



**EDISON ELECTRIC  
INSTITUTE**

*Via next day delivery*

June 29, 1999

Mr. Dale Hardy Roberts  
Secretary  
Missouri Public Service Commission  
Truman State Office Building  
301 West High Street, Suite 530  
Jefferson City, MO 65101

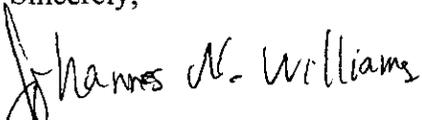
Re: <sup>EX 442</sup>  
Case No. HX-99-443

Dear Mr. Roberts:

Enclosed for filing, please find an original and fourteen copies of the Initial Comments of the Edison Electric Institute.

Thank you for your attention in this matter.

Sincerely,

  
Johannes W. Williams  
Director, Industry Legal Affairs

Enclosures

cc: William Niehoff (w/ encl.)  
Patrick J. Joyce (w/ encl.)  
William G. Riggins (w/ encl.)  
Mathew Morey (w/ encl.)  
Louis Harris (w/ encl.)

**FILED**

JUN 30 1999

Missouri Public  
Service Commission

FILED

JUN 30 1999

BEFORE THE  
MISSOURI PUBLIC SERVICE COMMISSION

In the Matter of the Commission's Consideration :  
of Proposed Rules on Affiliate Transactions, :  
4 CSR 240-20.015 :

Missouri Public  
Service Commission  
Case No. ~~HX-99-443~~  
EX-99-442

INITIAL COMMENTS OF EDISON ELECTRIC INSTITUTE

**I. Introduction**

The Edison Electric Institute ("EEI"), the national trade association of the investor-owned electric utility industry and its domestic and international affiliates, hereby respectfully submits the following comments on the Missouri Public Service Commission's proposed rules on affiliated transactions pursuant to the Notice of Proposed Rules published at 24 Missouri Register 1340 (June 1, 1999). EEI's members generate nearly three quarters percent of all electricity in the United States and serve approximately ninety percent of all end-use customers served by the shareholder-owned segment of the industry. EEI's Missouri members are AmerenUE, UtiliCorp United, Kansas City Power and Light Company, St. Joseph Light and Power Company, and Empire District Electric Company.

EEI has participated in proceedings involving the regulation of intracorporate transactions between a utility's regulated and unregulated businesses before numerous state regulatory agencies, including Missouri. In carrying out this initiative, EEI has assembled a panel of internationally recognized economists who have written extensively about and conducted considerable research into the economics of regulation and restructuring. EEI's initial comments in this proceeding reflect the accumulated and refined thinking of these economists and of the experience EEI has gained in the dozens of cases where the issues that the Commission is addressing in this proceeding have already been debated.

## **II. Background: Because Economies of Scope Benefit Utility Ratepayers, the Commission Should Preserve Them**

Many firms sell more than one product or service because it often costs less to provide several products in one firm than it does to provide each separately in different firms. These multiproduct firms, whether in utility or unregulated businesses, capitalize on these economies of scope to lower the prices of all products they sell. These scope economies occur in a variety of ways. Many reflect savings realized when identical inputs needed to produce different products are purchased in bulk; others result from a reduction in managerial overhead; still others reflect a lower cost of advertising and marketing. Economists Mark Lowry and Lawrence Kaufmann characterize these economies as better utilizing slack resources within the firm.<sup>1</sup>

Lowry and Kaufmann also point out that, in addition to making better use of slack resources, economies of scope can also lower transaction costs to customers.<sup>2</sup> Costs might be lower to the firm and customer satisfaction might be higher if a firm provides maintenance and other services, in addition to the services that it already provides. Also, customers might lower their overall costs and benefit from the convenience of procuring several services from a single provider.

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<sup>1</sup> Lowry, Mark N. and Kaufmann, Lawrence, *The Cost Structure of Power Distribution* (Edison Electric Institute 1999) at 12.

