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TESTIMONY FOR THE RECORD ON ELECTRICITY COMPETITION AND FEDERAL AND STATE ROLES

BEFORE THE ENERGY AND POWER SUBCOMMITTEE OF THE HOUSE COMMERCE COMMITTEE

SUBMITTED BY BOB KEINGSTEIN, PRESIDENT AIR CONDITIONING CONTRACTOR OF AMERICA

MARCH 18, 1999

Chairman Barton and members of the Energy and Power Subcommittee, thank you for holding this hearing which we trust will be the first of several during the 106th Congress which addresses the issue of electricity utility deregulation. In addition to being president of the Air Conditioning Contractors of America this year, I'm Senior Vice President of AFGO Mechanical Services in Woodside, NY, an independent HVAC contracting firm.

At the outset, let me state that we in ACCA wholeheartedly support competition in the utility field. We, too, are consumers of electricity. Where we are concerned, however, is how the unintended consequences of this competition are affecting thousands of small business across the land.

The advent of utility deregulation has dramatically spurred the entry of utilities into business ventures traditionally served by small businesses, many of which are family owned and operated. These ventures fall outside the role of traditional utility regulation. As a result, utilities and their affiliates inhabit a mixed world of regulated and unregulated economies where it is all too easy to shift the cost of the unregulated, competitive venture onto the regulated utility operation with its guaranteed coverage of costs and protected rate of return.

This not only results in inefficient uses of ratepayer money, but in the long run, higher costs for energy.

We in the heating, ventilation, air conditioning and refrigeration market are experiencing this phenomenon on a daily basis for we now compete with the affiliates of many utilities. Those who work in plumbing, electric work, home security, cablevision,

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the Internet, remodeling and even maid service, are experiencing the same competitive pressure as the utilities seek to bundle as many services as they can in order to bond with their customer in preparation for the impact of true competition. For some, it's a survival strategy. For others, a hoped for new revenue stream.

By virtue of their current monopoly status, utilities enjoy substantial advantages over their prospective competitors in customer and marketing information, "name brand" recognition, equipment, tools, shared employees and other resources paid for out of the ratebase. Many of these preexisting monopolies are increasingly using these ratepayer-based assets as a "transition strategy" to leverage their market power through the use of tangible and intangible assets, paid for by the ratepayer, to increase their market share in related markets through unregulated affiliates. This is cross-subsidization.

Because captive utility customers deal with the local utility for their power needs, the utility is in a position to abuse these customer contacts by steering business away from competitors and towards their affiliates. Obviously, these discriminatory actions give them an unfair economic advantage over competitors.

We aren't against competition as long as it is fair. As other free-market advocates, we don't accept or seek subsidies. Subsidies distort the concept of a free market and threaten the end goals of electric utility deregulation - lower prices and choice. Consequently, we don't think that those affiliates who compete against us and others should be subsidized...and this is happening.

Quite frankly, small business such as mine cannot compete for very long against a utility affiliate that is subsidized by ratepayers.

We aren't the only ones to raise these storm warnings. In a study released in February 1998, the National Regulatory Research Institute, research arm of the National Regulatory Utility Commissioners, warned that in a deregulated, competitive market, utilities can gain the upper hand over competitors by passing through undetected and unauthorized costs to their captive customers. As a result, NARUC approved a set of rules at their 1998 winter meeting to guide utility commissioners in trying to prevent cross-subsidization and other abuses. The staff of the FTC issued similar warnings in testimony before hearings held by several state Public Utility Commissions, most recently in Texas, as did the Office of Advocacy of the U.S. SBA over ten years ago.

Among the detrimental effects of cross-subsidies are:

- Harm to Competition: Cross-subsidization creates inefficiencies that retard true competition both in the market for retail electricity and in adjacent energy service markets such as HVACR contracting. Potential new entrants in the market for retail sales of electric power are harmed because ratepayer-based assets are being used to support unregulated affiliates whose services are then "bundled" with those of the incumbent utility to discourage new entrants.

  Competitors in adjacent energy services markets are also unfairly disadvantaged as these cross-subsidies allow the affiliates to make uneconomic decisions. Because the affiliate's costs are lower than other market participants or potential new competitors, the affiliates can use this cost advantage to undercut bids and drive out incumbent competitors or prevent new entries.

