13] The distinction between these traditional scenarios and the issue raised by the poolco model lies in the fact that the under traditional analysis the public utility has a choice of supplier, whereas under a poolco structure, the local electric distribution company has no choice and would be required to buy from the power pool. Further, FERC has claimed exclusive jurisdiction over California's PX, as explained previously. Thus, FERC's jurisdiction may be used to preclude the state from performing a similar "prudence review" of the poolco price.

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[11] *See, Nantahala Power and Light Company v. Thornburg,* 476 U.S. 953 (1986).

[12] *See, Pike County Light and Power Company v. Pennsylvania Public Utility Commission*, 465 A.2d 735 (Pa.1983).

[13] The Missouri PSC, in the context of a gas case, has recognized the *Pike County* doctrine. *See American National Can Company v. Laclede Gas Company,* 30 Mo.P.S.C. (N.S.) 32, 35 (1989); *See also Kentucky West Virginia Gas Company v. Pennsylvania Public Utility Commission,* 837 F.2d 600 (3rd Cir. 1988), *cert. denied,* 488 U.S. 941 (1988).

C. Constitutional Issues Related to Market Power

1. Additional Mitigation Measures

The following additional mitigation measures may raise federal constitutional issues:

(a) Prohibiting the use of the name of an incumbent by a retail electric provider ("REP") affiliate;

(b) Prohibiting an affiliate of an incumbent utility from advertising or promoting its services for a period of time;

(c) Requiring the Local Distribution Utility ("LDU") to exit the merchant function;

(d) Requiring REPs or LDUs to involuntarily serve customers or otherwise designating a default provider for customers who "choose not to choose" a REP;

Each of these mitigation measures will be discussed in the following section in light of potential constitutional issues.

2. Analysis of Additional Mitigation Measures in Light of Constitutional Principles

(a) Prohibiting the Use of the Name of an Incumbent by an Affiliate

The Market Structure and Market Power working group has considered the possibility of prohibiting the use of the name of an incumbent public utility by an unregulated affiliate. This proposal apparently is designed to ensure that unregulated affiliates do not obtain an advantage over unaffiliated companies operating in the same market. Some proponents have suggested that: "In a market area that is currently being served by a single provider (utility), if that same provider is allowed to compete as a REP using the same name, this may be a hurdle that other REPs must overcome to gain significant market shares. Thus, all REPs will not begin competition on a level playing field."[14] As a mitigation measure to address this potential concern, the Market Structure and Market Power working group has considered the following restriction: "Require the REP to use a name different from the utility's current name."[15]

A complete prohibition on the use of brand names may raise constitutional issues. In other public utility-related contexts, the use of utility brand names has been challenged. In one case involving a large Minnesota local distribution company (Minnegasco), the public utility had been providing appliance maintenance services through an affiliated company that used the Minnegasco name. The Minnesota Alliance for Fair Competition, an umbrella group representing plumbing, electrical and appliance services providers, brought a complaint before the Minnesota Public Utilities Commission ("MPUC"), alleging that Minnegasco enjoyed an unfair advantage in the maintenance service market since it was able to capitalize on the goodwill value of the utility's name. After hearing, the MPUC concluded that the public utility affiliate did derive advantages from the use of the name. Accordingly, the MPUC decided that the appliance maintenance affiliate should make a payment to the utility for the use of that goodwill.

Upon review, the Minnesota Supreme Court reversed the MPUC decision.[16] The Supreme Court held that the MPUC lacked the statutory authority to impute revenue to the public utility, for rate making purposes, for the value of the company's goodwill associated with the use of its name

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[14] "Market Power and Other Competitive Issues for Retail Electric Competition," A Report to the Missouri Public Service Commission's Task Force on Retail Electric Competition from the Task Force's Working Group on Market Structure and Market Power. (March 6, 1998, at 11).

[15] *Id.*

[16] *Minnegasco v. Minnesota Public Utility Commission*, 549 N.W.2d 904 (Minn. 1996).

by its affiliate. The Court reasoned that goodwill payments were not appropriate because the value of the utility's reputation had not been considered a "cost" of providing utility service and customers had not borne these costs in their rates. Moreover, goodwill was determined to be an asset of the company, and "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. . . . The ratepayer remains a consumer and the assets remain the property of the utility."[17]

In Missouri, the Missouri PSC has also rejected arguments that affiliates of a local exchange company should be required to pay royalties for the use of its local exchange company's name and logo.[18] In *Southwestern Bell Telephone Company*, the Missouri PSC rejected a Staff proposal to charge affiliates a royalty for use of the local exchange company's name and logo. The Commission found that ". . . there is no basis for charging the other subsidiaries a royalty fee for use of the [Southwestern Bell] name and logo."[19] Similarly, in *Re United Telephone Long Distance ("UTLD")*, the Public Counsel suggested that, as a condition for the grant of a certificate of service authority, UTLD should be required to pay ten percent of its gross profits to United Telephone Company of the Midwest ("UTM"), an affiliated local exchange company, as a payment for the goodwill that UTM had acquired from its operations as a local exchange company. The Missouri PSC, however,

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[17] *Id.*at 909. (Since the court decided the case on statutory grounds, it declined to address the Company's constitutional arguments).

[18] *Staff v. Southwestern Bell Telephone Company*, 2 Mo.P.S.C.3d 479, 518 (Mo.P.S.C. 1993); *Re United Telephone Long Distance*, 29 Mo.P.S.C. (N.S.) 531, 544-45 (Mo.P.S.C. 1989).

[19] 2 Mo.P.S.C.3d at 518.

rejected the Public Counsel's position on the ground that there was insufficient evidence to justify the proposed royalty payment.[20]

In the telecommunications area, the FCC has generally adopted a favorable public stance toward LEC's use of utility brands in competitive markets. For example, the FCC reasoned that Regional Bell Operating Company's ("RBOC") entry into a wide range of competitive services "offers the prospect of fostering vigorous competition among providers of such services, because of the unique assets that RBOCs possess. RBOCs can offer a widely recognized brand name that is associated with telecommunications services, the benefits of 'one-stop shopping', and other advantages of vertical integration."[21] As a result, the FCC has adopted a generally light-handed approach toward the use of brand names by the RBOCs and GTE. The RBOCs and GTE have used their brands in important retail markets (*e.g.,* cellular, yellow pages, and interexchange service) that they have been allowed to enter. These companies have also been allowed both to extend the basic utility brand or abandon it as their business strategies dictated. To the extent that outright prohibitions on the use of brand names were incorporated into legislation or regulations, there may be First Amendment and other constitutional questions raised.

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[20] 29 Mo.P.S.C. (N.S.) at 545.

[21] FCC, Notice of Proposed Rulemaking, CC Docket No. 96-152, July 18, 1996.

(b) Prohibiting an affiliate of an incumbent utility from advertising or promoting its services for a period of time. (Bill of Attainder, Equal Protection Clause, First Amendment).

1) First Amendment

The First Amendment, as applied to the states through the Fourteenth Amendment, protects commercial speech from unwarranted governmental regulation. U.S.C.A. Const. Amends. 1, 14.