<sup>2</sup> *Id.*, at 13.

Utilities frequently have been multiproduct firms, providing both regulated and unregulated goods and services. The efficiencies of providing multiple services are considerable. For example, a utility can offset the costs of billing by sharing facilities not used during off-peak periods with non-utility businesses. The sharing of assets between utility and non-utility businesses can similarly reduce the cost of office space, maintenance crews, and management. These cost reductions yield lower prices for consumers of regulated and unregulated services.

Multiproduct utilities require special regulatory treatment to ensure that utility customers do not inappropriately subsidize their nonutility affiliates. Cross-subsidization occurs when the unregulated businesses uses corporate assets at prices that are below the cost the utility incurs. Alternatively, cross subsidization results when the utility pays more for the services provided in-house than it would pay to purchase the goods from an unaffiliated provider. Both situations raise the rates that utility ratepayers pay for utility services, requiring regulatory oversight.

Another regulatory consideration of multiproduct firms involves the business relationships between the utility and its affiliate. The Commission needs to ensure the utility does not confer undue preferential treatment in the sale of utility services used to provide unregulated businesses. Without regulatory oversight, this would convey an unfair advantage to the utility in providing these services, at the expense of utility ratepayers and to the detriment of its competitors.

Establishing these rules entails risk. Eminent economists William Baumol, Paul Joskow, and Alfred Kahn characterize one risk as asymmetrical burdens and handicaps, which refers to regulatory requirements that apply only to the utility's competitive affiliate, but not to other

competitors.<sup>3</sup> By imposing costs on only one competitor or by preventing the utility from using legitimate cost advantages in competing to provide non-utility services, these asymmetrical burdens spare the nonaffiliated competitors from having to match or improve upon the affiliate's efficiency. The effect would be to undermine the creative dynamism inherent in competitive markets, in which rivals continuously seek to improve the quality and lower the costs of services to win market share.

Economic theory predicts that regulatory intervention in non-utility markets results in market distortions and inefficiency, and, ultimately, higher prices and inferior service quality. The only beneficiaries of the handicaps are the competitive rivals of the utility. The Commission can avoid imposing asymmetrical obligations by regulating only the utility services that a firm provides and by shunning any intervention or prescription in the non-regulated products and services.

Baumol, Joskow, and Kahn refer to a second risk: sacrificing efficiencies of vertical integration. These economies are a beneficial result of a utility using slack resources to provide non-utility services. Loss of these economies raises the cost of both the regulated utility services and the competitively provided services as well. The Commission can avoid sacrificing economies of scope by preserving the utility's ability to offer non-regulated services. Moreover, the Commission should minimize regulations that would inhibit these non-utility offerings.

Thus, the Commission is faced with a delicate balancing act. In guarding against preferential treatment, rules need to preserve legitimate, efficiency enhancing practices and transactions. In preventing cross-subsidization, pricing of affiliate transactions needs to permit

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<sup>3</sup> Baumol, WJ, Joskow, PL and Kahn, AE, The Challenge for Federal and State Regulators: The Transition from Regulation to Efficient Competition in Electric Power (Edison Electric Institute 1995) at 29-33.

lower costs that reflect *bona-fide* vertical efficiencies. Indeed, the benefits to consumers of both products from economies of scope can be so great, the Commission should actually encourage affiliate transactions. Unfortunately, the Proposed Rule does precisely the opposite.

### **III. The Draft Affiliate Transactions Rules Sacrifice Economies of Scope by Discouraging Affiliate Transactions**

Many transactions in Missouri will involve affiliates of a holding company registered under the Public Utility Holding Company Act ("PUHCA") of 1935. PUHCA requires transactions between affiliates of a registered holding company "at cost." Unless Congress modifies PUHCA, the pricing provisions of the Proposed Rule may not apply to all utility affiliates.