- Harm to Consumers: While cross-subsidies may initially allow the utilities' unregulated affiliates to offer a lower cost of service, prices will invariably rise in that market once existing competitors have been driven out. The threat of such price undercutting will be sufficient to discourage new entries into the market.

- Harm to Small Business: Small and medium-sized businesses will be disproportionately harmed by cross-subsidization. Adjacent energy service markets, such as HVACR contracting, are dominated by small business. While the competition in these markets is vigorous, these small businesses will be the first to be eliminated by the below cost pricing allowed by cross-subsidization.

ACCA strongly supports definitive language prohibiting cross-subsidization in any federal legislation deregulating the retail sale of electric power. Such legislation must include a definition of cross-subsidization sufficient to capture transfers of both tangible assets (i.e. shared tools and equipment) as well as intangible assets (i.e. shared logos and trademarks). At the very least, ACCA believes that federal legislation must condemn cross-subsidization as contrary to the goal of fair and open competition, and provide specific examples of inefficient cross-subsidies to guide state commissions in their consideration of the many issues surrounding electric deregulation.

In addition, there is a jurisdictional issue. Federal legislation is needed to help state regulators and legislators do their job. Once PUHCA, and possibly PURPA, are repealed, the question of who has the authority to regulate multi-state holding companies must be faced. As many other industries, the electric utility industry is undergoing a dramatic consolidation effort. In three to five years, large regional and national companies may meet most of our utility needs. The state-based utility that we know may be on the endangered list.

Since the states don't have statutory authority to regulate multi-state holding companies, as a minimum, they need open access to the books and records of holding companies as well as sufficient enforcement tools to make them abide by the regulations.

It should be noted that we aren't asking for anything new. Congress prohibited cross-subsidization in the Telecom Act of 1996, specifically focusing on the home alarm industry and telephone directory publishing. This precedent is applicable to electricity deregulation.

If Congress addresses these problems, then the long-term goals of a competitive market for electric power – lower prices and choice – will be achieved.

#

ACCA is a national, bi-partisan, not-profit organization with 68 state and local chapters and a membership of approximately 9,000 heating, ventilation, air conditioning, and refrigeration contractors, manufacturers, designers, suppliers and educators.

ATTACHMENT A

TOOLS AND CONDITIONS NEEDED TO PREVENT COST SHIFTING AND CROSS SUBSIDIZATION BETWEEN REGULATED AND NON-REGULATED AFFILIATES

Adopted by the National Association of Regulatory Utility Commissioners
at its 1998 Winter Committee Meetings

TOOLS AND CONDITIONS NEEDED TO PREVENT COST SHIFTING AND CROSS SUBSIDIZATION BETWEEN REGULATED AND NON-REGULATED AFFILIATES:

Purpose: A utility may wish to provide competitive services through the regulated utility as either a regulated or non-regulated service or through a non-regulated subsidiary or affiliate. It is important that the law allow the Federal and State Commissions to employ the tools necessary to prevent cost shifting and to ensure the competitiveness in unregulated markets is not adversely affected by interactions with regulated markets. This cannot be guaranteed if the Commission must seek an agreement from a non-regulated subsidiary or affiliate in order to employ such tools.

A). Cost shifting between regulated and non-regulated affiliates shall be prevented through the following means:

1). Federal Access to Books and Records
The appropriate Federal Commission shall have access to all books, accounts and records of all non-regulated affiliates of a public utility.

2). State Access to Books and Records and Personnel capable of responding to inquiry from regulators
A State Commission may examine the books, accounts, memoranda, contracts and records and have access to personnel capable of responding to inquiries of:

a). a public utility subject to its regulatory authority under state law;

b). any non-regulated company, which is an affiliate, parent or subsidiary of the state-regulated public utility company selling or receiving products or services to and/or from the state-regulated public utility;

c). any non-regulated company which is an affiliate, parent or subsidiary of the state-regulated public utility company to determine if direct or indirect transactions have taken place between the non-regulated company and the state-regulated public utility. Where a State Commission accesses the books

and records of a non-regulated affiliate company, the State Commission shall not publicly disclose trade secrets or sensitive commercial information;

d). any Service Companies selling or receiving products or services to and/or from the state-regulated public utility;

e). any Service Companies to determine if direct or indirect transactions have taken place between the Service Company and the state-regulated public utility. Where a State Commission accesses the books and records of a non-regulated affiliate company, the State Commission shall not publicly disclose trade secrets or sensitive commercial information.