In *Central Hudson Gas & Electric Corp. v. Public Service Commission*, 447 U.S. 557 (1980), the court articulated a standard for First Amendment commercial speech challenges. The case involved a challenge to a New York Public Service Commission ("New York PSC") regulation that completely banned any advertising by electric utilities that promoted the use of electricity during the 1970's energy crisis. While acknowledging the state's interest in energy conservation, the court found that the New York PSC had gone too far to promote such an interest. It held that the regulation was an impermissible infringement on the utilities' First Amendment right to commercial speech.

In ruling that the regulation was unconstitutional, the court identified four factors that must be taken into consideration:

1) a threshold question is first whether the commercial speech concerns truthful and lawful activity;

2) then it must be determined that the governmental interest in regulating the speech is substantial;

3) the regulation must directly advance the government's asserted interest; and

4) the regulation or restriction must not be broader that it required to serve the stated interest.

Ibid. at 566.

Arguably analogous to the *Central Hudson* case, the Legislature or the Missouri PSC would be trying to stop an affiliated company from advertising about its product. The court found it unacceptable that the New York PSC attempted to suppress completely what would be ordinarily permissible commercial speech. A court may find a complete prohibition against affiliate advertising similarly unlawful.

2) Bill of Attainder

Recently, a Texas District Court ruled that the constitutional prohibition against bills of attainder applied to corporations. *SBC Communications, Inc. v. Federal Communications Commission,* 981 F.Supp. 996 (N.D. Texas 1997) ("SBC"). In *SBC,* the local exchange carriers and the RBOCs, brought action against the FCC challenging the constitutionality of certain provisions of the Telecommunications Act of 1996 ("Act") which impose restrictions on the RBOCs. In fact, these provisions were called "Special Provisions Concerning Bell Operating Companies." These provisions restricted the entry of RBOCs into the long-distance telephone market, prohibited electronic publishing by RBOCs through use of basic telephone service, required RBOCs to use affiliates for certain lines of business and restricted manufacturing activities and provision of alarm monitoring services. The RBOCs were singled out by name for the imposition of these restrictions as well as other conditions, checklists, and review processes.

The RBOCs argued that these "special provisions" were unconstitutional because they unfairly singled out them and their affiliates; the provisions put up barriers and imposed conditions that others similarly situated were not subjected to; that the provisions punished them financially;

and the provisions took from the RBOCs rights and freedoms they had previously enjoyed. The RBOCs argued the provisions were intended to "punish" them for presumed anticompetitive behavior and because of the past allegations of anticompetitive behavior of its former corporate parent. They bitterly complained that it was not fair that the state sanctioned franchised protected status for local service was taken away yet at the same time they were not allowed to compete in other telephone business, particularly long distance. In other words, ". . . the proverbial carrot has been removed but they are still receiving the stick." *Ibid.* at 1000.

The Court defined a bill of attainder as a statute that (1) identifies a specific individual or group, (2) inflicts punishment on that individual or group, and (3) without the benefit of a judicial trial. *Ibid.* at 1004 (citing *Selective Serv. Sys. v. Minnesota Public Interest Research Group,* 468 U.S. 841, 846 (1984)). Because the 1996 Act's provisions were entitled "Special Provisions Concerning Bell Operating Companies," the specification element was met and because it was agreed that there had been no judicial trial which found the RBOCs guilty of anti-competitive behavior the last element was also met. The pivotal issue was whether the restrictions were "punishment." The Court then outlined a three step analysis to help it distinguish between lawful regulation and impermissible punishment which should be deemed a bill of attainder. After reviewing the various restrictions, conditions and checklists imposed solely on the RBOCs, the Court determined the provisions constituted punishment that should be deemed a bill of attainder.

The review of the three step analysis is not necessary to determine whether an advertising prohibition for affiliates of incumbent utilities would be a bill of attainder. Such a prohibition would fall on a class or group of affiliates and not single out a particular affiliate by name. The *SBC* Court was struck mostly by the fact that the RBOCs were singled out by name. It was the failure of the Act to treat RBOCs as it did other local exchange carriers that troubled the Court. The subcommittee is unaware of any legislative plans to, by name, or otherwise single out a particular affiliate for advertising prohibitions. Moreover, an advertising prohibition may not be considered so severe as to be deemed "punishment." Therefore, under the *SBC* analysis, an advertising prohibition for all affiliates of incumbent utilities may not constitute a bill of attainder.

3) Equal Protection

Generally, the Equal Protection Clause requires that the government treat similarly situated persons alike. *Keevan v. Smith*, 100 F.3d 644 (8th Cir. 1996). When the government action has affected a fundamental right (such as freedom of speech), then a compelling interest would have to be shown for the restriction. *St. Louis County, Mo. v. City of Town & Country*, 590 F. Supp. 731 (1984).

An affiliate of an incumbent may find relief in the Equal Protection Clause by arguing that the advertising prohibition is burdening it unfairly simply because it is an affiliate of an incumbent. The affiliate would have to demonstrate that there are other affiliates or competitors that are similarly situated that are not subject to the same prohibition and that the state's interest in preventing anti-competitive behavior is too broad and not compelling enough to warrant suppression of its right of commercial speech.

(c) Requiring a local distribution facility to exit the merchant function

1) Bill of Attainder

Under the *SBC* analysis, unless a specific LDU is going to be identified, it is unlikely that a bill of attainder argument would be successful.

2) Takings Clause

Analysis of this issue will have to be made under general takings principles that requiring the LDU to exit the merchant function deprives it of a source of revenue and a use of its property for which it is not compensated.

(d) Requiring REPs or LDUs to involuntarily serve customers or otherwise designating a default provider for customers who "choose not to choose" a REP

1) Taking Issue

In Peter Fox-Penner's book, "Electric Utility Restructuring" (Public Utility Reports, Inc. 1996), the author discusses universal service and how utilities may become the providers of last resort. Although he remarks that the LDU may become the supplier of last resort because of its instantaneous operation of the power grid, he also suggests that in a competitive environment, mere operation of the grid may not be enough to legally mandate supplier of last resort responsibility upon the operator of the grid. He also analyzed the "taking" aspect of forcing universal service or provider-of-last resort status upon specific public utilities. Discussing the argument of some proponents that the obligation for universal service is not truly an obligation imposed, but really part of the quid pro quo of having a franchise agreement, he suggested that the "right" to exclusively serve a territory comes with the "duty" to serve everyone in that territory. With the adoption of a competitive model, the fundamental rights and obligations of the public utility would be expected to change. Having eliminated the "right" to serve everyone in the service territory, it would be argued that there should no longer be a "duty" to serve any customer without reasonable compensation. The imposition of a "duty to serve" customers without adequate compensation could become a confiscatory taking of private property for public use.

Recently, the Missouri PSC has designated certain independent local exchange companies, over their objection, as "intraLATA toll carriers of last resort."[22] In the same order, the Commission also found that competitive local exchange carriers would be responsible for providing intraLATA toll service to their basic local exchange customers as a "provider of last resort."

