STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

THE PEOPLE OF COOK COUNTY	**)**	
THE CITY OF CHICAGO	**)**	
THE STATE OF ILLINOIS	**)**	
THE CITIZENS UTILITY BOARD	**)**	
THE ENVIRONMENTAL LAW &	**)**	
POLICY CENTER OF THE MIDWEST	**)**	
	)	**98-0013**
Petition for Rulemaking on Non-Discrimination in	**)**	
Affiliate Transactions for Electric Utilities	**)**	
	)	**(Cons.)**
	)	
ILLINOIS COMMERCE COMMISSION	**)**	
On Its Own Motion	**)**	
	)	**98-0035**
Implementation of Section 16-121 of the Public	**)**	
Utilities Act	**)**	

DIRECT TESTIMONY OF SCOTT HEMPLING

on behalf of

THE CONSUMER AND GOVERNMENTAL INTEREST PARTIES:

CITIZENS UTILITY BOARD
CITY OF CHICAGO
THE PEOPLE OF COOK COUNTY
ATTORNEY GENERAL OF THE STATE OF ILLINOIS

February 20, 1998

DIRECT TESTIMONY OF
SCOTT HEMPLING

Q1. Please state your name and business address.

A.1 Scott Hempling, Attorney at Law, 417 St. Lawrence Dr., Silver Spring MD 20901.

Q2. Please state your educational background and professional qualifications.

A.2 I received a B.A. cum laude in Economics and Political Science from Yale College. I received a J.D. magna cum laude from Georgetown University Law Center. I am a member of the Bars of the District of Columbia and Maryland.

I provide legal and policy advice and representation to clients in the electric industry. In particular, I have advised the state commissions of Arkansas, Arizona, Connecticut, District of Columbia, Kansas, Massachusetts, Michigan, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island and Virginia; the consumer counsels of Connecticut, Nevada, Pennsylvania and Texas; municipal systems in Connecticut and Iowa; the National Independent Energy Producers; and public interest organizations. I have published articles in The Electricity Journal and Public Utilities Fortnightly.

I have testified before committees of the United States Congress on 10 occasions, and before committees of the state legislatures of California, Maryland, Minnesota, Nevada, North Carolina and Vermont. I am a frequent lecturer at professional conferences and training sessions, including sessions sponsored by the U.S. Department of Energy and the National Association of Regulatory Utility Commissioners.

More detail on my professional background appears in Ex. ___ (SH-1).

Q3. On whose behalf are you testifying?

A.3 The Consumer and Governmental Interest Parties, consisting of the Citizens Utility Board, the People of Cook County, the Attorney General of the State of Illinois and the City of Chicago.

Q.4 What is the purpose of your testimony?

A.4 I offer principles for the Commission to follow in meeting its legislative obligation to design regulations relating to interaffiliate transactions involving the incumbent utility. I conclude that the regulations proposed by the Consumer and Governmental Interest Parties (attached as Ex. ___ (SH-2)) are consistent with these principles.

My testimony has three main parts:

Part I explains that the continuing presence of a utility monopoly poses challenges to the goals of effective competition and protection against cross-subsidization.

Part II explains that interaffiliate transaction rules are necessary to address the problem of preferential utility access to resources, where the value of those resources is attributable in part to the utility's historic government protection from competition and its role as sole supplier of certain services. Part II also covers the principles that should be applied in designing these rules.

Part III addresses the Commission's changing role, from a steward of a monopoly market to a promoter and protector of effective competition in electric services markets.

Part I
The Continuing Presence of a Utility Monopoly Poses Challenges to the Goal of Effective Competition

Q.5 In designing rules concerning interaffiliate transactions, what should be the Commission's chief goals?

A.5 The regulations should be consistent with the key objectives of the Legislature, including "promot[ing] the development of an effectively competitive electricity market," 220 ILCS 5/16-101A(d); and "... ensuring nondiscrimination in services provided to the utility's affiliates and any alternative retail electric supplier including, without limitation, cost allocation, cross-subsidization and information sharing." Id. at 16-121.

Concerns about effective competition and consumer protection can and should be addressed together. As one commission stated, when addressing this issue:

> The consumer interests we seek to protect go hand in hand with promoting competition. For example, we wish to prevent cross-subsidization, so that a utility's customers will not subsidize the affiliate's operation. This is especially important in our transition to a competitive market, since such leveraging, together with a utility's market power, could inefficiently skew the market to the detriment of other potential entrants. As product promotion and advertising become more intense, we also believe it important to craft rules which prevent consumer confusion, such as the representation or implication that the affiliate assumes all the attributes of the Commission-regulated utility, merely because of its corporate connection. We also recognize that customer-specific information can become quite valuable to businesses in a competitive environment, and we wish to protect the utility's release of customer-specific information, except where the customer has consented in writing to the disclosure.

Standards of Conduct Governing Relationships Between Utilities and Their Affiliates, Decision No. 97-12-088, 1997 Cal. PUC LEXIS 1139 at *20-21 (Dec. 16, 1997) (hereinafter "California Standards").

Q.6 Is the task of implementing effective competition complicated by the participation in the market of monopoly utilities?

A.6 Yes. A market in which a major participant is a company which the government historically has protected from competition, and on whom the public has relied as the sole supplier of certain services, and which is permitted to use benefits gained from that status to its competitive advantage, is not a market which automatically can be characterized as having effective competition.

Q.7 What do you mean by "effective competition"?

A.7 By "effective competition," I mean a market structure and process having the following features:

1. No single firm, or group of firms acting in concert, large enough relative to the size of the relevant product and geographic markets to be able to sustain a price above competitive levels, or withhold supply below competitive levels, for more than a short period.

2. Nondiscriminatory access to essential facilities, and to information necessary to compete effectively.

3. Easy of market entry; i.e., low entry barriers.

The 1997 electric competition statute enacted by the Nevada Legislature provides useful guidance:

> Sec. 32: "Effective competition" means, with respect to a particular service, a market structure and a process under which an individual seller is not able to influence significantly the price of the service as a result of:
>
> 1. The number of sellers of the service;
>
> 2. The size of each seller's share of the market;
>
> 3. The ability of the sellers to enter or exit the market; and
>
> 4. The price and availability of comparable substitutes for the service.

Q.8 Why does the utility's history of government protection from competition affect the potential for effective competition to develop?

A.8 The direct result of this history is that the utility has resources which many of its new competitors do not have. The incumbent utility has had, for decades, exclusive responsibility for determining and meeting customer needs within its service territory. This experience gives the utility certain resources which its competitors lack. A short list includes:

1. a brand name associated in the public's mind with long-term, reliable service and with government approval;
2. a monthly bill, providing an opportunity to communicate with customers and thereby build and cement loyalty;
3. skilled, loyal employees trained with funds whose recovery was largely assured by the government;
4. intimate knowledge of the service territory, including load patterns, weather, and available sites for generation, transmission and distribution facilities;
5. information on the consumption patterns of each household and each commercial and industrial customer;
6. economic, professional, social and political relationships with important components of the local economy, such as banks, major manufacturers, and local and state government officials;
7. working relationships with surrounding utilities; and
8. a corporate support infrastructure built with funds whose recovery is largely assured by the government.

It is natural for a utility to want to preserve these advantages, and to use them in its new competitive ventures. In an effectively competitive market, where all competitors have access to comparable resources and options, actions by a competitor to preserve and exploit its advantages can be harmless, and in fact can promote effective competition by inducing other competitors to increase their efficiencies. In a market which begins as a monopoly market, however, and in which the incumbent has a set of resources not initially available to its competitors, the behavior can result in entry barriers.

One court has defined an entry barrier as "(a)ny market condition that makes entry more costly or time-consuming and thus reduces the effectiveness of potential competition as a constraint on the pricing behavior of the dominant firm." Southern Pacific Communications Co. v. American Tel. & Tel. Co., 740 F. 2d 980, 1001 (D.C. Cir. 1984). Where barriers to entry exist, thus, a dominant company may raise prices above competitive levels without the risk that new competitors will enter the market, offer lower prices and erode the dominant company's market share. In contrast, where effective competition exists, price increases above competitive levels will attract new competitors, who will exert downward pressure on prices.

Q.9 Do the incumbent utilities' advantages require Commission action?

A.9 Because of the possibility of entry barriers, the Commission must be sure that where there are resources available to the utility, which resources are attributable to its historic government protection from competition, and which are difficult to replicate during the period when competition is immature, the utility is not in a position to gain a competitive advantage from these resources. In the next section, I discuss principles for interaffiliate transactions which can achieve this end.

Part II
Interaffiliate Transaction Rules Are Necessary to Address the Problem of Preferential Utility Access to Resources Whose Value Is Attributable to Government Protection from Competition

Q.10 What subject will you address in this Part of your testimony?

A.10 I will explain that interaffiliate transaction rules are necessary to address the problem of preferential utility access to resources whose value is attributable to government protection from competition. I also will describe principles which should apply to such rules. This Part covers four topics:

A. Interaffiliate Pricing Issues

B. Non-Price Issues

C. Distribution Monopoly as Retail Competitor in Its Service Territory

D. Enforcement Issues

This testimony assumes, <u>arguendo</u>, that the Commission will be permitting the types of affiliate relationships that cause regulatory concern.

A. Interaffiliate Pricing Issues

Q.11 In addressing interaffiliate pricing issues, what topics will you cover?

A.11 I will cover three topics:

1. Transfers from the Utility to the Competitive Affiliates

2. Transfers from the Competitive Affiliate to the Utility

3. The Connection Between Interaffiliate Pricing Rules and Establishment of Revenue Requirements

1. Transfers from the Utility to the Competitive Affiliates

Q.12 What principles should apply to transfers from the utility to its competitive affiliates?

A.12 The principles should ensure that the affiliate of a utility has no advantage attributable to the utility's history of government protection from competition. When a traditional utility seeks to enter competitive markets, it is possible for it to make use of resources whose cost has been recovered from ratepayers who were legally bound to pay those costs due to previous government-imposed limits on competition. To allow the utility to exploit those resources without fully compensating ratepayers for this use would create a mismatch of risk and reward.

The California Commission found, 10 years ago, that affiliates of Southern California Edison attributed their success in part to "having Edison as a financially strong and highly reputable parent with excellent organizational resources." These

> affiliates have easy access to Edison's management employees and their expertise. ... The affiliates do not have to maintain expensive staffs of experts, office space, and associated support functions. With Edison as a backup, they can expand and contract their operations without worrying about excess or insufficient resources.

1988 Cal. PUC LEXIS 2, 20; 90 P.U.R.4th 45; 27 CPUC2d 347.

Before addressing pricing issues directly, it is necessary to establish the universe of services to which these rules should apply. There are three main questions to address: (1) Are there some resources which the utility should be barred from sharing with its affiliate? (2) Are there some resources which the utility should be allowed to share with its affiliate, but only if it shares the resources with non-affiliates? (3) For those resources which the utility is allowed to share with its affiliate, but only if it shares the resources with the nonaffiliate, what should the pricing rule be? I will address each in turn.

Q.13 Are there some resources which the utility should be barred from sharing with its affiliate?

A.13 There is one: the corporate name, where the name is associated in the public's mind with a government-approved, sole supplier of certain services. I address this point in Part II.B.1 below.