3). "Ordinary Course of Business" Contracts
The term "ordinary course of business", as it applies to contracts between affiliates that need not be approved by the Federal and State Commissions, should be clarified. It should be clarified that the transactions between the utility and the affiliate are for transactions which are customary for conducting regular utility business and that the goods or services being sold are typical for business transactions between a utility and another entity.

4). Separation plans or operating agreements

a). A separation plan or operating agreement shall be filed with and approved by the Federal and State Commissions which ensures, to the maximum extent practicable, the operations, resources, and employees involved in the provision or marketing of non-regulated services, and the books and records associated with those services shall be separate from the operations, resources, and employees involved in the provision of state-regulated services and the books and records associated with the state-regulated services.

b). Item 4).a). will apply even if the public utility company demonstrates a structural or physical separation of the regulated and non-regulated services.

c). Transactions between regulated and non-regulated service providers within the public utility company should be recorded in separate subaccounts to facilitate auditing by Federal and State Commission Staff.

5). Allocation of Costs

a). Public Utility companies should develop and maintain written guidelines for the methods used to allocate the costs of conducting and charging for or allocating transactions between regulated and non-regulated service providers within the public utility company. Such guidelines should be filed with and approved by the Federal and State Commissions.

b). Revenues received by state-regulated companies for services provided to non-regulated affiliates shall be recorded in "operating revenue" accounts, if corresponding costs were recorded in "operating expense" accounts.

c). Costs charged by regulated sectors to non-regulated sectors as affiliate transactions should be at fully allocated costs. In the case of a charge for facilities, the fully allocated costs should include at a minimum property taxes, depreciation expenses, maintenance expenses and a rate of return on the investment in the asset. In the case of personnel, the fully allocated costs should include all employee benefits, payroll taxes, insurance, pension and post retirement benefits other than pension.

d). In cases where costs cannot be charged directly and it is necessary to use an allocation formula, revenues should not be a factor in the formula unless the utility can prove a direct cause causation with the revenues. Generally, revenue based allocations are not based on cost causation or utilization of resources.

6). Audit Authority for State Commissions

The State Commission may order an audit to be performed no more frequently than on an annual basis, of all matters deemed relevant by the selected auditor that reasonably relate to retail rates.

a). The public utility company and the affiliated or associated companies involved in non-regulated services shall cooperate fully with all requests necessary to perform the audit.

b). In the event the State ordered audit is performed by an independent auditor, the public utility company and its affiliates shall bear all costs of having the audit performed.

c). The audit report shall be provided to the State Commission not later than 6 months after the onset of the audit, and provided to the public utility company not later than 60 days thereafter.

d). Transactions between regulated and non-regulated sectors should be subjected to regular internal audits by the utility. These audits should test compliance with all Commission Orders, compliance with proper accounting procedures and compliance with the written guidelines. The audits should included written reports of conclusions which, along with associated workpapers, are to be made available to the Commission Staff for review.

B). Tools to protect competitiveness and avoid subsidized or predatory pricing in unregulated markets:

Purpose:
The same tools that the Federal and State Commissions need to prevent cost shifting also protect competitiveness of unregulated markets because they also prevent the non-regulated sectors from benefiting from lower costs than their competitors that result from shifting costs to regulated sectors.

In addition, non-regulated sectors or the regulated utility providing competitive services can benefit unfairly from free access to customer records of the regulated sectors. The non-regulated sectors, as well as the regulated public utility company,

should be prohibited from unfair practices.

1). The regulated public utility company and its affiliates shall follow a code of conduct, filed with Federal and State Commissions, which governs the company's activities in a competitive market and the sharing of information, data bases and resources between its employees involved in the marketing or provision of non-regulated services and those employees involved in the provision of regulated services.

2). The public utility company and its affiliates shall maintain records subject to Federal and State Commission review, which document compliance with the code of conduct.

3). The Code of Conduct shall include, at a minimum, the following for any affiliate, including Service Companies engaged in competitive services:

a). affiliate shall operate independently from the Utility company;

b). affiliate shall maintain books, records, and accounts in the manner prescribed by the appropriate Federal and State Commissions which shall be separate from the books, records, and accounts maintained by the Utility company;

c). affiliate shall have separate officers, directors, and employees from the Utility company;

d). affiliate may not obtain credit under any arrangement that would permit a creditor, upon default, to have recourse to the assets of the Utility company; and

e). affiliate shall conduct all transactions with the Utility on an arm's length basis with any such transactions reduced to writing and available for public inspection.