2) Equal Protection Clause

Any Equal Protection argument will be made under general constitutional law principles. Often the court will not entertain Equal Protection arguments when it has resolved the case on other grounds. For example, even though the Plaintiffs in the *SBC* case raised First Amendment and Equal Protection arguments, the Court declined to hear them since it had found the FCC provisions to constitute a bill of attainder. *SBC*, at 1007. Also, a court may not entertain an Equal Protection argument, if it determines that there has been a "taking" or deprivation of substantive due process. A plaintiff may argue that property has been taken from him if the utility is forced to serve certain customers without adequate compensation. A designated provider of last resort may also be able to make an Equal Protection argument because it could argue that it was designated as the provider of last resort even though there are other similarly situated utilities just as capable of being provider of last resort. The determining factor may ultimately be whether the provider of last resort is being adequately compensated for providing this service.

(e) Mandatory divestiture of generation assets by the incumbent utility

None of the market structures that are being considered by the Market Structure and Market Power working group include a provision for the mandatory divestiture of

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[22] *See* Report & Order, *Re: Investigation Concerning the Continuation or Modification of the Primary Toll Carrier Plan When IntraLATA Presubscription is Implemented in Missouri*, Case Nos. TO-97-217 and TO-97-220. (March 12, 1998).

generation assets by the incumbent utilities. However, such divestiture is discussed in the working group's report as a possible mitigation measure for specific market power concerns. As a result, the Legal Subcommittee believed that this issue should be briefly addressed, especially in light of the significant legal issues that could be raised by a policy of mandatory divestitures of generation assets.

The Legal Subcommittee on Stranded Costs has considered case law and various constitutional principles in depth that would be applicable to the stranded cost issue.[23] Many of those principles would also be important in consideration of the policy of mandatory divestiture of generation assets. More specifically, the Just Compensation Clause of the Fifth Amendment (applicable to the states through the Fourteenth Amendment) and the Contract Clause establish the principle that the state must provide just compensation when it takes private property for public use and prohibits a state from impairing the obligation of contracts. Depending upon how divestiture of generation assets were to be accomplished, it is likely that constitutional issues could be raised by a policy of mandatory divestiture of generation assets by incumbent utilities. A detailed discussion of the related case law is beyond the scope of this Report. However, before the Task Force and/or Legislature seriously entertains the possibility of mandatory divestiture of generation assets, the subcommittee believes that additional legal analysis should be provided.

[23] *See* "Legal Issues Related to Recovery of Stranded Costs," A Report to the Missouri Public Service Commission's Task Force on Retail Electric Competition from the Task Force's Legal Subcommittee on Stranded Costs.

C. Antitrust Issues Related to Market Structures[24]

Antitrust law will play an increasingly important role as regulated monopoly utilities transition to a competitive electricity market. All stakeholders will need to educate themselves about the limits antitrust laws place on their activities as the competitive market is developing, or rather, to ensure that a competitive market does develop. Congress has plenary power to regulate interstate commerce; it has enacted numerous federal antitrust laws. Federal regulatory agencies, state legislatures, and state regulatory agencies are all subject to federal antitrust laws. However, some exceptions apply.

Valid government action confers antitrust immunity on private parties only when the government determines that competition is not the *summum bonum* in a particular field and deliberately attempts to provide an alternate form of public regulation.[25] Activities under the jurisdiction of a regulatory agency may still be subject to antitrust laws.[26]

Congress may impliedly repeal federal antitrust laws, however such repeals are disfavored and are narrowly construed.[27] Implied repeals must be "justified only by a convincing showing of clear repugnancy between the antitrust laws and the regulatory system."[28] The implied repeal must

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[24] Portions of this discussion are derived from the treatise, Antitrust Exemptions and Immunities, by Daniel G. Swanson. (December 1995).

[25] *R. Whitten, Jr. Inc. v. Paddock Pool Builders, Inc.*, 424 F.2d 25 (1st Cir. 1970), *cert. denied,* 400 U.S. 850.

[26] *Otter Tail Power Co. v. U.S.*, 410 U.S. 366 (1973).

[27] *United States v. National Ass'n of Securities Dealers, Inc.*, 422 U.S. 694, 719-20 (1975).

[28] *Id.*

be necessary to make the regulatory scheme work and is limited to the minimum extent necessary to accomplish that goal.[29] Two common cases of implied repeal appear in case law. In one case, the federal regulatory scheme must be so pervasive as to indicate that Congress has "'forsworn the paradigm of competition' by giving the agency control over every aspect of the defendant's behavior."[30] In another case, the acts must be "required by law or the relevant agency" or "scrutinized and approved by the agency" under its statutory authority.[31] Private decisions not "required or approved" by an agency have been found illegal.[32]

Congress has expressly refused to give a blanket exemption from antitrust laws to electric utilities, despite the fact that such utilities have been heavily regulated. The FPA expressly prohibits, "[c]ombinations, agreements, arrangements, or understandings, express or implied, to limit the output of electrical energy, to restrain trade, or to fix, maintain, or increase prices for electrical energy or services."[33] The Public Utility Regulatory Policies Act of 1978 ("PURPA") also states, "[n]othing in this Act or any amendment made to this Act affects -- (1) the applicability of the antitrust laws to any electric utility or gas utility, or (2) any authority of the Secretary or of the Commission under any other provision of law (including the Federal Power Act [16 U.S.C.A. § 791a et seq.] and the Natural Gas Act [15 U.S.C.A. § 717 et seq.]) respecting unfair methods of

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[29] *Silver v. New York Stock Exch.*, 373 U.S. 341, 357 (1963).

[30] *Supra,* note 24 (citing *MCI Communications Corp. v. AT&T,* 708 F.2d 1081, 1102 (7th Cir.), *cert. denied,* 464 U.S. 891 (1983).

[31] *Am. Agric. Movement v. Board of Directors of Trade*, 977 F.2d 1147, 1158 (7th Cir. 1992) (citations omitted).

[32] *Nat'l Germimedical Hosp. & Gerentology Ctr. v. Blue Cross*, 452 U.S. 378 (1981).

[33] 16 U.S.C.A. § 803(h)(1).

competition or anti-competitive acts or practices."[34] The Fifth Circuit found that federal antitrust laws are applicable to electric utilities.[35] Thus, the doctrine of implied repeal must be used to evaluate whether acts of entities operating in the electricity industry violate federal antitrust laws.

Because the Supremacy Clause of the U.S. Constitution makes federal law supreme over state law, state legislatures are even more limited in their ability to pass laws that violate federal antitrust statutes. The "state action doctrine" has developed in case law; it delineates when a state law is a valid exercise of its power, even though the law might otherwise conflict with federal antitrust laws.[36] The Supreme Court limited immunity to conduct that is either "state action or official action directed by a state"; mere "authorization" of conduct by the state is insufficient.[37] To be a valid state action, the state must both: (1) clearly articulate and affirmatively express the challenged conduct as a state policy, and (2) actively supervise the policy itself.[38] "*Midcal* confirms that 'while a state may not confer antitrust immunity on private persons by fiat, it may displace competition with active state supervision if the displacement is both intended by the state and implemented in its specific details.'"[39]

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[34] 16 U.S.C.A. § 2603.

[35] *Alameda Mall, Inc. v. Houston Lighting & Power Co.*, 615 F.2d 343, 350 (5th Cir. 1980) (citations omitted).

[36] *Parker v. Brown*, U.S. 341, 351-52 (1943).