While the Proposed Rule properly preserves the utility's ability to transact with an affiliate in principle, several provisions make doing so impracticably expensive. Since prices will be higher than necessary, the Proposed Rule is contrary to the public interest. Moreover, by prohibiting a utility from providing a "financial advantage" in its provision of non-regulated goods and services, the proposed policy confuses the desirable efficiencies resulting from economies of scope with undesirable cross-subsidies. In the process, the policy would, as if by design, sacrifice all economies of scope inherent in the existing relationship between a utility and its affiliates. Customers of regulated and non-regulated services would suffer, while rival suppliers of the non-regulated services would be spared from having to compete.

In determining the appropriate prices for intracorporate use of utility assets for non-regulated services, the Commission needs to distinguish between the sharing of nonessential, non-utility services and essential, utility services. The following subsection will focus on the former

and subsection III, B will address the use of utility services by non-regulated affiliates.

**A. The Price of Utility Assets Used to Provide Non-utility Services.**

Proposed section 2(A)(2) demonstrates the problem. No competitive company would ever pay higher than market prices for goods and services, even if provided by an affiliated utility. Thus, the proposed requirements that affiliates pay utilities the higher of fully distributed costs ("FDC") or market prices ensures that no intracompany transaction will take place unless the utility's FDC is below market. Since the Proposed Rule effectively establishes market price as a floor for intracorporate use of slack resources, the affiliate will be indifferent to using these slack resources, even though utility ratepayers could benefit substantially by sharing the fixed costs of common facilities with nonutility businesses. If the price recovers the added cost the utility incurs to provide the services, there is no subsidy. Indeed, as described above, there are considerable real benefits to utility customers by applying slack resources to other, revenue-generating businesses.<sup>4</sup>

Incremental cost is the lower bound of what economists term "the range of subsidy free prices."<sup>5</sup> Any revenues that the utility receives for its services above incremental costs reduces the joint and common costs paid by utility customers. Simultaneously, customers of the affiliate benefit from the lower prices resulting from scope economies inherent in a multiproduct firm. While scope economies confer advantages to the utility affiliate, similar economies or, perhaps, entirely different

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<sup>4</sup> See, e.g., Gordon, Kenneth and Augustine, Charles, *Fostering Efficient Competition in the Retail Electric Industry* (Edison Electric Institute August 1998) at 25-26 for a broad discussion of this issue.

<sup>5</sup> See, e.g., Kaufmann, Lawrence; Meitzen, Mark; and Lowry, Mark Newton, *Controlling for Cross-Subsidization in Electric Utility Regulation* (Edison Electric Institute, July 1998), at 5. The upper bound of this range is stand-alone cost, since no competitive purchaser would ever pay more than what it would cost itself to produce the one product produced by a multiproduct firm.

economies, are available to all competitors who are multiproduct firms, regardless of utility affiliation. Thus, there is nothing inherently "unfair" about the utility's non-regulated businesses taking advantage of them. Quite to the contrary, the utility's scope economies establish a benchmark that competitors must exceed if their services are to provide greater value to consumers. If the competitor, either through its own economies of scope, product or service innovations, or lower production costs, cannot match the prices the affiliate can charge, that competitor appropriately will not survive.

The Proposed Rule defines "preferential service" as "information or treatment or actions by the regulated electrical corporation which places the affiliated entity at an unfair advantage over its competitors."<sup>6</sup> With this definition, plus the preclusion of any "financial advantage"<sup>7</sup> a utility offers in providing non-regulated products and services, as discussed above, the Proposed Rule confuses legitimate competitive advantages that accrue to multiproduct firms with the illegitimate advantages that only result from preferential provision of utility services and cross-subsidies. Since the customers of both regulated and non-regulated services benefit from this "Financial advantage," the Proposed Rule harms customers, which clearly is contrary to the public interest.