Q.14 Are there some resources which the utility should be allowed to share with its affiliate, but only if it shares the resources with non-affiliates?

A.14 Yes. I would include in this category resources that are not economically duplicable by the nonaffiliate competitors quickly enough to prevent the utility's affiliate from realizing a competitive advantage by virtue of its affiliation with the utility, where the utility has such resources due to its history as the government-approved, sole supplier of certain services. The determination of which resources fit into this category will depend on specific facts related to the resource and market at issue.

Q.15 For those resources which the utility is allowed to share with its affiliate, but only if it shares the resources with non-affiliates, what should the pricing rule be?

A.15 Under these circumstances, compensation to the utility must reflect the market price for the resource. This principle achieves the goal of arm's-length relations by placing the utility's competitive affiliate, and the competing nonaffiliates, in a similar position.

Q.16 Please compare your market price requirement with other possible standards.

A.16 Two other possible standards come to mind: incremental cost and fully-allocated book cost. In the context of a resource which is not economically duplicable quickly enough to prevent the utility's competitive affiliate from having a competitive advantage attributable to the utility's historic protected status, incremental cost is defective because it gives the affiliate an advantage denied to nonaffiliates: access to resources which were financed under low-risk circumstances in which most costs were assured recovery. <u>See</u>, <u>e.g.</u>, 220

ILCS 5/16-101A(a) (noting that the "electric utility system in ... Illinois has historically been subject to ... regulation ... aimed at ... assuring the utility system of a return on its investment").

Some defend incremental cost on grounds of economic efficiency: since the price does not fall below incremental cost, the argument goes, it does not result in overconsumption of the good or service, and protects the monopoly ratepayers from paying more than they would have in the absence of the affiliate's existence (assuming the utility has not previously acquired resources in excess of the quantity necessary to serve its monopoly ratepayers, and now is transferring the excess to its affiliate). But incremental pricing fails the other key criterion established by the Legislature: effective competition. Unless the nonreplicable resource is made available to nonaffiliates at the same incremental price, this approach grants one competitor access to important infrastructure services on terms not available to competitors. This difference in access terms would be attributable not to the incumbent's skill but to its history of government protection. (To the extent the costs of the infrastructure have been borne by shareholders rather than ratepayers, if for example the costs had been denied rate base treatment, then this rule should not apply and the incremental cost approach would not raise regulatory concern.)

The other alternative is fully allocated book cost. Fully allocated book cost, like incremental cost, will prevent cross subsidies in the narrow sense that use by the affiliate will not raise costs for the customers of the utility monopoly. Moreover, fully allocated book cost can eliminate some of the utility's advantage because at least some of its competitors will have access to their own existing infrastructure at fully allocated book cost. But the advantage is not eliminated completely. To the extent the utility incumbent incurred its book costs under a regime in which it was protected from competition, and in which its costs enjoy the relative certainty of recovery associated with government regulation, the utility retains an advantage, in terms of access to these resources, not available to those of its competitors who did not enjoy similar histories of government protection.

Moreover, neither incremental cost nor fully allocated cost is consistent with the utility's obligation to extract full value from all assets, and to pass that value on to the ratepayers, where the ratepayers historically have been required to pay for book costs which exceed market value. The utility, by charging the affiliate a sum (whether incremental cost or fully allocated book cost) lower than it would charge a nonaffiliate (fair market value), has obtained less for its ratepayers than it could had it dealt with a nonaffiliate. The utility has a duty to minimize costs. The converse of cost minimization is revenue maximization. A utility with surplus capacity has a duty to obtain maximum value for it.

Some argue that the cost allocation approach is common in unregulated industries. This argument confuses the differing roles of cost allocation in the regulated and unregulated contexts. In unregulated industries, businesses use cost allocation to assess the productivity of cost centers or profit centers. This assessment is impossible unless there is a home for every cost. Cost allocation determines the location of those homes. Cost allocation does not set prices; the market sets prices. In regulated industries, cost allocation serves a very different purpose: it sets prices for the regulated service. Regulators allocate costs to different products or customers to establish the prices for those products or customers.

Q.17 Please summarize your position on the pricing of transfers from the monopoly utility to the competitive affiliate.

A.17 Fair market value best balances all objectives: economic efficiency, avoidance of cross subsidy, promotion of effective competition and minimization of revenue requirement imposed on utility customers. This approach aids the implementation of effective competition by ensuring that the incumbent utility's affiliate does not receive a discount, relative to market price, which is unavailable to the nonaffiliates. Furthermore, it carries out the utility's obligation to minimize ratepayer cost.

Q.18 Is there a relationship between the higher-of-market-or-book rule and the treatment of stranded investment?

A.18 Yes. The higher-of-market-or-book rule is particularly important where ratepayers are required to bear past costs where these costs are below market value. To assign ratepayers the risk that costs will exceed market value, but deny them the benefits where market value exceeds costs, would be asymmetrical.

Q.19 Some utilities argue that affiliates of vertically integrated utilities from other states will be able to use their economies of scale and scope successfully in Illinois; therefore, affiliates of Illinois utilities should have the same opportunity. (<u>See</u> MidAmerican Letter of Jan. 2, 1998 at 2). What is your response?

A.19 This argument makes three errors. <u>First</u>, it makes the wrong comparison: Illinois vertically integrated utilities to other vertically integrated utilities. The proper comparison is among all companies coming to Illinois to compete. Many of these companies will not have a vertically integrated affiliate. For an Illinois competitive affiliate to insist on preferential access to its monopoly affiliate's resources on the grounds that similar access is available to its vertically integrated competitors from other states is to omit from the comparison a most significant sector: the newcomers that competition is intended to attract to Illinois. Implicit in such reasoning is the view that one should be satisfied with a market in which entities not affiliated with vertically integrated utilities face entry barriers attributable to historic government protection of their competitors' affiliates. I do not share this view.

Second, the argument assumes that if we do make the judgment that economies of scale and scope should be preserved, these economies should be available to the incumbent only. MidAmerican impliedly takes the position that these economies of scope and scale are MidAmerican's to exploit. MidAmerican thus asserts not only that preserving economies of scope and scale will serve the public interest, but that the public interest is served best if the economies are awarded to MidAmerian alone. While the first part of this proposition has obvious merit, the second part is unsupported. There is no principle pointing to MidAmerican, or any other incumbent, as the necessary beneficiary of economies made possible by a history of government protection. If government decisionmakers choose to preserve certain economies of scope and scale by permitting the owner of the distribution monopoly to share its infrastructure with its affiliates, the decisionmakers still could authorize a competition for the privilege of being the entity who has access to these advantages. Perhaps MidAmerican would be the winning bidder, perhaps someone else would. But to treat MidAmerican as entitled to the economies merely because MidAmerican controlled them (due to past government decisions) at the time these economies became competitively valuable does not have a factual basis.

Third, the state commission can address MidAmerican's concern about fairness by applying the fair market price requirement not only to Illinois' vertically integrated utilities, but to all vertically integrated utilities. Certainly the Commission cannot set the rules for the treatment of utilities in other states. But the Commission can set the rules for competition within this state. The Commission can state that no entity may sell at retail in Illinois if it is receiving inappropriate benefits from its affiliation with another vertically integrated utility, wherever located.

In summary, there is no perfect solution that satisfies all stakeholders. In choosing among the imperfect solutions, however, the Commission should emphasize the goals of effective competition and protection against cross subsidies, over the goals of particular utilities to advance themselves relative to their competitors.

To summarize: Embedded in MidAmerican's plea is an important concession: access to economies of scale and scope made possible by a competitive company's affiliation with the distribution monopoly has competitive value. If the Commission intends to implement effective competition, and that value is not readily replicable by the new competitors, the Commission should make the value available all on nondiscriminatory terms, or to no one. MidAmerican's proposal fails this test.

2. Transfers from the Competitive Affiliate to the Utility

Q.20 What principles should apply to transfers to the utility from its competitive affiliates?

A.20 When services are provided by the affiliate to the monopoly, they should be priced at the lower of fully allocated cost or market. This rule ensures that the nonutility affiliate does not provide goods or services to the utility at a price exceeding the cost the utility would have incurred had the utility purchased the good or service prudently from a third party or provided it in-house. If the affiliate can produce the good or service below market price, so can the utility. Without this rule, the affiliate would perform for a profit services which the utility is obligated, under its franchise, to perform at cost. The utility would be using corporate form to increase the shareholder return inappropriately.

3. The Connection Between Interaffiliate Pricing Rules and Establishment of Revenue Requirements

Q.21 Will the establishment of interaffiliate prices necessarily result in an appropriate allocation of risk and reward?

A.21 No. The purpose of interaffiliate pricing rules is to ensure that costs and risks are assigned appropriately between shareholders and ratepayers. Merely establishing interaffiliate pricing rules does not achieve this result, because absent appropriate adjustment to utility revenue requirements, the pricing rule alone does not ensure that the payments made by the nonutility affiliate are received by ratepayers. An additional step is necessary.

One approach is for the Commission, in establishing the base rates for the distribution utility, to make projections as to the volume of interaffiliate transactions and their prices, reflect the resulting revenues in the distribution utility's revenue requirement, and set rates accordingly. This approach is unsatisfactory because projections of the volume of interaffiliate transactions, and the market price that would prevail for the good or service transferred in the transaction, are likely to be speculative. Moreover, in the rate cases the utility will have an incentive to under-project its sales to the nonutility affiliate (so as to minimize the resulting reduction to its revenue requirement); conversely, between rate cases (which is to say, all the time, since the utility is always between rate cases), the utility will have an incentive to allow the affiliate to make maximum use of utility resources (because any incremental revenues between rate cases will not reduce the existing revenue requirement).

A better approach, therefore, would be to create a special account to reflect these transactions, and flow the revenues from the account to ratepayers periodically.

B. Non-Price Issues

Q.22 Will interaffiliate pricing rules, by themselves, remove advantages derived by the utility incumbent from its history of government protection from competition?

A.22 It seems unlikely. A number of advantages not readily addressed through interaffiliate pricing rules remain. I discuss those next.

1. Corporate Name

Q.23 Does the utility's corporate name give its affiliate a competitive advantage?

A.23 The corporate name of the distribution company will have considerable value in the emerging marketplace. A name used during the period of government protection is a name which the public may associate with government endorsement. This advantage is not replicable by any other competitor.

Other vertically integrated utilities are using their monopoly brand names in an attempt to gain a competitive advantage. For example, Kansas City Power & Light established a marketing partnership with Westar, a Western Resources subsidiary providing security services. In evaluating their marketing prospects, the vice president for marketing stated that

> The question is: How far does the equity in our brand reach? If you think in media terms of Area of Dominant Influence, that is what we're looking at. We look at the 13-county area, but we find that our brand does have more reach than that[.]

"Kansas City PL, Westar Security Ink Marketing Deal for Customers," <u>Energy Services and Telecom Report</u> (July 3, 1997).

Q.24 Why might this competitive advantage conflict with the goal of effective competition?

A.24 In the context of a traditional utility, at least part of the value of the corporate name is attributable to the history of government protection from competition, ratepayers' government-established payments, or both. For example, certain highly visible manifestations of the utility presence, such as sign and uniforms, are funded by ratepayers. Economic development efforts, in which the company's employees work directly with other local businesses to retain existing firms or attract new ones, resulting in loyalty to the utility, often are directed or approved by regulators and funded by ratepayers. Seasonal public service announcements, educating customers on how to save energy or reduce their bills, build customer loyalty and are often funded by ratepayer dollars.

