BEFORE THE STATE OF MISSOURI
PUBLIC SERVICE COMMISSION

In the Matter of the Commissions Consideration of Proposed Rules for Electric Utility Affiliate Transactions, 4 CSR 240.24.015	: : :	Case No. EX-99-442

SUPPLEMENTAL TESTIMONY OF THE EDISON ELECTRIC INSTITUTE

I. Introduction

Edison Electric Institute ("EEI") is the national trade association for the shareholder-owned segment of the electric utility industry. EEI is hereby respectfully submitting this supplemental written testimony today in conjunction with the oral testimony of Dr. Mathew J. Morey, EEI's Director of Economic Policy, in support of EEI's Missouri members. This testimony sets forth several key observations about the pitfalls many other states have faced in implementing rules governing the relationship between utilities and their affiliates in competitive markets. Dr. Morey has actively participated as a witness or by filing written comments in eleven state code of conduct proceedings. In addition, this supplemental testimony highlights the findings of several renowned regulatory and economic experts who have addressed the same questions that the Missouri Commission faces in this proceeding in other industries. EEI has assembled these findings from a series of commissioned monographs on the changing industry structure.

Even before Missouri has decided to allow retail customers the choice of electricity suppliers, the citizens of Missouri are at a turning point. At issue before the Commission are proposed regulations that govern current and future relationships

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between the utility and its affiliates. These rules will determine whether Missouri's electricity consumers enjoy the real benefits of free markets. They will determine whether Missouri's electric ratepayers continue to benefit from real economies that years of business experience have produced. They will determine whether Missouri's citizens will be able to determine easily the identity of the parties with whom they are dealing. They will determine whether Missouri's utility employees have a future in an ever-changing industry.

II. The Rules Need to Ensure Missouri's Citizens Will Benefit From Competitive Markets

By handicapping a utility affiliated entrant in a competitive market, the draft regulations relieve competitors of the utility affiliate from having to improve their products and lower their costs to retain existing customers and win new ones. Frequently these competitors are large corporations based outside of Missouri with bountiful resources, market savvy, and advantages that could offset any advantage a company might have by virtue of affiliation with a utility.

Efficient competitors will not be harmed by having to compete with the economies of scope that vertical integration bestows on the utility's affiliates. By definition, efficient competitors will have offsetting advantages. If a competitor is unable to match the efficiency a utility affiliate brings to the market, it should not seek to serve that market. The people of Missouri are not well served if this Commission protects inefficient businesses in competitive markets.

The Commission must not confuse legitimate competitive advantages that inure to any vertically integrated firm and unfair advantages that emerge from undue preferences and cross-subsidies. EEI articulated the legitimate advantages of vertical integration in our initial and reply comments at 4 and 2, respectively.

Some parties in this proceeding, especially Commission staff, argue that "[r]egulated utilities are not like other multi-product firms," and "[u]tilities are not in a competitive environment." Reply Comments of the Staff of the Missouri Public Service Commission ("Staff Reply Comments") at 31. Staff's analyses state the obvious but miss the implications. Every multi-product firm, regardless of whether it contains a utility, brings its own advantages and disadvantages to the competitive market. Many of these advantages derive from governmental associations, such as favorable tax treatment, subsidized mining concessions or oil drilling leases, lucrative defense contracts, or utility franchises. How these advantages arose is immaterial to Missouri consumers who benefit from lower prices and better services in competitive markets as a result of the economies of scope and scale in incumbent electric suppliers.

Staff's comments fail to reflect this important implication of its analysis. As a result, their recommendations are confusing. While arguing that "Consumers will benefit from a robust competitive market" (Staff Reply Comments at 12), staff advocates regulations that, by sidelining a major potential competitor, would produce competition that is anything but "robust." EEI does not "presume ... that consumers cannot benefit without the participation of the incumbent utility," as staff suggests. Id. Rather, since the threat of entry is a major check in competitive markets, reducing the threat of entry by the utility through handicaps and other restrictions will raise prices in those markets where utility affiliates have a natural and legitimate advantage. Regardless of whether the utility actually enters the market, restrictions on the utility's competitiveness harm customers.