The only beneficiaries of the Proposed Rule are the utility's rivals in providing the non-regulated services, who will likely attempt in this proceeding to convince the Commission that they cannot succeed without handicapping the utility. Their arguments are all familiar. They will suggest that they are somehow in an "infant industry" that needs special protection if a competitive market

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<sup>6</sup> Proposed Rule, Section 1(F).

<sup>7</sup> *Id.*, Section 2(A).

is to emerge, or that the utility's incumbency somehow creates unfair advantages, or that utility ratepayers who paid for the facilities are entitled to compensation whenever a utility uses these economies of scope in non-utility businesses.

The eminent economist Dr. Alfred E. Kahn debunks these and other propositions in a book that he describes as "a sequel and third volume"<sup>8</sup> to his seminal two-volume work, The Economics of Regulation: Principles and Institutions, first published in 1970-71. Kahn offers a general warning against "the temptation to produce some competitors, even competitors less efficient than the incumbents, by extending to them special preferences or protections and restraining efficient competitive responses by the incumbents."<sup>9</sup> While acknowledging that the infant industry is legitimate in theory, Kahn warns that such protections impose costs that might never be offset by real efficiency gains made by the "infant," who might not really be "struggling, inexperienced newcomer that both requires and deserves some special preference"<sup>10</sup> for it to succeed. Moreover, he argues that infants often devote their entrepreneurial energies to preserving the handicaps, rather than using the handicaps to learn to compete or "grow up."

On the argument about the benefits of incumbency, Kahn notes that being a utility in a non-regulated market imposes costs of its own, and that the utility's competitors bring their own unique efficiencies to the market that are not shared. Moreover, "competitive advantages arising out economies of ... scope are precisely the kind of efficiency advantages that we expect and *want*

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<sup>8</sup> Kahn, Alfred E, *Letting Go: Deregulating the Process of Deregulation* (MSU Public Utilities Papers, 1998), page 1, footnote.

<sup>9</sup> *Id.*, at 16.

<sup>10</sup> *Id.*, at 21.

to prevail under competition."<sup>11</sup> Finally, on the proposition that utility ratepayers need to benefit because they "paid for" the facilities, Kahn notes that regulation is necessary to ensure that non-utility businesses pay the incremental cost of the shared resources to avoid cross-subsidies. When customers pay utility rates, he says, they pay "those costs of the services they received when they received them. The depreciation and profit components of the prices [ratepayers] paid represented reimbursements to the companies of economic costs already incurred in providing services and clearly belong to [the companies] to use as they see fit."<sup>12</sup>

To ensure that economies of scope are preserved and to avoid unnecessary handicaps that benefit competitors to the detriment of customers, the Commission should modify proposed section 2(A)(2) of the Proposed Rule. It should ensure that utilities receive at least incremental cost when using slack utility resources for non-regulated businesses.

**B. The Price Utility Services Used For Non-regulated Businesses**

These comments thusfar has focused on the price a utility affiliate pays for "nonessential" services purchased from the utility. Different policies need to apply to the intracorporate supply of utility services to a non-regulated business.

Distinguished economists Karl McDermott, Ken Gordon, William Taylor, and Agustin Ros identify four basic conditions of all essential facilities. These are:

- The input is controlled by a monopolist;

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<sup>11</sup> *Id.*, at 24 (emphasis in original).

<sup>12</sup> *Id.*, at 83.

- The input is essential to the sustainability of competition;
- The input is neither available from another source nor capable of being duplicated;
- The input can be feasibly (practically) shared by the monopolist.<sup>13</sup>

Clearly, the provision of retail electricity services or wholesale transmission access would fall into the category of an essential service because it meets all for tests suggested by McDermott, Gordon, Taylor, and Ros.

By contrast, “nonessential” services are not controlled by a monopolist, are not necessary for competitive businesses to succeed, are readily available in competitive markets or can be produced by any firm in-house. Nonessential services include office space, personnel, and billing facilities. These services should not be subject to utility regulation.