To some extent, the value of the corporate name may be attributable to the quality of the company's past service. One might argue that such quality is a product of management skill and shareholder risk, not government protection or ratepayer dollars, and therefore should remain available to the company. The fact that a company has a history of excellent service does not mean that full credit for that service lies with the shareholders. Excellent service is in part attributable to the dollars spent. The more dollars, the more frequent the maintenance, the more numerous the employees, the better compensated those employees, the higher their quality. A company subject to monopoly regulation has a higher assurance that the costs it incurs in these efforts will be recovered than a company subject to competition; and therefore will be more likely to incur them. Thus even excellence in service is not attributable only to management decisions and shareholder risk, but is attributable at least in part to the history of government protection.

Q.25 What are some solutions?

A.25 Where the utility's competitive affiliate is permitted to sell within the monopoly distribution company's service territory, the solution most likely to prevent undue competitive advantage is to prohibit the affiliate from using the corporate name or in any way associating itself with the distribution affiliate. This prohibition would apply to joint advertising and any claim that the affiliate is better because of its connection with the monopoly supplier. This approach places the utility incumbent on the same competitive footing as its new competitors, in terms of name recognition with the public.

Where a utility's competitive affiliate is permitted to sell in other service territories, but not in the monopoly distribution company's territory, the corporate name still can have value. In this situation it is appropriate to require the affiliate to pay a royalty to the monopoly distribution company, which then should pass the payment on to the ratepayers. In this way the ratepayers are compensated for the value of their contribution. It is particularly important to pass on to ratepayers this example of a value exceeding book cost, where ratepayers have to pay for investment whose market value is below book cost.

The calculation of the royalty is not a simple matter. It would be a fact-based determination in which the Commission would allocate the value of the name between ratepayers and shareholders by weighing the individual influences of ratepayer contribution, government protection and managerial skill.

I have noted that payment of a royalty for use of the corporate name would be appropriate where the utility's competitive affiliate is using the name outside the monopoly service territory. The royalty approach is not a complete solution, however, where the competitive affiliate is selling within the distribution monopoly's service territory. Although the royalty payment can compensate the historic ratepayers for their contributions, it does not solve the competitive problem. It leaves in place an advantage for the incumbent that is not replicable by new competitors: an opportunity to show affiliation with the provider that enjoyed exclusive government approval for decades.

Q.26 Are there are any other reasons to prohibit the competitive affiliate from using the utility's corporate name?

A.26 Yes: prevention of deception. If the other principles set forth in this testimony are adopted, the competitive affiliate will have few benefits attributable to its affiliation with the monopoly. To advertise itself as being affiliated with the government-appointed distribution monopoly is to imply otherwise, and to invite customers to make purchase decisions based on that implication.

2. The Monthly Bill

Q.27 Might the monthly bill give the utility's affiliate competitive advantages attributable in part to the utility's historic monopoly status?

A.27 Yes. The monthly bill gives the utility the opportunity to communicate easily with customers, whether for purposes of marketing new services or bolstering its reputation. The utility also has the advantage of being able to bill for competitive services together with regulated services on one consolidated bill, which is a possible convenience to customers. As one example, customers of Kansas City Power & Light's HVAC program, "Worry Free Service," pay a monthly fee on their utility bill. "KCP&L Pushes its Worry Free HVAC Service into Houston, Dallas Markets," Energy Services & Telecom Report, Mar. 27,1997.

The monthly bill goes from the distribution monopoly to every customer in the service territory. It is one piece of mail opened by every customer. The costs associated with the bill (at least those costs which are necessary to the provision of the monopoly service) are assured recovery by virtue of government decision. No competitor other than the utility has this benefit.

Q.28 Are there possible solutions?

A.28 Yes. The Commission should preclude the distribution monopoly from using the monthly bill preferentially to advance its competitive goals or those of its affiliates. The Commission instead can state that utility affiliates may have access to the billing envelopes if other competitors are offered the same access on the same terms and conditions. See California Standards, supra at *94-95 (Rule V.F.3)..

3. Customer Information

Q.29 Does access to customer information give the utility's affiliate competitive advantages attributable in part to the utility's historic monopoly status?

A.29 Access to information about market conditions and customer behavior is an essential attribute of competitive markets. The incumbent utility has unparalleled information, most of it collected by incurring expenses supported by government-approved rates. The incumbent utility's possession of years of customer usage information gives the utility affiliate a unique competitive advantage, where this information is not economically duplicable by competitors, by allowing the utility to target its marketing of various products to the most likely potential customers. See, e.g., In the Matter of Competitive Opportunities Regarding Electric Service, 1997 N.Y. PUC LEXIS 450 (August 1, 1997) (finding that "access to usage data is a critical component of an effective competitive retail market").

Q.30 Are there possible solutions to this problem?

A.30 Yes. Several commissions have addressed the issue. The New York Commission directed utilities to make 24 months of usage and load profile data available with the customers' consent at no charge. Id. Furthermore, the California Commission ordered the creation of a nonconfidential database, consisting of zip codes, rate categories, monthly usage, meter reading dates and billing cycles. This nonconfidential database will include the last 12 months of data and will not identify the customer. There also will be an "opt-in" database with confidential information about customer usage, not to be released except at a customer's request. 1997 Cal. PUC LEXIS 960 (Oct. 9, 1997). See also 1997 Cal. PUC LEXIS 341; 177 P.U.R.4th 1 (May 6, 1997), which established that customer information must be made available using the same "procedures" for affiliates and non-affiliates:

> Customer information held by the regulated UDC shall be made available to the affiliated energy service provider only with customer consent and using the same procedures for disseminating such information as is made available to unaffiliated energy service providers.

The commission goes on to state that customer information should be available in the same "form and manner" to affiliates and nonaffiliates, and again that customer consent will be required for access by affiliates and nonaffiliates:

> Affiliates of the UDC should not be granted preferential treatment with respect to customer information. Any information made available to the UDC affiliate should also be made available in the same form and manner to other unaffiliated electric service providers. Before the UDC affiliate or an electric service provider can access any of this information about a particular customer, the electric service provider must obtain the customer's consent.

There may be circumstances in which a utility acquired information using shareholder funds, and the access to the information was not enhanced due to the utility's government-protected status. Under these facts (if found by the Commission), the utility should be permitted to share this information with its affiliate free of the foregoing principles.

Finally, customer-specific information should be available to any competitive company (including utility affiliates) only with the consent of the customer. The process for granting that consent should not vary depending on whether the grantee is the affiliate or a nonaffiliate of the distribution monopoly.

4. Transfers of Utility Employees

Q.31 Would the ability to transfer employees back and forth between the utility and its competitive affiliate give the affiliate an advantage attributable in part to the utility's historic monopoly status?

A.31 Yes. Experienced utility staff, trained through ratepayer dollars, are an important asset. In the developing competitive markets, the government must be seen as choosing no favorites. If the perception is that employees are trained at the monopoly affiliate, and training costs are recovered under monopoly regulation, and that highly trained employees are then assigned to the competitive affiliate, under circumstances in which the competitive affiliate and the employee expect that if sufficient business does not develop the employee can return to the monopoly affiliate, the perception will be that the utility's competitive affiliate has access to resources that its competitors do not.

The concern over employee movement covers not only effective competition, but cross-subsidization as well. The existence of nonutility affiliate opportunities can divert the attention of utility management (including managers of affiliates or of the holding company who have some responsibility for utility service) in ways that adversely affect the utility's monopoly customers. A manager focusing on nonutility problems is not focusing on the utility business. During these rapidly changing times, customers of noncompetitive services need managers whose priority is to pursue the best course for the ratepayers.

Q.32 How might the Commission address the matter of employees in a manner which promotes effective competition while minimizing the chance of cross subsidization?

A.32 The Commission should not permitting unlimited crossing between the utility and the nonutility affiliate. Such crossing would encourage the training of employees on the ratepayer dollar, their transfer to the nonregulated affiliate for temporary employ, and then their transfer back to the utility to undertake more training and to ensure their salaries are fully recovered. This would give the local utility an advantage over its nonutility competitors, and would put utility monopoly ratepayers in a position of bearing costs of competitive operations.

5. Other Important Prerequisites for Effective Competition

Q.33 Are there other nonprice relationships between a utility and its competitive affiliate which might cause concern?

A.33 Yes. If the Commission permits a continuing affiliated relationship, there are at least four other concerns that do not fall neatly within the previously mentioned categories. They are as follows:

1. Competitive referrals: The Commission should require that when customers ask the distribution monopoly for a recommended provider of a competitive service, the distribution monopoly should provide objective information or no information. As the California Commission stated:

> With respect to referrals, we agree that permitting the utility to act as its affiliate's referral service would give affiliates an unfair advantage which is hard to overcome. Once the utility has made the referral to its affiliate, any subsequently provided list is irrelevant. This rationale applies equally to all affiliates covered under these rules. We adopt Petitioners' proposal as modified to provide that the Commission will authorize a list of service providers, or approve an alternate procedure for referrals, in response to the utilities' advice letter filings.

California Standards, supra at *67.

2. Joint marketing: For similar reasons, there should be no joint marketing by the utility monopoly and its competitive affiliates. As the California Commission has stated:

> Joint marketing by a utility and affiliate creates opportunities for cross-subsidization, and also has the strong potential to mislead the consumer, for example, by implying that taking affiliate services is somehow related to the provision of the monopoly utility service. Joint marketing opportunities, especially when coupled with the joint use of a name and logo, will promote customer confusion by allowing affiliates to capitalize on the public perception that their products are closely associated with the regulated utility's. For example, the utility advertisements set forth in our discussion on the use of name and logo, above, demonstrate that juxtaposing discussions about the affiliates and utility's services, even if factually correct, inappropriately blurs the separation between the affiliate and utility.

California Standards, supra at *92.

3. Processing of requests: Where a customer, or an unaffiliated competitor, requests services or information that is exclusive to the distribution company and which is not economically duplicable, the distribution company must process the request as rapidly and thoroughly as it does when the requestor is an affiliate. One example would be the monopoly affiliate's plans for future expansion of its transmission and distribution systems. If only the competitive affiliate of the distribution monopoly knows about future expansion, it can plan its generation investments or marketing programs aided by an advantage over its competitors.

4. Variations in price or quality: The monopoly affiliate may not vary the price or quality of its distribution service, or offer any other benefit, to a customer depending on whether the customer buys competitive service from an affiliate or a nonaffiliate.

C. Distribution Monopoly as Retail Competitor in Its Service Territory

Q.34 The Commission has asked whether it should permit the incumbent utility both to provide monopoly distribution service and sponsor an affiliate competing to sell electricity in the territory served by the monopoly distribution company. What is your response?

A.34 There are at least three general answers to this question:

1. Permit this dual engagement, subject to affiliate transaction rules.

2. Permit the dual engagement, but limit the utility affiliate's market share.

3. Phase out the dual engagement over a fixed period, such as two years; the effect is to require the utility to choose between continuing as the distribution company or selling in the service territory as a retail competitor.