Instead of preventing the utility's competitive market affiliate from using its "tremendous competitive advantage over companies attempting to sell the same goods and services" (Id. at 33), as staff indicates is necessary, the Commission should <u>insist</u> on it, so long as utility ratepayers are unharmed. Since these are competitive markets, customers will reap the benefits that such advantages convey through lower prices and better service. That many of the customers served by the utility will also seek services in competitive markets served by the utility's affiliate is irrelevant. As long as the utility provides utility services with no preference to its affiliate, society will be better off because of the affiliate's ability to put downward pressure on prices while providing a contribution to the fixed costs of the utility.

III. The Markets in Question are Competitive

The markets at issue in this proceeding are for services routinely provided by competitive suppliers. Since Missouri is not restructuring its electric markets at this time, the rules will be governing affiliates providing markedly different services than those provided by the utility. In most cases, the affiliate's market share will be small or zero; in all cases, the utility's share will be zero. Indeed, the utility affiliate will be the entrant, not the incumbent.

The assertion of staff that these restrictions are necessary because of "the fact that the utility is a monopoly that has 100% market share and almost unparalleled name recognition" is irrelevant. Staff Comments at 11. Utilities have monopoly franchises to sell only electricity at retail in certain geographic areas, but Missouri is not implementing competition for electricity. Staff has not explained how <u>a utility</u> monopoly necessarily affects an affiliate's performance <u>in other markets</u>, especially when the affiliate is a new player in mature markets already dominated by well-established firms with strong brand identity. Indeed, some are huge conglomerates. Nor has staff indicated how a franchise in one location affects the market for non-utility goods in other locations. Despite this lack of purpose, staff asserts repeatedly that utilities are "monopolies and have no competitors" (id. at 13), or "one supplier controls the market" (id. at 12), or "the utility is a monopoly that has a 100% percent market share...." Id. at 11. Staff does not – and cannot – assert that affiliates have any of these attributes.

III. Appropriate Transfer Pricing, As Justified In Utility Rate Proceedings, Will Guard Against Cross-Subsidies

While the Commission needs to guard against cross-subsidies, it can put transfer pricing rules in place that permit the sharing of legitimate economies of scope. These rules, when combined with utility informational filings to justify the reasonableness of its actions, provide ample safeguards against cross-subsidies. Moreover, appropriate rules should result in the same transfer price whichever direction the transaction is going.

The price an affiliate pays for nonutility goods and services provided by the utility should be within the subsidy-free zone, which lies between the utility's incremental cost and the stand-alone cost of the affiliate producing the good from scratch. For all practical purposes, this zone will lie between incremental cost and market price, as discussed in EEI's initial and reply comments at 5-12 and 17-21, respectively. With regard to traditional, essential utility services, affiliates should purchase these services on the same tariffed rates, terms and conditions as other utility customers.

For one-time utility purchases from its affiliate, pricing should reflect opportunity costs and transactions costs. It will fall between market price and utility's incremental cost. For longer term transactions, such as for powerplant fuel, the Commission should allow a pricing the reflects the complexity of the transaction and the full opportunity cost.

Several parties fail to recognize the difference between legitimate competitive advantages and illegitimate cross-subsidies. Combining this misunderstanding with its erroneous insistence that the markets in question are not competitive, staff makes recommendations harmful to customers of both utility and competitive markets. In the name guarding against cross-subsidies, staff advocates transfer pricing policies that would effectively cancel the economies of scope inherent in vertical integration. The substantial cost savings that already benefit consumers of both markets would be eliminated.