[37] *Supra*, note 24 at 7-13 (citing *Parker*, 317 U.S. at 351).

[38] *Supra*, note 24 (citing *Cal. Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 105 (1980)).

[39] *Supra*, note 24 (citing *FTC v. Ticor Title Ins. Co.*, 504 U.S. 621, 633 (1992)).

Interestingly, the *Midcal* case involved a scheme to fix wholesale wine prices which was held not to be actively supervised by the state because the state did not establish the prices or review their reasonableness.[40] "The Supreme Court has made it clear that the mere presence of some state involvement or monitoring does not suffice to establish active supervision for purposes of the state action doctrine."[41] "Active supervision" requires that the state exert significant control over the terms of the restraint.[42] Where prices are set as an initial matter by private parties, subject only to a veto if the state chooses to exercise it, the party claiming immunity must show that state officials have undertaken the necessary steps to determine the specifics of the price-fixing or rate setting scheme. The mere potential for state supervision is not an adequate substitute for a decision by the state.[43]

In light of this background, it is appropriate to determine whether any antitrust issues arise with respect to market structure or market power in a restructured electricity market in Missouri.

Although not an exhaustive list, some of the following market structure issues have been identified:

(1) Whether a PX is a price fixing mechanism that, absent an exemption, would violate federal antitrust laws;

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[40] *Supra*, note 24 (citing 445 U.S. 97-105-106).

[41] *Supra*, note 24 at 7-18 to 7-19 (discussing *324 Liquor Corp. v. Duffy*, 479 U.S. 335 (1987) (struck down state law permitting liquor wholesalers to set minimum retail prices); *Patrick v. Burget*, 486 U.S. 94 (1988) (struck down hospital peer review process where state had no power to review decisions); *FTC v. Ticor Title Insurance Co.*, 504 U.S. 621 (1992) struck down "negative option" regulatory scheme for setting title insurance changes).

[42] *Supra*, note 24 at 7-19 (citing *Duffy*, 479 U.S. at 345 n. 7.

[43] *Ticor*, 504 U.S. at 638.

(2) Whether a PX with a mandatory monopoly, absent an exemption, would violate federal antitrust laws;

(3) Whether a state legislature may confer antitrust immunity on a PX;

(4) Whether the FERC may confer antitrust immunity on a PX.

The federal antitrust law most relevant to market structure issues is the Sherman Act. The Sherman Act declares illegal, "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations."[44] Further, "[e]very person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a felony . . . ."[45] Section 1 of the Sherman Act declares the following practices illegal, however, this list is not exhaustive:

(1) horizontal price fixing, in which firms at the same level of the market structure agree upon the prices that they will charge customers or suppliers;

(2) vertical price fixing, in which firms at different levels of the market structure fix prices at one or more market levels;

(3) horizontal allocations of territories or customers among actual or potential competitors;

(4) vertical territorial, customer, or other nonprice restraints involving firms at different levels of the market hierarchy;

(5) competitively motivated group boycotts and concerted refusals to deal;

(6) tying agreements, in which the availability of one product or service is conditioned upon purchasing another product or service or upon refraining from purchasing the products or services of the seller's competitors; and

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[44] 15 U.S.C.A. § 1.

[45] 15 U.S.C.A. § 2.

(7) exclusive dealing agreements, in which a supplier agrees to supply only a designated purchaser, or a purchaser agrees to buy exclusively from a particular supplier.[46]

The first four practices have been found to be *per se* illegal by courts.[47] Price fixing is a *per se* violation of section 1 regardless of the machinery employed to achieve the price fixing.[48]

1. Whether a PX is a Price Fixing Mechanism that, Absent an Exemption, Would Violate Federal Antitrust Laws;

(a) Analysis of Proponents of Direct Access Model

With respect to the first issue, it is immediately apparent that a PX of the type contemplated by the poolco market structure model is a horizontal price fixing mechanism that, absent an exemption, would violate federal antitrust laws. The power pool would actually fix the wholesale price of power, called the "market clearing price", and purchasers could only buy power from the pool if they paid the market clearing price set by the pool. Horizontal price fixing has long been held to be a *per se* violation of the Sherman Act.[49] Even indirect price fixing is illegal. In *Socony Oil*, the Supreme Court stated that ". . . a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilizing the price of a commodity in interstate or foreign commerce is illegal *per se*."[50] This means that no proof of an "unreasonable restraint of trade" is necessary where price fixing is present.

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[46] William C. Holmes, *Antitrust Law Handbook*, at 191-93 (Clark Boardman Callaghan (1997)).

[47] *Id.* at 225-26.

[48] *In re Plywood Antitrust Litigation*, 655 F.2d 627 (5th Cir. 1982).

[49] *Supra*, note 46 at 223-26, 244 (citing *U.S. v. Sekani-Vacuum Oil Co.*, 310 U.S. 150 (1940)).

[50] *Id.* at 254.

It is true that a Section 1 violation requires "concerted action" by at least two separate persons or entities as a threshold requirement.[51] In a poolco market structure, the first entity is the supplier and the second entity is the power pool. Each seller's act of selling to the pool where that seller knows that the price will be fixed by the pool at a "market clearing price" is sufficient to meet the "concerted action" requirement. In the *Interstate Circuit* case, sellers' parallel acceptances of unilateral "invitations" to engage in identical pricing behavior met the concerted action requirement.[52] Like the *Interstate Circuit* case, all suppliers bidding into a power pool are accepting the pool's unilateral invitation to engage in identical pricing behavior. The sellers in a poolco model are not paid the price at which they offered to sell, rather, they receive an *identical* market clearing price that is fixed by the pool. Thus, each seller's response to the pool's invitation to engage in identical pricing behavior would satisfy the concerted action requirement.

Because the creation of a power pool would violate Section 1 of the Sherman Act, a poolco market structure could only be implemented if federal antitrust laws were expressly or impliedly repealed. As discussed previously, there is no express repeal of antitrust laws in this area. Thus, only the state action doctrine or an implied repeal by Congress would permit the establishment of a power pool that engages in price fixing activities. These options are discussed below.

In analyzing the market structure issues, it is immediately apparent that a PX of the type contemplated by the poolco market structure model is a horizontal price fixing mechanism. Because price fixing is a *per se* violation of the Sherman Act, this type of market structure could only be

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[51] *Supra*, note 46 at 195 (citations omitted).

[52] *Supra*, note 46 at 214 (citing *Interstate Circuit, Inc. v. U.S.*, 306 U.S. 208 (1939) (acceptance by suppliers of a unilateral invitation to engage in identical pricing behavior held to be conspiratorial action).

implemented if federal antitrust laws were expressly or impliedly repealed. As discussed previously, there is no express repeal of antitrust laws in this area, thus, only the state action doctrine or an implied repeal by Congress will permit the establishment of this type of market structure.