The proper treatment should be based on the facts. The regulator should have the legal ability to take any one of these three actions, depending on the facts. The Nevada legislation, Section 43, takes that approach:

> Sec. 43
>
> 1. An affiliate of a provider of a noncompetitive service may provide a potentially competitive service only upon a finding by the commission after a hearing that:
>
>   (a) The provider of the noncompetitive service is in compliance with subsection 2 of section 41 of this act [requiring "each provider of a noncompetitive service that is necessary to the provision of a potentially competitive service to make its facilities or services available to all alternative sellers on equal and nondiscriminatory terms and conditions"];
>
>   (b) The affiliate will have, with respect to the provision of the electric service, an arm's length relationship with the entity that provides the noncompetitive service;
>
>   (c) The business or organizational relationship, or both, between the provider of the noncompetitive service and the affiliate providing the potentially competitive service does not interfere with the development of effective competition; and
>
>   (d) The risk of anticompetitive behavior by the provider of the noncompetitive service or the affiliate providing the potentially competitive service, or both, is minimal and the regulatory expenses to prevent the anticompetitive behavior are minimal.

A similar approach should be considered by the Commission.

D. Enforcement Issues

Q.35 Assuming the Commission promulgates regulations concerning interaffiliate transactions, do you have any recommendation concerning enforcement?

A.35 Enforcement must be expeditious, and the sanctions must be sufficient to deter violations.

Q.36 Why is expedition necessary?

A.36 Expedition is necessary because of the dynamic nature of the market. In traditional regulation, the monopoly market had one seller. Abuses had cost consequences that could be associated with a defined period. Swift action was not as critical, because refunds could be measured based on that period, and then made to the appropriate customers. (If too many years lapsed between the abuse and the refund, however, there could be a mismatch between the customers suffering the abuse and the customers receiving the refund.) In a market where competition is first developing, anyone with advantages has incentive to exploit them.

The exploitation of these advantages can have a positive impact, producing the mutual pressures among competitors that leads to innovation and cost reduction. But if the wrong advantages -- such as those associated with monopoly affiliation -- are exploited, competition can be harmed. That harm can be irreparable, if competitors lacking such advantages decide to depart (or decline to enter). Moreover, misbehavior by one competitor can prompt misbehavior by others, leading to a spiraling decline in the quality of competition.

Consequently, the Commission needs to address legitimate complaints within a time frame reflective of the new pace of customer decisionmaking likely under competition. A one-year lapse between complaint and proceeding leaves a very long time during which the perpetrator of behavior inconsistent with effective competition can be rewarded. The Commission should aim for much shorter time frames, such as 30-60 days.

Q.37 What types of sanctions would you recommend?

A.37 Sanctions should fall into two categories: structural and financial.

Structural sanctions should address the features of corporate structure which facilitate the improper behavior. Sanctions related to abuse of the affiliate relationship should focus on the source of the problem: the affiliate relationship. The monopoly utility is the monopoly utility only because the government granted the monopoly privilege. A privilege which is abused should be forfeited. Compliance with the affiliate rules therefore should be a condition of continuing to have the right to be a utility. Conversely, violation of a rule could result in a ban on the affiliate's entry into the retail competitive market.

A distinct reason for using structural sanctions is that behaviors which obstruct the development of effective competition have consequences which are difficult to quantify. Efforts to determine the costs of unnecessary diminution in competitive forces will run aground quickly, as litigants dispute the probability that because of particular utility behavior, Competitors X and Y left the market, and Competitors A and B declined to enter the market, not to mention competing calculations of the benefits foregone because of the absence of X, Y, A and B.

Financial sanctions: Whereas the structural sanction targets the underlying corporate structure, financial sanctions assign to the wrongdoer the cost consequences of the behavior, plus a penalty. These cost consequences can include the cost to consumers of excess charges or loss in benefits arising from the diminution of competition; as well as the foregone profits which competitors suffer due to the misbehavior. Adding a multiplier (such as the treble damages required in antitrust law) assists in deterrence because the wrongdoer loses more than the ill-gotten gains, and therefore must take the cost into account before deciding whether to engage in the improper behavior.

The California Commission has recognized this distinction between structural sanctions and financial sanctions:

> [U]tilities and their affiliates should not perceive potential penalties as simply a cost of doing business. To this end, we may consider such penalties as not allowing a utility affiliate to switch any new customers to it for a specified period of time, or we may consider penalties for severe or recurring violations such as revocation of an affiliate's registration.

<u>California Standards</u>, <u>supra</u> at *161.

Q.38 Do you have any comments on reporting requirements and on Commission access to books and records?

A.38 The principle should be that the Commission should have data in the detail necessary, and at the time necessary, to preclude affiliates of the utility from gaining an improper advantage. The detail and the timeliness will vary depending on the type of data and the stage in competitive development. The Commission will need flexibility. At the very least, data on affiliate transfers must be available as soon as they occur, and include the detail necessary to ensure compliance with the Commission's pricing rules.

Access to books and records is necessary not to gain insight into affiliates' competitive strategies, but to ensure that the utility's behavior is consistent with the Commission's rules. Again, the detail of the access and the frequency will be determined by the issue and the stage of competitive development.

Q.39 Do you have any additional recommendations on enforcement?

A.39 Yes. The Commission should require each utility to identify to the Commission a senior, respected official responsible for enforcing the Commission's interaffiliate rules, and for certifying under oath each year that the company has in fact complied with all rules. In addition to certifying compliance, this person also should be responsible for bringing to the Commission's attention all evidence of non-compliance.

The premise for this requirement is simple: there will be numerous opportunities to test and violate these rules. The Commission and intervening parties will not be capable of detecting and preventing each one. The success of the rules will depend on a strong internal commitment. With the pressures toward profit induced by competition, there will be conflicts within the organization between advancing the company's competitive position and complying with the rules. Someone inside the company must be responsible for identifying these conflicts and ensuring that they are resolved consistently with the Commission's rules.

It is common for government to limit the profit motive when those limits serve broader interests than the interests of the regulatee. There is nothing wrong with the profit motive; the premise of competition is that the profit motive will encourage all parties to behave more efficiently. For a vertically integrated utility engaged in both monopoly and competitive services, the profit motive would lead the company to exploit all its advantages, regardless of their source, to benefit the competitive business. The purpose of the present rules is to condition the profit motive so that the utility uses only those advantages accruing from its skills, and none of those advantages accruing from its history of government protection from competition.

Given the natural conflict between the private and public interests, the responsibility for compliance inside the company should be placed with someone whose job and career do not depend on advancing the company's competitive agenda.

III.
The Commission's Role Must Change From a Steward of a Monopoly Market to a Promoter and Protector of an Effectively Competitive Market

Q.40 The Commission has asked what "philosophical framework" is appropriate to follow in designing its rules. What is your response?

A.40 The Commission suggests the choice is between a "strong regulatory approach"; a "mild antitrust approach in which the Commission is the first forum for viewing complaints regarding anti-competitive behavior"; or "an approach in which antitrust violations should be left to the courts in the first instance with the Commission taking secondary responsibility for enforcement".

I respectfully suggest that appropriate regulations of interaffiliate transactions should be based not on philosophy, but on facts. Under the present facts, reliance on antitrust law alone will not achieve this goal, not because of "philosophy" but because of facts. Under the present facts, the incumbent begins with almost 100 percent market share, may have access to resources not available to or replicable by its competitors, and owes this favored position in part to a history of government protection from competition. The factual question is whether under these circumstances, the Legislature's goal of effective competition is achievable without some government role. This is a question of fact, not philosophy.

Q.41 Are you saying that the Commission must play a role distinct from antitrust enforcement?

A.41 Yes. Antitrust enforcement is not a tool for creating competition from scratch. In Illinois, the Legislature has directed that a competitive market come into being. This directive comes after decades of dependence on a sole supplier. It is therefore appropriate for the Commission to enact regulations that will assist in the development of effective competition. Exclusive reliance on antitrust is inappropriate because the task is to create effective competition where none exists.

There are several other reasons why reliance solely on antitrust law to achieve effective competition is not appropriate. First, the Legislature has placed the Commission at the center of the effort to ensure that proper regulations are in place to foster the development of effective competition. The Commission must have the tools to do the job, and the public must be able to hold the Commission accountable. Exclusive reliance on antitrust law is incompatible with this principle.

Second, there is a gap between the behaviors which are the focus of antitrust law, and the behaviors which can preclude effective competition from developing. Failure to fill this gap means that no public entity will be responsible for protecting the public from certain types of harms. For example, when a company with 100% market share, attributable to a history of government protection, exploits its brand name, there is no violation of antitrust law. But the behavior heightens an entry barrier that can be detrimental to the development of effective competition. When the utility incumbent exploits its preferred access to economies of scale and scope, there is not necessarily a violation of antitrust law (provided the incumbent is not denying access to a bottleneck facility); however, this activity again builds on an entry barrier and renders competition less effective.

Third, as a practical matter new competitors cannot rely on private antitrust enforcement because antitrust litigation occurs after anticompetitive behavior has occurred, and often after serious competitive harm has been felt. Most plaintiffs do not decide to incur the substantial expense and uncertainty of litigation until they are reasonably sure they have experienced, or are likely to experience, economic harm. The majority of consumers who will suffer from the absence of effective competition are not necessarily the types that will bring the litigation. A large customer or competitor with the resources to bring antitrust litigation will focus on its own harm and its own remedies. This harm and these remedies are not necessarily common to the majority of the consuming public.

Finally, antitrust enforcement cases can be long, involved proceedings. Market participants should have guidance on appropriate behavior before competition starts; then they can compete aggressively without fear of sanctions accompanied by litigation uncertainty and delay.

Q.42 Does the Commission role you describe differ from the Commission role under monopoly regulation?

A.42 Yes. The Commission must foster effective competition where competition has not previously existed. This challenge requires affirmative steps to create the conditions essential to competition. These conditions may not emerge on their own, particularly where the entity benefiting from a history of government protection from competition will be entering the competition against those who have lacked such advantages.

This role differs from that of traditional monopoly regulation. Monopoly regulation presupposes a monopoly market structure. Under monopoly regulation, by definition, the customers and regulators lack alternatives. The absence of alternatives means that regulators cannot be indifferent to the financial fate of the utility. Although as a legal matter, the regulator is not obligated to protect the utility from all financial harm, see Market St. Ry. Co. v. R.R. Comm'n of California, 324 U.S. 548, 567 (1945) ("The due process clause has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values that have been lost by the operation of economic forces."); as a practical matter a regulator having no alternative to the present utility might refrain from taking actions which make the utility bear fully the cost responsibility for its errors. See, e.g., Investigation of Citizens Utility Company, Docket Nos. 5841/5849 (June 16, 1997) (finding that although utility's "persistent pattern of misconduct, violations of law, failure to comply with regulatory directives, and disdain for traditional principles of utility accounting and management", as well as a "pattern of mismanagement, imprudence and disregard for Vermont law and regulation, extending over a period of decades" justified revocation of utility's franchise, revocation of the utility's franchise would not serve the public interest because such action "might well be accompanied by transactions costs and unintended consequences that are inimical to the end results sought by petitioners and the general public.")

Under competition, the regulator should be no more concerned with the financial health of the utility's afffiliate than any other competitor. To paraphrase a statement made often about antitrust law, the purpose of regulation now must be not to assist a particular competitor, but to promote competition. Where the government allows the historic monopoly to retain advantages which it gained by virtue of government regulation, the government would be assisting a particular competitor, to the detriment of competition.