For access to and use of essential services, the non-regulated businesses should pay the same regulated rates as their competitors. Allowing an unregulated business within the utility to purchase utility services at lower rates that are not available to other competitors would be an unfair preference and might constitute a subsidy.

The proposed requirements in section 2(A)(2) do not distinguish between the acquisition of utility and nonutility’s services. The Commission should establish a different rule that requires the utility’s non-utility business to pay the same regulated rates for the utility’s services as any other business. The higher of FDC or market is inappropriate for the purchase of essential utility services, as it is for non-essential services, as discussed above at 6-7.

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<sup>13</sup> McDermott, Karl; Gordon, Kenneth; Taylor, William E; Ros, Agustin J; *Compelling Access to Electric Utilities’ Resources and Facilities: An Economic Appraisal of Essential Facilities* (Edison Electric Institute, 1999), at 13-22.

### **C. Purchases by A Utility from Its Non-regulated Businesses**

Regarding the pricing of goods and services provided by a non-regulated business to its affiliated utility, the Proposed Rule, while better at achieving fairness and efficiency than that proposed for transactions in the other direction, needs modification. Proposed section 2(A)(1) requires that compensation be the lesser of market price or the utility's FDC. This is little different from the standard typically used in the traditional regulatory review of costs any utility seeks to recover from customers, irrespective of whether the provider is affiliated with the utility. This result would also prevail under PUHCA. "At cost" equals market prices when the utility purchases a good from competitive suppliers. The utility's own cost would set the standard in cases where there are no transparent market prices. The Commission should modify proposed section 2(A)(1) to specify a range between the utility's increment costs and the market price.

While the pricing rule with minor modification is reasonable, the evidentiary standards in proposed section 3 are onerous and unnecessary. When the transaction involves the utility sharing the non-regulated business's resources, requiring the utility to solicit bids adds many costs with little benefit. As discussed above, customers of both the utility and its non-utility businesses enjoy tremendous benefits when they make better use of slack resources. Since the utility needs regulatory approval before passing on all costs to ratepayers, the Commission will have an opportunity to ensure the utility is adhering to the pricing standard of section 2(A)(1). It should be indifferent as to who provides the goods or services to the utility.

The danger in the proposed standards in section 3 arises from the transactions costs they

impose, which might offset any gains from economies. Consider the sharing of office space. No efficient multiproduct firm would undertake a competitive solicitation to procure office space when it already possesses empty offices, nor would the firm have to justify not engaging in a solicitation, as the Proposed Rule would require. Such a solicitation or, alternatively, justification for not having a solicitation, would be a waste of time and resources for all involved B the utility, the responders to the solicitation, and the Commission.

As with office space, many of the resources likely to be shared fall into the category of corporate overhead, such as computer equipment, personnel, and management. These could be amply and cheaply supplied by the utility to its non-regulated business. If they could not, the utility will have to procure them from the outside. Regardless of the circumstances, Commission has nothing to gain from micromanaging the procurement process.

Here, as above, these needless regulations raise prices customers pay for utility and non-utility services. The only beneficiaries will be the affiliate=s inefficient competitors, who need these arbitrary handicaps in order to be competitive. The Commission should delete proposed section 3 in its entirety.

#### **IV. Conclusion**

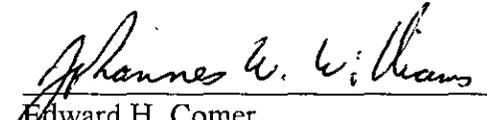
To summarize, the appropriate pricing for affiliate transactions are:

- Incremental cost floor for the use of utility property for a non-utility business.
- A range between incremental cost and market price for the purchase of non-utility goods by the utility.
- Regulated utility rates, which may be based on fully distributed costs for access to and use of essential utility goods.

If the Commission implements this as a policy, it will have no need to adopt section 9 as there will be no "variances" in need of special treatment.

Date: June 29, 1999

Respectfully submitted,

  
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