(b) Analysis of Proponents of Poolco and Hybrid Models

A power pool or PX as contemplated by the poolco or hybrid models, would not constitute "horizontal pricing fixing" and would not be a *per se* violation of the Sherman Act. In its *Declaratory Order Concerning Sales of Electricity into the California Power Exchange*, Docket No. EL97-36-000 (September 10, 1997) ("California PX Order"), the FERC approved the creation of the California PX and described its function as follows:

> In this proceeding, we are faced with a new market institution in which sellers and buyers of electric energy will not contract directly with one another, as has been traditionally done in the industry, but instead will contract with the PX. While the PX will not take title to electric energy, and pursuant to the PX Tariff it is not considered a party to a PX trade, it nevertheless will be the intermediary that contracts with the entities that sell into the PX as well as with the wholesale and retail customers that purchase from the PX. Additionally, the PX will be the entity that, pursuant to the PX Tariff and Protocols, will determine which power is bought and sold (dispatched), which power goes to wholesale buyers and which power goes to retail buyers (how aggregate wholesale and retail load is served), [FN16] and at what price the power is sold. This means that the PX is an integral part of the transactional chain and that it takes the combined action of both the participants that bid generation into the PX as well as the PX itself to effectuate the sales to the PX customer participants. In these circumstances, we believe it is reasonable to construe both the bidding participants and the PX to be engaged in sales of electric energy. Accordingly, we conclude that the bidding PX participants will be engaged in sales of electric energy at wholesale to the PX, who will then resell that energy to wholesale and retail customer participants. [FN17] Because the bidding PX participants will be selling electric energy at wholesale as that term is defined in section 201(d) of the FPA, entities that otherwise meet the EWG criteria of section 32 of PUHCA and that bid energy into the PX will maintain their EWG status.

(footnotes omitted)

Rather than illegal "price fixing," the power pool or PX will be facilitating the creation of a competitive marketplace of energy and power. The function of the PX will be to bring willing buyers and sellers together by determining a "market clearing price" for energy.[53] This function is analogous to a stock market or a commodities market that brings together willing buyers and sellers of stocks or commodities. This function is to make a market, but not to engage in prohibited "price fixing." Under the hybrid model, it is also important to note that generators will have a choice of selling to the PX, selling directly to REPs, selling to wholesale markets, becoming a REP and selling to individual customers, or all of the above.

2. Whether a PX with a Mandatory Monopoly, Absent an Exemption, Would Violate Federal Antitrust Laws

(a) Analysis of Proponents of Direct Access Model

The second issue asks whether a PX with a mandatory monopoly, absent an exemption, would violate federal antitrust laws. If all buyers in a relevant market were required by state law to purchase their power requirements only from the PX, then the PX would have a monopoly in the market so restricted. This monopoly restriction could occur in only one state, like Missouri, or it could affect multiple states, like NEPOOL does. Section 2 of the Sherman Act makes it illegal to monopolize or attempt to monopolize trade. As discussed earlier, sanction by state law does not automatically exempt a monopoly PX from federal antitrust laws. Thus, an implied repeal or the state action doctrine must apply if a state grants a mandatory monopoly to a PX.

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[53] For a discussion of the manner in which the "market clearing price" is determined under the poolco and hybrid models, see "Alternative Market Structures for Retail Competition," *supra*, at 34-37 and 47-49.

(b) Analysis of Proponents of Poolco and Hybrid Models

Under the hybrid model, the PX would not impose any mandatory buy-sell arrangements on the market. Participation in the PX would strictly be voluntary. Generators will have the choice of selling to the wholesale markets, selling to REPs, selling to the PX, becoming a REP and selling to individual customers, or all of the above.

Under the poolco model, a single poolco would serve the entire state, and the poolco would take bids to supply the projected power needs of the state from any entity that owns or controls generation. The low bidders would win and would supply the power to the poolco over existing transmission lines. LDUs would buy all of their power from the poolco at the competitive market clearing price established by the bidding system and would distribute that power to all of the customers within their respective service areas. Alternatively, the power under the poolco model could be purchased at the bid price rather than the market clearing price or at some other price determined by the bidding rules. In any event, this market structure is similar to the wholesale market that has existed for several years, and would not violate any antitrust laws.

3. Whether a State Legislature May Confer Antitrust Immunity on a PX

(a) Analysis of Proponents of Direct Access Model

The third issue is whether a state legislature may confer antitrust immunity on a PX. The only way a state legislature may confer antitrust immunity on a private party is if the state action doctrine applies. To meet the first state action requirement, the PX, and thus, the desire to fix wholesale market prices, must be clearly articulated by the state as a policy. Once articulated, to meet the second requirement the state must "actively supervise" the policy. The Fourth Circuit has stated that, "such action must be state action, not individual action masquerading as state action.

A state can neither authorize individuals to perform acts which violate antitrust laws nor declare that such action is lawful."[54]

As discussed in the previous section on jurisdictional issues, a state would not have any jurisdiction over a PX because federal law gives FERC exclusive jurisdiction over wholesale sales. Already FERC has claimed exclusive jurisdiction over power pools because they are engaging in wholesale sales of electricity. Thus, the state action doctrine could not be applied to exempt a PX from federal antitrust laws because the state would not have jurisdiction to "actively supervise" the exchange.

To meet the state action requirement, the PX and thus, the desire to fix market prices, must be clearly articulated by the state as a policy. Once articulated, the state must "actively supervise" the policy. As discussed in the previous section on jurisdictional issues, the state would not have any authority to supervise the PX because FERC has claimed exclusive jurisdiction over power pools engaging in wholesale sales. Thus, the state action doctrine could not be applied to exempt a PX from federal antitrust law.

(b) Analysis of Proponents of Poolco and Hybrid Models

Since there would be no "price fixing" as prohibited by the antitrust laws, there would be no need for an exemption from antitrust laws. In any event, the FERC has indicated that it intends to regulate PXs as Exempt Wholesale Generators ("EWG"). *See* California PX Order.

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[54] *Schenley Industries, Inc. v. N.J. Wine & Spirit Whole. Ass'n*, 272 F.Supp. 872, 882 (citing *Asheville Tobacco Board of directors. of Trade v. FTC*, 263 F.2d at 509).

4. Whether the FERC may confer antitrust immunity on a PX

(a) Analysis of Proponents of Direct Access Model

The next issue is whether Congress has impliedly repealed the antitrust laws to permit the creation of PXs. There is no specific mention in the FPA, Public Utility Holding Company Act ("PUHCA"), PURPA, or other federal laws regarding the creation of PXs. The only reference to power pools in the federal statutes is to the pooling study order in 16 U.S.C.A. § 824a-1. This section orders FERC to (1) "study opportunities for conservation of energy, optimization in the efficiency of use of facilities and resources, and increased reliability, through pooling arrangements," and (2) recommend that electric utilities voluntarily enter into negotiations where these opportunities exist. There is no reference in this section to the creation of PXs to set market prices. In fact, this section specifically states that it contemplates the voluntary coordination of "dispatch," not pricing.

The more appropriate interpretation of this section is that it permits FERC to study and recommend the creation of ISOs to coordinate dispatch. An ISO is an independent entity that engages in operational control of the interconnected transmission grid.[55] The ISO does not own transmission assets, rather, it is an independent manager of transmission assets for the owners of those assets. This is the only way to ensure that owners of monopoly transmission assets provide non-discriminatory open access to transmission facilities at non-discriminatory rates. Some advocates have argued that FERC does not have the authority under current law to order utilities to join ISOs. If this is so, it can then be argued that the FERC has far less authority to approve the creation of PXs.