The Commission will have only one chance to make the transition from government protection to effective competition work. Competition is especially vulnerable when it barely exists. The adverse effects of conduct inconsistent with effective competition, when carried out during this transition, may be longlasting and in fact irreparable. The Commission's rules are among its most important actions to prevent such effects. The rules therefore must establish prophylactic protections againts misappropriation of utility's present advantages, and also must promise swift remedial actions, both structural and financial, to support those protections.

Q.43 Some utilities argue that special treatment is necessary to ensure the financial well-being of the entity providing monopoly distribution service. What is your response?

A.43 A utility should not be able to demand special treatment as a competitor to ensure the financial viability of its monopoly distribution operations. The financial viability of its distribution operations is properly addressed through the traditional rate regulation of those operations. If the utility is taking actions in a competitive market that endanger its ability to carry out its monopoly duties, then the utility should be required to choose one business or the other.

Similarly, if a regulator finds that it is giving a utility-as-competitor better treatment than other competitors, merely so that the utility-as-distribution-monopoly remains strong, the regulator should re-examine its policies on permitting the distribution monopoly to have competitive affiliates. The regulator should not distort the competitive market to preserve one company's ability to remain vertically integrated. The distortion will discourage entry, thus depriving the customers of choice and accountability in the market.

Conclusion

Q.44 Have you reviewed the draft rules proposed by the Consumer and Governmental Interest Parties, and attached to your testimony as Ex. ____ (SH-2)?

A.44 Yes.

Q.45 Are they consistent with the principles you have described in your testimony?

A.45 Yes.

Q.46 Does this complete your direct testimony?

A.46 Yes.

REBUTTAL TESTIMONY OF SCOTT HEMPLING

Q.1 ARE YOU THE SAME SCOTT HEMPLING WHO OFFERED DIRECT TESTIMONY IN THIS PROCEEDING?

A.1 Yes.

Q.2 PLEASE OUTLINE THE MAIN THEMES OF YOUR REBUTTAL TESTIMONY.

A.2 Some utility witnesses have argued for retention of those economies and other benefits which have accrued to them as a result of their historic role as the government-appointed, sole seller of retail electric service. Their chief justification is that to deny them these benefits would be to destroy economic efficiencies that otherwise would benefit customers. I explain that these arguments are based on the incorrect premise that these economies cannot be preserved for customers unless they are assigned solely to the incumbent and to no one else.

Some utility witnesses also argue that inter-affiliate rules should be limited to those necessary to prevent cross-subsidies. These arguments fail because there are two other important goals: (1) to assure the development of effective competition by eliminating entry barriers attributable to historic government intervention on behalf of the incumbent;

and (2) to assure that historic utility customers receive rewards commensurate with their historic risks.

Q.3 WHAT TOPICS WILL YOU ADDRESS?

A.3 I will address five topics:

1. Economies of Scope
2. Affiliated Interest Agreements
3. Applicability of the FERC Code of Conduct
4. Competitive Activities Within the Utility Corporation
5. Relevance of the Telecommunications Experience

Economies of Scope

Q.4 SEVERAL UTILITY WITNESSES ARGUE THAT THE INCUMBENT UTILITY AND ITS AFFILIATES SHOULD BE FREE TO EXPLOIT ALL ADVANTAGES ASSOCIATED WITH ECONOMIES OF SCOPE AND SCALE. WHAT IS YOUR RESPONSE?

A.4 I addressed this issue in detail in my direct testimony. I will respond here to certain specific arguments made by the witnesses.

The utilities' efforts to retain the benefits of these economies of scale and scope suggest several points:

First, if economies of scale and scope are valuable to consumers, the public policy should be to maximize that value. Regulators can maximize that value not by allowing the incumbent exclusive access to these economies, but instead by requiring the incumbent to compete to retain these economies by giving all possible competitors an opportunity to replace the incumbent.

Second, if economies of scope are valuable, then the company with access to them will have an advantage. That advantage should go to the company which earns it; not the company which has controlled it historically as a result of government preference. It is no better, no less arbitrary, and no less inconsistent with the principles of competition, to hand the exclusive right to exploit certain economies of scope to the incumbent utility as it would be to hand it to a nonutility. Certainly if this Commission, without explanation, announced that Nonutility X now would be the local utility distribution monopoly and would be allowed to realize the economies of scale and scope associated therewith, to the exclusion of all others, all of those others (including the incumbent utility) would have grounds for objection. But that is the position taken by the utilities here: that they should have these benefits automatically, without having to compete for them.

Third, if the economies of scale and scope are valuable, then they represent an entry barrier to the extent they are available to the incumbent but not to the newcomer. Again, it is an entry barrier erected not by the utility's skill but by government policy. It is that government policy that now requires reconsideration.

Fourth, the value of incumbency to the utilities comes from more than mere reputation and skill. It comes from being the beneficiary of this entry barrier. The utility became this beneficiary not because it competed for the role. Thus at the very outset of competition, we have an exception from competition: an advantage accruing due to government favor.

The error of the utilities' reasoning is capsulized in the statement of ComEd's witness Dr. Landon. Direct Testimony at 8. He asserts that regulatory removal from the incumbent of the competitive advantages associated with economies of scale and scope "in order to favor new entrants subverts the competitive process, making superior firms less efficient and less able to compete on the merits of their abilities." If the economy of scope or scale at issue were solely the result of the utility's "abilities," then Dr. Landon would be correct. He is doing no more than articulating the theory of competition. But his application of that principle here is erroneous. Many of the economies of scope and scale presently available to utilities are not the result of "their abilities," but are instead the result of a government grant of a franchise and a power of eminent domain , a grant not extended to the utility's competitors. To require those benefits to be available to others is not to "favor new entrants." To allow only the incumbent and its affiliates to have those benefits is to favor the incumbent.

Dr. Landon thus states "it would be anti-competitive to permit incumbent companies not to take advantage of" economies of scale and scope. This an important admission. If it is anti-competitive not to allow the utilities to take advantage of them, then it is anti-competitive not to let the non-utilities take advantage of them, where these advantages are attributable to government policy rather than incumbent skill. But that is precisely the effect of Dr. Landon's argument. Where the economies of scale and scope are attributable to past intervention by the government, on behalf of the utility, and are not replicable by non-utility competitors, then the effect of allowing the utility to exploit these economies is to preclude the non-utility from doing so. But as Dr. Landon points out, to preclude companies from taking advantage of economies of scale and scope would be "anti-competitive." This is the very problem I have addressed, by arguing that the economies need to be made available to all competitors. I do not mean all economies, of course; only those which, as I explained in my

Direct Testimony, are not economically duplicable by the non-affiliate competitors quickly enough to prevent the utility's affiliate from realizing a competitive advantage by virtue of its affiliation with the utility.

Similarly, Prof. Kahn argues that utilities and their affiliates should be able to exploit "efficiencies legitimately available" to them. Direct Testimony at 3. He thus implies that "efficiencies legitimately available" to utilities include efficiencies that are available only to the utilities, because of their past grant of monopoly privileges and government powers. Using the word "legitimate" implies, incorrectly, that the analysis includes some moral or legal element, allowing retention of "legitimate" efficiencies but requiring rejection of "illegitimate" efficiencies. For example, he later indicates that the advantage is "legitimate" if it is "in no way dependent on or related to abuses of monopoly power." Id. at 12.

This terminology obscures the point. Economies of scale and scope cannot be called "illegitimate" if they arose from a historical policy, lawfully applied, of government protection. But going forward the analysis is different: what market structure will achieve the goal of effective competition? Allowing the utility and its affiliates to retain all historical government-granted benefits, merely because they are "legitimate" today, misses the point.

Dr. Kahn focuses specifically on the economies from vertical integration. To the extent the opportunity to be vertically integrated in the Illinois market is available to all, then Dr. Kahn's reasoning can apply. The rewards in competition should go to those who exploit such economies most skillfully. But vertical integration in the electric industry is problematic. For a particular territory, there is only one distribution owner and one transmission owner. Therefore only one entity can be vertically integrated, in the sense of being engaged in the provision of generation, transmission, distribution and retail services. Dr. Kahn's reasoning, that it is pro-competitive to allow vertical integration, does not work in this context since only one company can be vertically integrated, and that company attained its status through governmental grant rather than through merit.

Dr. Kahn's list of examples of possible economies of scope and scale illustrates the point well. Id. at 14-16. He lists inputs such as the monthly bill, fleet of repair trucks, and data processing equipment; knowledge economies such as expertise in demand-side management programs; and marketing economies such as the ability to offer one-stop shopping. Most of these economies are attributable in substantial part to the utility's government-granted sole-seller status. Provided the expenditures associated with these economies were prudent, the monopoly customers will have funded them entirely, even during periods when they were not necessary to serve the customer. The customers thus have been the risk-bearers with respect to these benefits. To allow the utility and its affiliates to exploit them now and retain all the benefits is to create an asymmetry of risk and reward that cannot be justified by saying "it's not anti-competitive." The non-utility competitors have lacked that opportunity to have monopoly customers finance the sizeable advantage in expertise that Dr. Kahn asserts is so important competitively.

Q.5 DR. KAHN ARGUES AT P. 6 THAT INCUMBENT UTILITIES AND THEIR AFFILIATES SHOULD HAVE THE "FREEDOM TO INTEGRATE" IN COMPETITIVE MARKETS. WHAT IS YOUR RESPONSE?

A.5 He ignores the fact that where the facilities to be integrated include natural monopoly facilities, the "freedom to integrate" can be available only to the company which controls those facilities. No one else can have this "freedom to integrate." If there is to be "freedom" in this area, therefore, it must be the freedom to have an opportunity to integrate. This freedom cannot be realized by excluding all but the incumbent from the opportunity to integrate. There would need to be a competition for the right to exploit these economies of integration.

Note that with respect to these bottleneck facilities, the focus of most policymaking has been on granting nondiscriminatory access. But access alone is not the same as the opportunity available to the incumbents to integrate through ownership of the various stages of production.

Q.6 DR. KAHN ARGUES THAT COMPETITION SHOULD BE BASED ON PROSPECTIVE, RELATIVE EFFICIENCIES. WHAT IS YOUR RESPONSE?

A.6 That is my point as well. But differences in prospective efficiencies can be obscured by differences in initial resources. Assisted by economies of scale to which no other competitor has access, an incumbent utility can actually operate less efficiently than its less well-endowed competitors, but still offer a lower price than its more efficient competitors. If it offers this lower price for a sufficiently long period of time, it can deter entry by others, and thereby succeed "competitively" despite not having the highest prospective efficiencies. Dr. Kahn does not address this possibility.