The harm from staff's policy proscriptions would be felt greatly by utility customers, who benefit from sharing utility fixed and common costs with nonutility affiliates and from purchasing supplies from the affiliate at prices below the utility's costs, as set forth in EEI's initial and reply comments at 2-5 and 3-4, respectively. EEI will not restate these benefits here, but notes that staff only acknowledges that the proposed "rules may increase the costs of transactions with the affiliated entities." Id. at 27. However, staff's unsupported assertion that "[t]he impact of subsidization on rates has the potential to be much greater than the impact of the transaction costs" (id.), is cold comfort to utility ratepayers now forced to pay, in addition to higher transactions, the full costs of utility facilities and equipment which, with the right incentives, could easily be shared with the utility's unregulated, competitive affiliates.

Staff's proposed policy also creates distortions because of the asymmetrical character of the resulting prices. This occurs because there will different prices for transactions of the same good or service, depending on its direction. Namely, transactions will always be priced higher from the utility to the affiliate than they would be in the other direction.

A policy that produces such asymmetries is bound to create inefficiency because an affiliate in a competitive market will never pay a utility more than market price for the good, regardless of the utility's fully distributed costs. Even though the ratepayers of the utility could benefit tremendously from a transaction that recovers less than full costs, the transaction would not occur. In looking at the other direction, the competitive affiliate would never sell a good for less than market, unless there were other offsetting benefits of the transactions not recognized by the blanket pricing policy that is proposed. The proposed policy would discourage mutually beneficial transfers from the affiliate to the utility.

To ensure the utility is acting in a reasonable manner, the Commission can require the submission of cost and other supporting data during ordinary rate cases. Moreover, it can also require routine audits and other evaluations. In addition, the Commission can require the maintenance of accounts to assure adequate cost support for the costs underpinning utility rates.

The Commission's authority to approve and disapprove rates is vast. It has enormously powerful tools at its disposal to ensure pricing of goods and services between an utility and its affiliates is subsidy free and, where appropriate, consistent with market conditions. Staff's oft repeated mantra that utility records do not permit an adequate tracking of costs or that utilities can withhold records (*see e.g.* id., at 28 and 46), is a red herring. The Commission has ample authority to examine books and records to ensure utilities are not subsidizing affiliates with utility rates and need not implement the needlessly burdensome requirements suggested by staff and others.

IV. Other States Have Avoided Asymmetrical Pricing and, Thereby, Benefitted Consumers

In a recent survey conducted for EEI, the accounting firm Deloitte & Touche found that other state regulatory agencies have taken a variety of approaches in their affiliate transfer pricing policies. Moreover, they have not taken a blanket approach that asymmetric pricing is appropriate.

For products and services sold from the non-regulated affiliate to the utility, only 24 out of 40 commissions surveyed (60%) had a policy in place, and most of those were initiating retail choice and open access. Of those, only eight commissions (33%) adopted strictly an asymmetric, "lower of cost or market," standard, which would produce different pricing results if the transaction were to go in the other direction. The remaining states have adopted far more pragmatic, sensible approaches. Seven commissions (29%) decide on a "case by case" basis and have no blanket rules in place. Six commissions (25%) use multiple methods including fully distributed cost, market and incremental cost depending on the transaction. Three commissions (13%) use the "prevailing or fair market price" as the standard.

The surveys finds similar results for products and services transacted in the other direction, that is, from the utility to the non-regulated affiliate. Only 25 out of 40 commissions surveyed (63%) even have a policy. Of those, only ten commissions (40%) adopted the asymmetric, "higher of cost or market" as the standard. The remaining commissions have avoided a blanket approach. six commissions (24%) adopted "case by case" approaches including fully distributed cost, prevailing market and incremental cost depending on the transaction, while five commissions (20%) adopted "multiple methods" using market, fully distributed cost or other methods depending on the transaction. Two commissions (8%) adopted "prevailing or fair market price" as the standard, and two commissions (8%) adopted "fully distributed cost" as the standard.

VI. Conclusion

EEI urges the Commission to revise the proposed draft rules to ensure the consumers of the competitive market and ratepayers of the utility benefit from the utility's economies of scope through lower prices and lower utility rates. The Commission should shun asymmetrical pricing in favor of a more flexible approach that will yield the same price whichever direction the transaction goes and prevent cross-subsidies.

Dated: September 14, 1999

Respectfully submitted,

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