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[55] *Profiles on Electricity Issues: Independent System Operators*, Electricity Consumers Resource Council, No. 18, March 1997.

In several cases, courts have struck down federal agencies' attempts to approve private parties' conduct which violates federal antitrust laws. In *Consolidated Gas Electric Light & Power Co.*, the Fourth Circuit held that an electric power contract violated anti-trust statutes, even though the Federal Power Commission ("FPC," now "FERC") had approved the contract after a formal rate proceeding.[56] In that case, the court required the FPC to "devise a plan to effectuate the purposes of the Federal Power Act and at the same time conform to the anti-trust statutes."[57] In *Georgia v. Pennsylvania R. Co.*, the U.S. Supreme Court struck down rates approved by the Interstate Commerce Commission because an antitrust violation had affected the rates.[58] The courts in these cases stressed that repeals by implication are not favored and that only a clear repugnancy will cause the antitrust laws to give way to the new statute, and then only to the minimum extent necessary.[59]

Similarly, FERC's jurisdiction based on implied repeal of antitrust laws is likely to be restrictively interpreted. Assuming that PXs are price fixing mechanisms that violate antitrust laws, FERC would be required to use other means that do not violate antitrust laws to effectuate its purposes. The creation of ISOs is sufficient to ensure economic dispatch; FERC need not establish PXs to effectuate that purpose when the result is a violation of antitrust laws. Thus, it does not appear that FERC could confer immunity on a PX whose activities would violate antitrust laws.

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[56] 194 F.2d 89, 99 (4th Cir. 1952).

[57] *Id.* at 99.

[58] *Consolidated*, 194 F.2d at 98-99 (citing 324 U.S. 439). *See also U.S. v. Terminal R. Ass'n of St. Louis*, 224 U.S. 383; *McLean Trucking Co. v. U.S.*, 321 U.S. 67; *U.S. v. South Eastern Underwriters' Ass'n*, 322 U.S. 533; *Southern S.S. Co. v. N.L.R.B.*, 316 U.S. 31; *U.S. Alkali Ass'n v. U.S.*, 325 U.S. 196; *U.S. v. Borden Co.*, 308 U.S. 188.

[59] *Consolidated*, 194 F.2d at 99 (citations omitted). *See also, supra,* notes 27-32 and accompanying text.

(b) Analysis of Proponents of Poolco and Hybrid Models

Since there is no illegal price fixing contemplated under the poolco or hybrid models, there is no need to determine if Congress has repealed the antitrust laws or given FERC jurisdiction to confer antitrust immunity upon pools and PXs. It is also important to point out that power pools have existed for many years (*e.g.*, Northeast Power Pool ("NEPOOL"),[60] and Pennsylvania, New Jersey and Maryland Interconnection ("PJM") without any challenge to their existence on antitrust grounds. In addition, virtually every state that has implemented or is seriously considering implementing electric industry restructuring, has included a power pool or PX as a part of the fundamental structure of the new industry.

MARKET POWER ISSUES[61]

Because electric utilities currently have monopolies in their respective service territories, issues of market power arise. Antitrust laws look to two types of market power: horizontal market power and vertical market power. Horizontal market power exists when a company has a sufficient market share to affect prices. Vertical market power exists when a company owns enough of the raw materials used by its business and other businesses to affect the price of raw materials purchased by competing horizontal suppliers, and thereby affect the price of the finished product. Currently, all mergers of electric utilities undergo review by state commissions, FERC and the FTC to ensure

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[60] NEPOOL was originally organized in 1971 and is a "tight pool," *i.e.*, unlike SPP, MAIN and MAPP, NEPOOL entails the central dispatch of nearly all of the generation and transmission facilities in New England as a single control area.

[61] For a more depth analysis of market power issues, see "Market Power and Other Competitive Issues for Retail Electric Competition," Report of the Market Structure and Market Power Working Group (March 6, 1998).

market power is mitigated. However, in a restructured market, competitive suppliers will want less regulation on their ability to merge horizontally and vertically. Many horizontal and vertical mergers have already taken place recently. If not properly monitored, an unregulated monopoly market could develop. Some companies are attempting to secure their monopoly position in the impending competitive market by leveraging their position as sole supplier to secure long term contracts that will preclude competition for their existing customers for many years.

In light of this background, the following market power issues have been identified, although this list is not exhaustive:

1) Whether the existence of a PX requires more stringent regulation of the association of, merging of, or cooperation of entities selling to or buying from the exchange to mitigate market power;

2) Whether an existing utility's use of its monopoly position to negotiate long term contracts that are intended to be effective after competition is implemented might violate Section 2 of the Sherman Act.

A. Whether the Existence of a PX Requires More Stringent Regulation of the Association of, merging of, or Cooperation of Entities Selling to or Buying from the Exchange to Mitigate Market Power

Will the existence of a PX require more stringent regulation of the association of, merging of, or cooperation of entities selling to or buying from the exchange? There has been much discussion regarding the ease with which utilities with market power could easily "game" PXs to maximize their profits. Mandatory buy-sell arrangements on power pools exacerbate these market power problems even more because purchasers have no choice from whom to buy and may be forced to pay higher prices from a PX if "gaming" occurs. The susceptibility of PXs to bid rigging and manipulation by players with market power and the need for an antitrust exemption by the pool would require regulation of the pool and regulation of entities selling to the pool. Forced divestiture is one option being discussed.[62] For constitutional issues related to divestiture, see preceding section.

To use an analogy, companies publicly traded on stock exchanges are subject to stringent reporting requirements and other regulations. The exchanges themselves are subject to a stringent regulatory scheme. In the case of stock exchanges, the exchange is merely reporting the price of trades that occurred during the day's trading. No buyers or sellers were forced to trade with each other or with the exchange. On the other hand, the poolco market structure would force buyers and sellers to trade with the exchange and would allow the exchange to set the wholesale price for power. This arrangement is far different than existing commodities exchanges or stock exchanges, and may not be permissible under existing federal law as discussed in the previous section.

B. Whether an Existing Utility's Use of its Monopoly Position to Negotiate Long Term Contracts that are Intended to Be Effective After Competition is Implemented Might Violate Section 2 of the Sherman Act

Are those utilities that are using their current monopoly position to negotiate long term contracts that will be effective long after competition in the industry is mandated violating Section 2 of the Sherman Act by attempting to monopolize? The answer to this question depends on the facts and circumstances of each case, but as the *Consolidated Gas* case showed, a regulatory agency's approval cannot make an otherwise illegal contract legal. Exclusive dealings contracts are not *per*

[62] Joel I. Klein, Assistant Attorney General, U.S. Dept. of Justice, *Making the Transition from Regulation to Competition: Thinking About Merger Policy During the Process of Electric Power Restructuring*, Address given at FERC Distinguished Speaker Series, January 21, 1998.

se unlawful, however, attempting to monopolize is unlawful. Utilities that attempt to "lock up" their market with long term contracts prior to the market actually opening up may be engaging in anti-competitive conduct. Public service commission involvement may not be able to immunize such conduct from antitrust laws because immunization requires state action and state action requires a clear articulation of policy and active supervision by the state. It does not appear that the state has articulated a policy that its incumbent utilities should engage in long term contracts on the eve of electricity restructuring, nor has the Missouri PSC actively supervised the execution of these contracts.