Q.7 DR. KAHN STATES THAT "[T]HE BURDEN OF PROOF THAT UNFETTERED COMPETITION WILL NOT SUCCEED RESTS WITH THOSE WHO PROPOSE RESTRICTIONS THAT WOULD SACRIFICE THOSE EFFICIENCIES AND HANDICAP OR SUPPRESS THE COMPETITION BETWEEN THE INCUMBENT AND ITS RIVALS." <u>ID.</u> AT

4. WHAT IS YOUR RESPONSE?

A.7 Burden of proof is a policy judgment about which experts can legitimately disagree. One could respond to Dr. Kahn by saying that those who have derived exclusive benefits from their association with government decision-makers over many decades have the burden of demonstrating that those benefits do not create a competitive advantage when retained by them exclusively. (The utilities will have difficulty carrying this burden, since their vigorous position in this case is that they should retain these advantages because it will help them competitively.) Rather than debate who should bear what burden in this important area, regulators should ascertain the facts as to whether allowing the incumbents access to advantages not available to non-incumbents will create entry barriers that can be removed without losing the efficiencies underlying those advantages.

In any event, Dr. Kahn's statement itself has a circularity: the assumption of "unfettered competition." Unfettered means unfettered by entry barriers, among other things. The very question at issue is whether the utilities' preferential access to economies of scope and scale constitutes an entry barrier.

Q.8 IS IT APPROPRIATE TO DESCRIBE A POLICY OF DENYING TO THE INCUMBENT UTILITY AUTOMATIC, UNCHALLENGED ACCESS TO

ECONOMIES OF SCOPE AND SCALE, WHERE THOSE ECONOMIES ARE AVAILABLE ONLY TO THE INCUMBENT UTILITY AND ARE ATTRIBUTABLE TO PAST GOVERNMENT POLICIES, AS "SPECIAL PROTECTIONS TO SO-CALLED INFANT INDUSTRIES"? (<u>SEE</u> KAHN DIRECT AT 8).

A.8 No. It is not "special protection of infant industries" to deny a monopoly incumbent advantages not replicable by those who have not had a history of government protection. What would be "special protection" would be a policy that says only the incumbent has an opportunity to exploit economies born of the incumbent's historical government protection.

The Commission should take care not to adopt or accept terminology that describes the elimination of government-granted advantages as "special protections" for those who do not have those advantages. None of the principles in my testimony seeks special protections for the new competitors; my principles seek only to avoid "special protections" of the incumbents.

Q.9 IS IT NECESSARY TO SACRIFICE ECONOMIES OF SCALE AND SCOPE IN ORDER TO ENSURE EFFECTIVE COMPETITION?

A.9 No. There is a way to preserve economies of scale and scope without artificially advantaging the incumbent: allow all competitors to compete for the chance to be the utility franchisee with distribution, transmission and other responsibilities assigned to the traditional utility. These responsibilities are, in part, the economies that the incumbent utilities now wish to preserve for themselves. While no utility has proposed this approach, resistance would signal an inconsistency: It would indicate that the utility wanted to be allowed into competition to take advantages of economies of scope, but would want to preclude competition for the opportunity to realize those economies of scope.

2. Affiliated Interest Agreements

Q.10 SOME WITNESSES ARGUE THAT THE "AFFILIATED INTERESTS AGREEMENTS" PREVIOUSLY APPROVED BY THE COMMISSION ARE SUFFICIENT TO ENSURE THE DEVELOPMENT OF EFFECTIVE COMPETITION AND PROTECTION AGAINST CROSS-SUBSIDIES. <u>SEE</u>, <u>E.G.</u>, ComEd WITNESS BERDELLE. WHAT IS YOUR RESPONSE?

A.10 The ComEd AIA, as described by Mr. Berdelle, has elements that can address cross-subsidies, but it does not respond to the challenges to effective competition posed by the presence of an incumbent monopoly. I explained the distinction between the two goals in my direct testimony. I offer some additional comments in response to certain witnesses below.

For sales from the utility to the non-utility affiliate, the AIA described by Mr. Berdelle appears to prefer market price when a market price is available; but when a market price is not available, the AIA calls for fully distributed cost. This approach might make sense if the goal were solely to protect against cross subsidy. But when the goal is also to promote the development of effective competition, the approach has a bias favoring the incumbent. If market price is not available, the solution should not be to let the monopolist engage in transaction on an allocated cost basis, on the grounds that "this is the best we can do." Instead, government should set itself against inappropriate competitive advantages, especially those which the government had a hand in making. A market price is essential to ensuring that the incumbent does not enter competition with inappropriate advantages. If the market price is not available, there is no way to be sure the incumbent will not have such advantages. In fact, the absence of a market price is likely to indicate that the transaction involves some unique benefit not available from sellers who did have the past, government-granted role of the incumbent utility, a benefit now made available exclusively to the utility's affiliates. On those bases, the transaction should be prohibited.

This approach also will create a strong incentive in the incumbent to locate proxies for market value and bring them to the Commission's attention. The incentive should be for parties to produce more, not less information, since more information allows regulators to detect inappropriate competitive advantages and take the necessary action.

Moreover, in determining the market price for these purposes, the Commission should look at more than the price which the incumbent utility is charging to others. See Testimony of Mr. Berdelle at 5 (stating that "[i]f ComEd does not provide such service or facility for sale to the general public, and therefore no prevailing price exists, then the requesting Unicom Entity will be charged the fully distributed cost...."). Even if the utility is not providing the service to the public, other sellers might be; therefore the Commission should look at the prices charged by those sellers to determine the prevailing market price. It is hard to imagine a product sold by the utility to its affiliate that is so unusual that no one else is selling it anywhere, unless it is a product uniquely available from a utility due to its special status.

Moreover, where the utility does sell the service to the public, the utility's price alone might not reflect the market price. The utility may be selling at a low, loss-leader price to attract new customers. Such action, even if legitimate, is aimed at gaining market share in new markets for the benefit of shareholders. It is not the price which should be used to ensure that ratepayers are properly compensated. That price should be the <u>prevailing</u> market price, because the utility is obligated to obtain the highest possible value for the ratepayers.

3. Applicability of the FERC Code of Conduct

Q.11 SEVERAL WITNESSES ARGUE THAT THE FERC CODE OF CONDUCT IS SUFFICIENT TO PROTECT AGAINST INAPPROPRIATE UTILITY-

AFFILIATE RELATIONS. WHAT IS YOUR RESPONSE?

A.11 These witnesses reduce the problem incorrectly. They focus on cross subsidization only, not on the development of effective competition in new retail markets.

In the FERC context, the buyers of wholesale electricity are generally sophisticated, have access to large sums for consultants and lawyers, and are unlikely to be susceptible to advertising, use of the corporate name and other efforts to influence them not to incur the cost of switching. They and their consultants can readily identify, in any power supply market, the gamut of viable suppliers, and evaluate their prices and qualities. In that market, the cost of searching for new suppliers should usually be small relative to the size of any particular purchase. In that context, rules that focus only on the prevention of cross subsidies and not on the development of effective competition might be appropriate, although this limitation in the FERC rules makes them less than fully reliable as a tool for promoting effective competition.

Retail electric markets are likely to differ from the FERC-regulated market. As explained in my Direct Testimony, incumbents will have many advantages not available to their retail competitors. Most residential buyers will be unsophisticated. For any single residential customer, the cost of searching and switching may be large relative to the benefits. Consequently, the regulatory role in fostering effective competition must be more than merely preventing cross-subsidies. For these reasons, the FERC rules are not a sufficient model for state-level rules.

4. Competitive Activities Within the Utility Corporation

Q.12 MIDAMERICAN WITNESS HOWARD STATES THAT "[I]RRESPECTIVE OF WHETHER AN ELECTRIC UTILITY ELECTS TO CONDUCT ITS COMPETITIVE ENERGY MARKETING BUSINESS WITHIN THE CORPORATE ORGANIZATION OF THE UTILITY OR THROUGH A SEPARATELY INCORPORATED AFFILIATE, THE RULES SHOULD NOT TREAT THE TWO BUSINESSES DIFFERENTLY." DIRECT AT 8-9. WHAT IS YOUR RESPONSE?

A.12 I agree with the principle that regulatory rules concerning the treatment of competitive and noncompetitive businesses within the same corporate family should not vary with corporate form. Where these activities all take place within the same corporation, however, the regulator's practical ability to enforce these rules is weakened, for at least two reasons.

First, detection of transfer pricing abuses would be difficult because within a single corporation, assets and services are not bought and sold with an invoice; they are simply shared. The notion of an arms-length relationship will disappear.

An invoice expresses the separateness of the parties to an arm's-length transaction. Failure to perform on an invoice, either as seller or buyer, subjects the non-performer to a lawsuit and damages. That accountability between the two parties to the transaction will exist in the relations between the utility and its non-affiliates. It must exist as well in the relations between the utility's competitive and noncompetitive operations. If a monopoly utility can sue a non-affiliate for failure to pay its bills, but cannot sue its own competitive operations, there is an unequal relationship that can deter the development of effective competition.

Second is the matter of employee inducements. To obtain the highest performance, management should ensure that employees are pursuing the corporation's legitimate aims with the utmost vigor. When within a single corporation there are the conflicting objectives of being fair to competitors and defeating competitors, it is too easy for management to send, or employees to receive, mixed signals as to whether and when to elevate one of these goals over the other. By separating the monopoly and competitive functions into separate corporations, these different aims can be pursued more reliably by the distinct corporations.

Relevance of the Telecommunications Experience

Q.13 DR. HARRIS STATES THAT IN THE TELECOMMUNICATIONS INDUSTRY, REGULATORS NOW ARE DISPENSING WITH STRUCTURAL SAFEGUARDS, AND COMPETITION IS FLOURISHING; THEREFORE ILLINOIS REGULATORS CAN MOVE DIRECTLY TO COMPETITION WITHOUT SUCH SAFEGUARDS. WHAT IS YOUR RESPONSE?

A.13 Assuming, for purposes of argument, the accuracy of Dr. Harris' assumption that telecommunications competition is flourishing, his reasoning ignores the possibility that telecommunications competition is flourishing now, in the absence of structural safeguards, because of the interim history of imposing safeguards. His logical error is the equivalent of saying that because we have had low fatalities during an era of seatbelts, we should dispense with seatbelts. He incorrectly labels as a regulatory "learning stage," that is, a stage we can skip the second time around, a public policy that may have been responsible for the structural health he now describes.

A key purpose of restrictions in the historical monopoly's preferential access to the benefits of government favors, is the reduction in entry barriers. Removing the safeguards after a period in which their existence was accompanied by diverse and multiple entries does not mean the safeguards played no role in permitting those entries.

When entry has occurred, name recognition established, with new providers establishing track records for quality, price and reliability, the introduction of a new product by the incumbent telephone monopolist can be viewed as one more new entrant who advances competition. But if that telephone company had been the only provider of that service at the time that competition for that service opened, the entry by others would have been less certain and the present success Dr. Harris alleges might not have existed.

Conclusion

Q.14 DOES THIS COMPLETE YOUR REBUTTAL TESTIMONY?

A.14 Yes.

SURREBUTTAL TESTIMONY OF
SCOTT HEMPLING

Q.1 Are you the same Scott Hempling who presented Direct and Rebuttal testimony in this proceeding?

A.1 Yes.

Q.2 What topics does your surrebuttal testimony cover?

A.2 It covers nine topics:

1. Economic Principles
2. Economies of Scale and Scope
3. Joint Advertising and Marketing
4. Interaffiliate Transactions
5. Distribution Utility Competing in Its Own Service Territory
6. Corporate Name
7. Monthly Billing
8. Customer Information
9. Employee Transfers

1. Economic Principles

Q.3 Dr. Murphy characterizes your testimony as an effort to "level the playing field." What is your response?