In one recent case, the Fifth Circuit upheld a jury verdict of illegal monopolization against Southwestern Bell Telephone Company ("Southwestern Bell").[63] In that case, Southwestern Bell had monopolized a regional "Yellow Pages" market by leveraging its monopoly access to white pages listing information to competitively disadvantage competing yellow page directories.[64] In this case, the market for yellow page directories was open to competition, however, the access to white pages listing information was still a monopoly. Similarly, electric utilities that leverage their current monopoly positions to competitively disadvantage competing suppliers in the impending restructured market may be engaging in a form of illegal monopolization. Their current monopoly may be legal; however, their use of that monopoly to ensure a continued monopoly in a restructured market may be subject to challenge by competing suppliers disadvantaged by their conduct.

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[63] *Supra,* note 46 at 84-88 (citing *Great Western Directories, Inc. v. Southwestern Bell Telephone Co.*, 63 F.3d 1378 (5th Cir. 1995)).

[64] *Id.* at 85.

CONCLUSION

This Report has briefly discussed jurisdictional, constitutional and antitrust issues that may arise from the proposed market structures and mitigation measures that are being discussed by the Market Structure and Market Power working group. As the Commission's Task Force and/or the General Assembly begin to reach consensus on a final market structure and specific mitigation measures to address market power concerns, it may be necessary to provide additional legal analysis or address in more detail the items discussed in this Report.

STRANDED COST REPORT
INTRODUCTION

This Report is not intended to contain or refer to all applicable legal authority and is not intended to express the individual or representative views of any of the Report's authors. Rather, the Report surveys and summarizes pertinent Constitutional and other legal authority and precedent concerning the identification and recovery of stranded costs.

Similarly, this report is directed to analyzing the legal foundation of claims to a right to recover stranded costs by investor owned utilities. For the views of Municipal and Cooperative utilities, the reader is directed to Appendices A and B to the Report of the Stranded Cost Working Group to the Retail Electric Competition Task Force.

The reader should note that parties who appear to agree because they may use similar terminology may actually be diametrically opposed when the underlying definitions for their terms are disclosed. Those seeking to understand the controversy must carefully analyze and identify these differences in terminology while assessing the respective arguments, and before reaching any conclusion on the overall topic. The purpose of this memorandum and report is not to try to advance any particular view of these issues, but rather to alert the reader to the existence of these issues and note the principal arguments that are advanced by proponents and opponents of particular views.

REPORT SUMMARY

Definition of "Stranded Costs"

The Report of the Stranded Cost Working Group has devoted substantial attention to the definition of stranded costs. (See, Report, pp. 3-9). The Legal Committee, for purposes of this report, will defer to the discussion by the Stranded Cost Working Group.

Issues Surrounding Stranded Cost Recovery

As might be expected, questions surrounding stranded cost recovery are "hot" topics that generate great controversy. While recognizing that controversy, this summary will attempt to identify the issues and the major arguments pro and con on the issue.

1. Constitutional Taking And Contract Clause Arguments

About the only thing that proponents and opponents of stranded cost recovery can agree upon is that the 5th Amendment to the United States Constitution prohibits the taking of private property for public purpose without just compensation and that the Contract Clause prohibits the States from impairing the obligations of contracts, including their own. Beyond that statement of rather abstract and unoffending principle, disagreement abounds.

The arguments about Taking and the Contract Clause fall into three general groups. These are:

- Proponents of stranded cost recovery argue that there is a regulatory compact which is protected by the Constitution in that utilities agreed to invest to provide service and to submit to rate of return regulation by the state. Correspondingly, the state agreed to provide an opportunity for the utility to earn a reasonable rate of return on this investment. This compact is protected from state action impairing it.

  Opponents, however, note that contemplated legislative or regulatory action would make generation supply competitive. Indeed, they argue, the entire purpose of regulation was and is to serve as an offset to monopoly power. Thus, when competition can be obtained without regulation, it should be. In that sense, legislative action to restructure the existing electricity market is not a physical taking, but rather a necessary readjustment of economic benefits and burdens. The "regulatory compact" is one of several considerations, but not the only one.

- Proponents of stranded cost recovery argue that the state had agreed to limit market entry to allow regulated utilities a fair opportunity to recover the costs of their investments plus a reasonable return and that <u>investors had relied on those agreements</u> in allowing their private capital to be invested and used for public service.

  Opponents of stranded cost recovery counter-argue that even under traditional regulation, there is no guarantee of recovery or guarantee of profit and often investments that are excessive or determined to be imprudent are disallowed. Moreover, they argue, there is no physical taking, and the assets that would be subject to competition continue to have value, potentially enhanced value, for the use of which rate of return regulation would compensate.

- Proponents of stranded cost recovery argue that a physical taking exists by the state compelling them to <u>make their distribution networks available to competitors</u>.

  Opponents of stranded cost recovery counter that here there is no physical taking, and that no argument has been made that such access should be free. Rather, proposals would continue to subject distribution assets and the value and investment that they represent, to rate of return regulation. Opponents counter that a passenger on a bus purchases transportation on the bus, but the bus itself remains the property of the bus company. They point to over a decade of voluntary access by third parties to transmission and distribution systems, noting that it is competition that is objected to, not access.

Both proponents and opponents cite numerous cases, in some instances the same cases, as supportive of their views.

2. <u>Fairness Arguments</u>

Even concepts of essential fairness are marshalled in support of views on stranded cost recovery issues, pro and con.

- Proponents of stranded cost recovery, while acknowledging that there may not be a right to perpetual maintenance of the present structure, nevertheless stoutly contend that any transition to a new structure must provide for full recoupment of the prudent investments made under the earlier structure, noting that no less good morals and good law require that square corners be turned in all such relationships.

  Opponents of stranded cost recovery counter-argue that again there is no guarantee of recovery and that it is unfair to ratepayers to continue to be charged for plant that they are no longer using and that is not needed to provide them with service. They note that the actual economic impact on the property owner may be small, while the public benefit in lower cost energy supplies for individuals and for employers may be very great. Regulation that does not destroy value, but simply shifts economic benefits and burdens, they argue, is not a taking.

- Proponents of stranded cost recovery point to investor expectations and argue that it would be unfair and unjust to change the "rules of the game" for private or institutional investors.

  Opponents of stranded cost recovery note on the other hand that a simple shift in the benefits and burdens of regulation, while certainly different than expectations, does not result in a taking, where the investor was seeking income rather than an interest in a specific property investment.

3. Confiscation Arguments

An additional line of arguments involves an assertion that property is being confiscated through restructuring, or that at least some portion of its value is being taken. One place that this argument surfaces is in conjunction with higher cost utilities. Both sides of the argument often cite FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944) and Bluefield Water Works & Improvement Co. v. PSC, 262 U.S. 679 (1923).

- Proponents of stranded cost recovery argue that even though a particular utility's costs may be high, unless recovery of those costs is allowed fully, confiscation results. Hope and Bluefield support the proposition that confiscation results unless the utility is provided an opportunity to earn a reasonable return on the value of its property.

Opponents of stranded cost recovery counter-argue that the due process clause protects existing economic values, but not to insure particular values or to restore values that have been lost by operation of economic forces. Hope and Bluefield stand only for the proposition that the overall impact of ratemaking is tested by the reasonableness of the result rather than by all the subsidiary aspects of valuation, nor do these cases require compensation for particular pieces of property.

Conclusion

The respective arguments, together with some case citations believed relevant, are presented in more expanded form on the following pages. Resolution of this controversy at this stage is unlikely, and is, accordingly, left to the reader to assess.

I. DISCUSSION

A. Arguments and Authority Supporting Recovery Of Stranded Costs

Proponents of full recovery of stranded costs note that the United States Constitution guarantees utilities the right to a reasonable opportunity to fully recover the costs it incurred under the current regulatory regime in fulfillment of its obligation to provide universal, non-discriminatory service to all within its franchise area. The Just Compensation Clause of the Fifth Amendment (applicable to the States through the Fourteenth Amendment) and the Contract Clause establish the principle that the State must provide just compensation when it takes private property for public use and prohibits a State from impairing the obligation of contracts, including their own. The property rights exist by virtue of the regulatory compact. The essence of the bargain is that utilities agreed to make the investments necessary to provide universal, non-discriminatory service to all within its territory and to submit to service and rate regulation by the State. The State, in turn, agreed to regulate rates and to control entry into the utility's territory so that the utility has the opportunity to earn a reasonable rate of return on its investments. Evidence of the existence of this contract right may be found in the State's Public Service Commission Act, numerous decisions of the Missouri Supreme Court, decisions of the Missouri Public Service Commission, permitting, even urging, utilities to make substantial investments in generation, transmission, and distribution facilities, and Commission orders and agreements resolving rate proceedings.

Proponents of full recovery have asserted that from an early time, public utility regulation has been recognized as essentially contractual in nature. Even before the enactment of the Public Service Commission Act, the Missouri Supreme Court, in a 1912 case, repeatedly referred to the "contract" that "arose upon acceptance of the terms of [a municipal franchise] ordinance and to "breach" of that contract that occurred when the company failed to deliver the "[s]ervice to the public" called for under the contract. State on Inf. Jones ex rel. City of St. Louis v. Light and Devel. Co., 152 S.W. 67 (Mo. 1912). This view by the courts continued after adoption of the PSC Act. See, Union Electric Company v. Land Clearance Redevel. Auth., 555 S.W.2d 29, 32 (Mo. 1977) (holding that Union Electric, when it "accept[ed] this franchise" from the city of St. Louis, "also accepted this condition as part of the contract").

The basic terms of the regulatory compact were set forth in the Public Service Commission Act of 1913 and remain in force today:

- Public utilities have the duty to provide "the instrumentalities and facilities" needed to provide service that is "safe and adequate" to all of the public on a non-discriminatory basis, V.A.M.S. §393.130;
- Utility rates shall be "just and reasonable," within limits specified in orders of the Commission, Id.;
- Rates shall be calculated "with due regard, among other things, to a reasonable average return on capital actually expended," V.A.M.S. §393.270.
- Utilities may not exercise "any right or privilege" under a municipal franchise without obtaining from the PSC a certificate that the intended service is "necessary or convenient for the public service," nor may they begin construct of new plants without the "permission and approval of the Commission," V.A.M.S. §393.170.

Missouri courts have recognized the importance of the State's agreement to limit market entry in order to allow regulated utilities a fair opportunity to recover the cost of their investments plus a reasonable return. See, State ex rel. McAllister v. Cupples Station Light, Heat & Power Co., 223 S.W. 75, 83 (Mo. 1920)(refusing to oust public utility that had "invested in equipment used in the overhead district about a quarter of a million dollars;...and that [its] service is, so far as this record reveals, satisfactory to the public.... [T]o oust respondent from this district would result in practical confiscation of all, or at least a large part, of this investment."); and Missouri Pub. Serv. Co. v. City of Trenton, 509 S.W.2d 770 (Mo. 1974)("the purpose of regulating utilities is to 'substitute regulated monopoly for destructive competition,' thereby serving the public interest.").

The United States Supreme Court has recognized and enforced the regulatory compact in numerous cases. See, e.g., Russell v. Sebastian, 233 U.S. 195 (1914); Detroit v. Detroit Citizens' Street Ry. Co., 184 U.S. 368 (1902); City of Walla Walla Water Co., 172 U.S. 1 (1898); New Orleans Water-Works Co. v. Rivers, 115 U.S. 674 (1885); The Binghampton Bridge, 70 U.S. (3 Wall.) 51 (1865); see also, Winstar Corp. v. United States, 116 S. Ct. 2432 (1996)(plurality opinion)(citing The Binghampton Bridge, 70 U.S. (3 Wall.) at 78. Likewise, "contract rights are a form of property and as such may be taken for a public purpose provided that just compensation is paid." United States Trust Co. v. New Jersey, 431 U.S. 1, 19 n. 16 (1977). See also, Lynch v. United States, 292 U.S. 571, 579 (1934)("valid contracts are property, whether the obligor be a private individual, a municipality, a state or the United States.").

Even where government representations of promises do not technically rise to the level of contract, they nevertheless may induce private action and investment in reliance on them. When the government has thus induced reasonable, investment-backed expectations that the government will act in some manner, a subsequent change in government policy - no matter how meritorious - that defeats these expectations renders the government liable for just compensation to those who held them. See, e.g., Ruckelshaus v. Monsanto Co., 467 U.S. 986, 1011 (1984); Kaiser Aetna v. United States, 444 U.S. 164, 179 (1979). Thus, even if the regulatory compact did not exist as a matter of law, the same extensive relationship between utilities and Missouri described above also establishes the basis for reasonable, investment-backed expectation, induced by government representations, that they would have a fair opportunity to recover its full economic costs of providing service to the public. Such expectations cannot be infringed without just compensation from the State.

In addition to breaching the regulatory compact and frustrating utilities "reasonable investment-backed expectations," mandatory access required by retail wheeling also constitutes a *per se* taking under Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419 (1982). As the Supreme Court stated in that case, "[w]hen faced with a constitutional challenge to a permanent physical occupation of real property, this Court has invariably found a taking." Id., at 427. Retail wheeling is characterized by mandatory transmission across the incumbent's network, and thus, falls within the Supreme Court's definition of a "permanent physical occupation." A competitor supplying power to an incumbent's customers physically occupies the utility's transmission and distribution facilities. Thus, the utility would be entitled to just compensation for the reduction in value of their overall property, where a partial *per se* taking has occurred. See, e.g., United States v. Grizzard, 219 U.S. 180, 183 (1911)("[w]henever there has been an actual physical taking of part of a distinct tract of land, the compensation to be awarded includes not only the market value of that part of the tract appropriated, but the damages to the remainder resulting from that taking, embracing, of course, injury due to the use to which the part appropriated is to be devoted"). In calculating such damages, courts award the difference between the overall value of the property before and after the taking. See, Id. at 185; United States v. 14.38 Acres of Land, 80 F.3d. 1074, 1077 (5th Cir. 1996). With respect to retail