A.3 His characterization is wrong. I never used the phrase "level the playing field." I argued that regulators should seek to ensure that the utility "use[] only those advantages accruing from its skills, and none of those advantages accruing from its history of government protection from competition." Direct Testimony at 31.

I therefore have challenged Dr. Murphy and his client to defend their implicit principle that the implementation of effective competition should include a deliberate decision by regulators to allow those entities who have received government protection for 60 years to retain, free, for use in competitive markets, the tangible and intangible resources that have accrued from that protection, and to deny those resources to all others.

Instead of confronting this difficult issue, Dr. Murphy attributes to me a "level the playing field" position, and proceeds to argue against that position.

The concept of "leveling the playing field," which Dr. Murphy does not define, is not a useful concept because it would sweep away advantages which accrue by virtue of superior efficiencies. I propose that success be based only on efficiencies attributed to the seller's skills, not on their preferential access to resources attained through government protection from competition.

Q.4 Dr. Murphy disagrees with your discussion of entry barriers. What is your response?

A.4 Dr. Murphy again misstates my position instead of confronting it. Dr. Murphy begins by stating that after I list a series of competitive advantages possessed by incumbent utilities, I assert that, in his words, "if we allow the incumbent to use these assets, other firms may face a barrier to entry and therefore that such use should be prohibited." Murphy Rebuttal at 45. Dr. Murphy provides no citation to my testimony because there is none. As with his treatment of "level playing field," Dr. Murphy improperly rewords his opponent's position to render it vulnerable, and then proceeds to show the vulnerabilities.

My position on entry barriers, set forth in Answer #9 of my Direct Testimony, is as follows:

> Because of the possibility of entry barriers, the Commission must be sure that where there are resources available to the utility, which resources are attributable to its historic government protection from competition, and which are difficult to replicate during the period when competition is immature, the utility is not in a position to gain a competitive advantage from these resources.

In his 81 pages of testimony, Dr. Murphy never confronts this position.

Dr. Murphy next offers a definition of entry barriers that exposes the underlying disagreement between us:

> [A] barrier to entry is something that prevents entry by raising the costs of potential competitors to the point that they cannot compete effectively in the market not something that increases the efficiency of incumbents.

Murphy Rebuttal at 45. From this point, he reasons that since none of the utility incumbents' advantages (including, presumably, those derived from their history of government protection) actually raises the costs for competitors, none of these advantages needs to be removed to make way for effective competition.

Dr. Murphy's definition of entry barriers is inappropriately limiting, in that it is indifferent to the statutory goal of effective competition. Effective competition exists when no seller can sustain for a non-transitory period a price in excess of competitive levels. An entry barrier is a condition which allows an incumbent to do so. Thus an entry barrier need not be a factor that raises costs for newcomers; it can instead be a difference in cost between incumbent and newcomer sufficiently large as to allow the incumbent to sustain a supra-competitive price.

Professor Viscusi and his colleagues, after stating that "[t]here is perhaps no subject that has created more controversy among industrial organization economists than that of barriers to entry," <u>Economics of Regulation and Antitrust</u> 159, note the following possible definitions offered by prominent economists:

> the extent to which, in the long run, established firms can elevate their selling prices above minimal average costs of production and distribution ... without inducing potential entrants to enter the industry [Bain]

> a cost of producing (at some or every rate of output) which must be borne by firms which seek to enter an industry but is not borne by firms already in the industry. [Stigler]
>
> and
>
> socially undesirable limitations to entry of resources which are due to protection of resource owners already in the market. [C. von Weizsacker]

As I indicated in my Direct Testimony, one court has defined entry barrier as "(a)ny market condition that makes entry more costly or time-consuming and thus reduces the effectiveness of potential competition as a constraint on the pricing behavior of the dominant firm." Southern Pacific Communications Co. v. American Tel. & Tel. Co., 740 F. 2d 980, 1001 (D.C. Cir. 1984). While not all these definitions are inconsistent with Dr. Murphy's, they indicate that his definition, which excludes any consideration of the incumbent's cost characteristics, or other unearned advantages, is quite narrow. It also is indifferent to the statutory goal of effective competition.

When a more appropriate definition of "entry barrier" is used, and when one defines the goal as I did in my Direct Testimony, i.e., to ensure that "where there are resources available to the utility, which resources are attributable to its historic government protection from competition, and which are difficult to replicate during the period when competition is immature, the utility is not in a position to gain a competitive advantage from these resources," Dr. Murphy's criticisms are misplaced.

2. Economies of Scale and Scope

Q.5 EEI Witness Harris defends the utility's retention of the benefits of economies of scope and scale in part on the grounds that "[t]he presence of these economies is a manifestation of efficient utility provision of service not government protection." Rebuttal at 2. What is your response?

A.5 Dr. Harris obscures the point. If there are economies, certainly they may be traceable to the integration of certain monopoly and nonmonopoly functions in the same organization. But the question now is whether the incumbent has earned these economies through its own efforts and, if not, whether the incumbent should be permitted sole access to them. What Dr. Harris and other witnesses, such as Dr. Kahn and Dr. Landon, fail to address, is that the reason these economies presently are controlled by their clients, and not by others, <u>is</u> the result of government protection.

The implementation of competition cannot favor any particular competitor. To assign the economies resulting from a history of government protection to the historic beneficiary of that protection, for no reason, is inconsistent with that principle.

Dr. Harris thus misuses the phrase "command and control regime" when he attributes it to those seeking to deal with this unearned economies. Harris Rebuttal at 3. When the government singles out a particular competitor for unique benefits, and excludes all others from those benefits, the distortion cannot be justified. It is neither "command and control" nor "prejudging" nor "overregulation" to take affirmative action to eliminate such artificial preferences.

Q.6 Dr. Kahn argues that a policy of limiting the access of utilities and their affiliates to existing economies of scale and scope should have as a basis "the facts of these several markets, that competition is unlikely otherwise to be able to develop or survive, which requires in turn a factual examination of whether rivals of the utility companies are likely to be in a situation to exploit similar economies -- of scale, scope, specialization, experience and reputation." Rebuttal at 3. What is your response?

A.6 Dr. Kahn's position is very similar to mine, and contrasts starkly with the position of other utility witnesses, who argue for unconditional, automatic and permanent access to all the benefits accruing from their history of government protection from competition, regardless of the facts. The commonality between Dr. Kahn's position and mine is that reality matters. I argue that government-granted benefits which are unearned, the retention of which impairs competition, should be removed.

The key difference between my position and Dr. Kahn's is over who carries the burden of proof. I argue that the difficulty of creating competition in highly concentrated markets where the small consumer will not initially be an active, incisive and analytical shopper, should caution the regulator against automatically granting unearned advantages to the incumbent. Dr. Kahn instead would place the burden on the proponent of curtailing unearned market advantage.

Q.7 In response to your argument that the utilities are not necessarily "entitled to the economies of scale and scope" associated with their historic monopoly status, Dr. Kahn argues that utilities should be allowed to retain the "difference between the incremental costs and the revenues from any sales they develop in unregulated markets" so that they can apply this excess "toward the recovery of costs that would otherwise be stranded." Rebuttal at 8. What is your response?

A.7 Dr. Kahn's reasoning, as set forth in this passage, appears to be in two steps. First, he asserts that the Legislature has assumed that the utilities would derive revenues in excess of costs from sales into competitive markets, and that this assumption is reflected in the Legislature's decision to cap lost revenues recovery at stated levels below 100% recovery. From this platform, he appears to argue that the Legislature intended that the utilities should have unrestricted use of their economies of scale.

Assuming without conceding that Dr. Kahn's interpretation of the Illinois statute is correct, his second point does not follow from his first. That is, even if the Legislature intended to allow utilities to keep all revenues from competitive sales in return for absorbing some portion of lost revenues, that intention says nothing about the appropriate treatment of economies of scope and scale.

There are two distinct issues.

1. What level of competitive sales should be assumed in determining the level of stranded cost recovery which utilities should receive?

2. When utilities or affiliates enter competitive markets, what advantages attributable to historic protection from competition should remain with the utilities?

The first question, in Dr. Kahn's view, has been determined by the Legislature. The second question is the one at issue here. There is no reason why a particular answer to Question 1 produces a particular answer to Question 2. There is no inconsistency in, and no apparent legislative intent contrary to, saying that --

1. Because we think utilities will be able to earn $50 million in profits from competitive sales, we will discount their stranded cost recovery by that amount;

while also saying

2. In seeking to make competitive sales, the utilities should not have any advantages accruing by virtue of their history of protection from competition.

That the Legislature put the utilities at risk with respect to some portion of stranded cost recovery does not mean that the Legislature intended to grant the utility all possible means of reducing that risk, including means that would impair the effective competition the Legislature intended to promote. Yet that is the result of Dr. Kahn's reasoning. I see nothing in the text of the statute, or in logic, supporting this assumption.

Q.8 What is your response to Dr. Murphy's criticism of your position on economies of scope and scale?

A.8 Dr. Murphy's suggestion that I favor "wasting" the valuable resources associated with economies of scope and scale, Murphy Rebuttal at 46, is inaccurate. I wish to see that resource exploited by the most efficient producer, not the one that happens to be the incumbent. What is wasteful is Dr. Murphy's approach, to allow a government-appointed entity to be the sole entity exploiting economies arising from historical government protection, to the exclusion of others who might do so more efficiently, where the government-appointed entity occupies this favored position not because of its own efficiencies but because it is the government-appointed entity.

Q.9 ComEd Witness Landon appears to interpret your testimony to say that you would "strip" Illinois utilities of their economies of scale and scope while allowing their non-Illinois competitors unlimited use of their economies of scale and scope. Rebuttal at 10. Is his interpretation correct?

A.9 No. I made clear that the only economies of scale or scope to which a utility should not have exclusive access are those which are attributable to the utility's history of government protection, and which are not readily duplicable by a competitor. I also indicated that the Commission should stand ready to make these economies available to all competitors. Dr. Landon says that if we do not give the economies to the incumbent alone, we must deprive the consumers of the economies entirely. He presents a false dichotomy. I offer the Commission a third option: preserve and maximize the economies for the consumers but making them available to all competitors where practical.

3. Joint Advertising and Marketing

Q.10 ComEd Witness Landon states "there is no reason to believe that joint advertising and marketing by a utility and its affiliate will provide a competitively significant marketing advantage." Rebuttal at 11. What is your response?

A.10 He contradicts himself three sentences later: "[A]llowing the utility and its affiliate to share these activities will result in cost savings due to economies of scale and scope that benefit the consumer."

Advertising is intended to attract the consumer. Advertising jointly means attracting the customer at a lower cost. That is the essence of a competitive advantage. Businesses do not normally invest in advertising unless they think it will provide a competitive advantage. It is true, as Dr. Landon indicates, that the affiliate's competitors can advertise also. But there should be no dispute that an incumbent's ability to advertise can create an entry barrier. See, e.g. General Foods Corp. v. Federal Trade Comm'n, 386

F.2d 936, 945 (3rd Cir. 1967) (finding that General Foods was able to advertise and promote S.O.S. less expensively than the pre-merger S.O.S. Co., especially because of the television discounts available to General Foods); Southern Pacific Communications Co. v. American Tel. & Tel. Co., 740 F. 2d 980, 1002 (D.C. Cir. 1984), (extensive image advertising expenditures constituted a barrier to entry); Davis v. Southern Bell Tel. & Tel. Co., 1993 U.S. Dist Lexis 2003, *15 (S.D. Fla. 1993) (the need for "corrective advertising" by newcomers acts as a market entry barrier). It is the potential existence of that entry barrier, and its possible effect on the development of effective competition, that should cause regulatory concern.

4. Interaffiliate Transactions

Q.11 Several witnesses attribute to you the position that when a utility transfers resources to its affiliate, the pricing rule should be the market or fully distributed cost, whichever is higher. See, e.g., Kahn Rebuttal at 23. Is this attribution correct?

A.11 No. My testimony nowhere adopts this rule. My testimony states that in sales from the utility to an affiliate, the market price should be used. See my Direct Testimony (Answers #15 and #17). The question and first phrase of the answer in #18 does refer, incorrectly, to a "higher-of-market-or-book-rule." Only a market price rule is practical, because if the utility sought to charge more than market the affiliate would buy elsewhere. Dr. Gordon recognizes that I have taken this position. Rebuttal at 12.

Q.12 ComEd Witness Berdelle argues against the use of a special account to record costs and revenues associated with interaffiliate transactions. Rebuttal at 15. What is your response?

A.12 Mr. Berdelle does not address the concern raised in my Direct Testimony, that reliance on periodically established revenue requirements would not work, because "projections of the volume of interaffiliate transactions, and the market price that would prevail for the good or service transferred in the transaction, are likely to be speculative." Direct Testimony Answer #21. Furthermore, I do not understand his point that the approach would "leav[e] the utility with potentially unrecovered cost." If the utility wants to devote some part of its costs to competitive ventures, it should be at risk of "potentially unrecovered costs." That is what competition is about. Otherwise, the utility is able to enter competitive markets with cost recovery assured by monopoly customers. Such a policy would be protection of a particular competitor rather than promotion of competition.

5. Distribution Utility Competing in Its Own Service Territory

Q.13 Dr. Kahn takes issue with your approach to the issue of the distribution monopoly competing as a retail seller of electricity in it own territory. Rebuttal at 13. What is your response?

A.13 I do not share his apparent indifference to whether markets in fact move from the monopolistic to the competitive. In response to the Commission's question as to whether the distribution monopoly should be permitted to compete at retail, I responded by listing the theoretical options -- which include no entry, unlimited entry, and entry limited to a particular market share. I then stated that "[t]he proper treatment should be based on the facts." I did not opt for a particular solution, but I recommended that the Commission be prepared to adopt whatever solution was consistent with the facts. As I believe Dr. Kahn acknowledged in the context of economies of scale and scope, we should base our regulatory decisions on facts, not unproven assumptions or hopes.

6. Corporate Name

Q.14 Nicor Gas Witness Behrens argues against compensation to monopoly customers for a utility affiliate's use of the utility's corporate name on the grounds that the customer does not "own" this asset, Rebuttal at 7, and because the name has been funded with shareholder funds, <u>id.</u> at 10. ComEd Witness Blake makes a similar point. Rebuttal at 19. What is your response?

A.14 The issue is not ownership, but the relationship of risk and reward. Ratepayers do not own the distribution facilities either; but in return for bearing distribution costs, they receive something in return: access to the distribution facilities. Where the value of a corporate name is attributable in part to ratepayer contributions, the ratepayers should receive part of the benefit.

Mr. Behrens misunderstands my argument when he states that "in Illinois the expenses of promoting a utility's name are clearly not recovered through a utility's rates." Rebuttal at 11. The argument for compensation is based not on the fact that customers have supported the cost of promotion, but that they have supported the entire company during its long period of government protection from competition, and the company's present reputation in the community, and its marketing strength, is attributable in part to that history of ratepayer support. In addition, the notion that no ratepayer dollars have supported the utility's name promotion is not credible. I assume Mr. Behrens is not saying that the costs of thousands of employee uniforms bearing the utility's name, the insignias on the bills sent to each of hundreds of thousands of customers 12 times a year for decades, and the sign on the company's corporate headquarters, have been excluded from rates.

Another example of this misunderstanding appears in the Rebuttal Testimony of CILCO Witness Ogden (at 2). In response to my argument that when captive utility customers have been required to pay for certain utility costs, symmetry requires that they receive compensating benefits, Mr. Ogden states: "Any business entity, if it is to remain financially viable, must recover its costs of doing business in the prices its customers pay. The fact that customers provide revenues to a company certainly does not give those customers ownership rights in the company's assets and resources...." Mr. Ogden analogizes incorrectly between a competitive company and a regulated utility. With a competitive company, the customer has no obligation to pay the company's price; the customer can go elsewhere. With a utility company, the customer is likely to be the guarantor of all prudent costs incurred by the utility. It is that guarantor relationship, not the mere fact that the customer pays for the service, that makes the utility customer different.

Q.15 Mr. Behrens argues that those seeking to limit the utility affiliate's use of the corporate name ignore "the possibility of a negative connotation that many consumers may draw from their past dealings." Rebuttal at 10. What is your response?

A.15 If the effect of maintaining the corporate name was negative on balance, I would expect the utility and its affiliates not to use the name. My assumption is that if a utility or affiliate actively chooses to maintain its name, then the utility or affiliate has decided that the effect would be positive. Under Mr. Behrens' approach, the utility has full freedom to drop its name when it has a negative connotation, but to exploit the name without limit when it has a positive connotation. This result is asymmetrical.

Q.16 Mr. Behrens argues that to limit use of the corporate name is to limit information available to the consumer. Rebuttal at 10. What is your response?

A.16 I agree in part. The consumer, reading advertising alone, might not be able to determine whether an entity is affiliated with the incumbent. But he or she also could determine the information by inquiring. If the fact of affiliation was particularly important to a customer, for either negative or positive reasons, a simple inquiry would produce the information. I am not proposing that any company be forbidden from releasing this information.

I readily acknowledge that a decision to limit use of the corporate name is not a cost-free decision. But Mr. Behrens and others imply that because the decision involves some costs, it necessarily is the wrong decision. Instead, it is a matter of balance. The potentially distorting effects of large-scale advertising which takes advantage of the utility's incumbent status, a status supported by a long history of government protection, are large relative to the minor cost which those customers who value information about affiliation will have to incur to obtain it.

Q.17 ComEd Witness Landon defends the use of the corporate name in part by arguing that the value of incumbency is not anticompetitive. Rebuttal at 13. What is your response?

A.17 I readily agree that the value of incumbency is not inherently anticompetitive. It is in part the desire to attain the competitive advantages of incumbency that draws newcomers into a market and induces them to compete vigorously, to the benefit of all consumers. But Dr. Landon commits the frequent error of applying competitive market concepts to a market which historically has not been competitive. The utility's advantages of incumbency were achieved in part not because of its own competitive skill and risk, but because of government exclusion of all other competitors. The utility is not just like any incumbent in a competitive market.

To suggest that those who express concern about the utility's status view incumbency as anticompetitive misses and obscures this point. The point is that a transition from a government-protected monopoly market to an effectively competitive market requires not the passive acceptance and continuation of all advantages gained from the past, but instead a careful separation of those advantages gained through competitive effort from those gained from government protection. To fail to do so is to protect one competitor to the disadvantage of competition.

Q.18 In response to your contention that the utility's use of its name "provides the utility with a competitive advantage that is not available to non-affiliates," Dr. Kahn says that Enron and Honeywell have the same opportunities to use their names. Rebuttal at 17. What is your response?

A.18 Dr. Kahn's examples support my point. Enron and Honeywell are not known in Illinois for providing retail electric service. They will have to invest many new dollars to establish that reputation. The incumbent utility need not do so to the same extent, because it is, literally, a household name. The utility is also the only one among the new competitors that has actually provided the to-be-competitive service, due to prior government decision to exclude competitors. That difference in cost, between the incumbent and the newcomer to Illinois, is an entry barrier that regulators must address.

Dr. Kahn also uses the Enron and Honeywell examples to support his view that the utility should not have to pay a royalty to its customers when using the name in other markets. The analogy to nonutilities is not appropriate. Unlike utilities, they did not have the secure cost recovery from captive customers. Every expenditure made by a nonutility company is at risk, and is subject to market discipline for that reason. The utility has not borne this type of risk.

7. Monthly Billing

Q.19 ComEd Witness Landon defends joint billing by the utility and the affiliate on the grounds that billing is not an "essential service"; <u>i.e.</u>, because other entrants can "assume the billing functions if they wish." Rebuttal at 12. What is your response?

A.19 Dr. Landon incorrectly assumes, implicitly, that if an incumbent's advantage is not attributable to a bottleneck or essential facility, the advantage has no adverse effect on the development of effective competition. I believe a similar error lies within ComEd Witness Blake's view that certain witnesses incorrectly "use the terms 'utility' and 'affiliates' ... as if all affiliates use the 'essential facility' transmission and distribution system...."

There can be an entry barrier without there being an essential or bottleneck facility. To ignore all entry barriers other than bottleneck facilities is to be indifferent to the effectiveness of competition, including the discipline that non-incumbents can bring to the market. The entire reason for introducing competition is to determine if customer welfare will improve by virtue of the introduction of non-incumbents who serve the market efficiently, at prices and quality comparable to or better than the status quo. Any entry barrier that is unearned because it flows from a history of government preference impairs this effort. If the entry barrier is attributable to an incumbent characteristic, such as its historic status, then it cannot be attributable to the incumbent's own skills and efforts. In this situation one cannot be sure that the resulting market shares are truly the result of competitive forces.

8. Customer Information

Q.20 ComEd Witness Blake criticizes the requirement that a utility share information with its competitors. Rebuttal at 20-21. What is your response?

A.20 Dr. Blake incorrectly assumes that under the requirement, the utility would have to share competitive information developed as such, as not flowing from its role as customer-supported transmission and distribution monopoly. The requirement assumes that competitive activities would be taking place in a utility affiliate, not within the utility corporation. Similarly, the concern expressed by ComEd Witness Millard, that I proposed to make available to competitors "marketing research data [which] is not developed or maintained as part of the T&D system" (Rebuttal at 15), is misplaced. If data are developed using shareholder funds, and those costs are not recovered from monopoly customers, the information need not be shared.

9. Employee Transfers

Q.21 Do ComEd Witness Landon and EEI Witness Gordon describe your position on employee sharing accurately?

A.21 No. Dr. Landon's question (p.12) states that I "recommend that any utility employees be prohibited from working for the utility's affiliate." I did not testify for a per se prohibition. In my Direct Testimony, in response to Question 32, I stated:

> The Commission should not permit unlimited crossing between the utility and the nonutility affiliate. Such crossing would encourage the training of employees on the ratepayer dollar, their transfer to the nonregulated affiliate for temporary employ, and then their transfer back to the utility to undertake more training and to ensure their salaries are fully recovered. This would give the local utility an advantage over its nonutility competitors, and would put utility monopoly ratepayers in a position of bearing costs of competitive operations.

For similar reasons, Dr. Gordon's statement (Rebuttal at 23) that I argue against "the transfer of employees" is inaccurate. I focused only "unlimited crossing" between the utility and its affiliates.

Conclusion

Q.22 Does this complete your surrebuttal testimony?

A.22 Yes.