4). The Code of Conduct should include, at a minimum, the following for the Utility who has an affiliate engaged in competitive services:

a). Utility may not discriminate between an affiliate and any other entity in the provision or procurement of goods, services, facilities, and information, or in the establishment of standards;

b). Utility shall account for all transactions with an affiliate in accordance with generally accepted accounting principles or accounting principles approved by the appropriate Federal and State Commissions; and

c). Utility shall not carry out any promotion, marketing, sales, advertising or research and development for or in conjunction with an affiliate.

NAFC Proposed Language

Comparable Telecommunications Act Language

Competitive Energy Service Markets

(a) **In General** - Notwithstanding any law to the contrary, any public utility company, subsidiary company, affiliate, or associate company of a public-utility company, may engage in, directly or indirectly, any activity whatsoever, wherever located, necessary or appropriate to the provision of energy services as described herein, subject to the provisions of this Act and the jurisdiction of the state regulatory commissions and the Federal Energy Regulatory Commission.

1. PROHIBITION OF SUBSIDIZATION

(b) **Prohibition of Cross-Subsidization -** The state regulatory authorities shall exercise their jurisdiction pursuant to this Act and to the extent otherwise authorized under applicable law with respect to prohibiting the cross subsidization of the activities described in subsection (a) by a public-utility company in its rates for electric or gas services, and (2) to make appropriate rate adjustments, disallow any cost recovery, or make any determination regarding the allocation of charges, to eliminate the effects of any cross-subsidization, improper cost shifting or to prohibit any unjust, unreasonable, preferential or discriminatory rate or act in the provision of energy services.

1. PROHIBITION OF SUBSIDIZATION

New section 260 of the 1934 Act [47 USC 260(1)] prohibits subsidization of telemessaging services from telephone exchange services:

"(a) NONDISCRIMINATION SAFEGUARDS.--Any local exchange carrier subject to the requirements of section 251(c) that provides telemessaging service--

"(1) shall not subsidize its telemessaging service directly or indirectly from its telephone exchange service or its exchange access.

Another prohibition on subsidization appears in new section 275 (b)(2) [47 USC 275(b)(2)] with respect to alarm monitoring services provided by BOC's That provision states that a BOC shall: *"(2) not subsidize its alarm monitoring services either directly or indirectly from telephone exchange service operations."*

Similar language prohibiting subsidization appears in new section 276(a)(1) of the 1934 Act [47 USC 276(a)(1)]:

(a) NONDISCRIMINATION SAFEGUARDS.--After the effective date of the rules prescribed pursuant to subsection (b), any Bell operating company that provides payphone service--

"(1) shall not subsidize its payphone service directly or indirectly from its telephone exchange service operations or its exchange access operations.

2. SEPARATE OPERATIONS AND TRANSACTIONAL REQUIREMENTS

(c) **Structural and Transactional Requirements. -** Any activity authorized under subsection (a) shall only be conducted under a subsidiary company, affiliate, or associate company which is operationally separate from any public utility company engaged in the generation, transmission, or distribution of electric power or gas.

(A) Such separate company, affiliate, or associate company ---

2. SEPARATE OPERATIONS AND TRANSACTIONAL REQUIREMENTS

New section 272 of the 1934 Act (47 USC 272) establishes requirements for separate affiliates for competitive activities. That section reads:

"(a) SEPARATE AFFILIATE REQUIRED FOR COMPETITIVE ACTIVITIES.--

"(1) IN GENERAL.--A Bell operating company (including any affiliate) which is a local exchange carrier that is subject to the requirements of section 251(c) may not provide any service described in paragraph (2) unless it provides that service through one or more affiliates that--

(1) shall maintain books, records, and accounts in the manner prescribed by the state public utility regulatory authority which shall be separate from the books, records, and accounts maintained by the public utility company of which it is an associate company and any other subsidiary or affiliate of such public utility company, shall maintain proper internal cost-allocation procedures as prescribed by the such authority;

(2) shall have separate officers, directors, and employees from the public utility company;

(3) may not obtain credit under any arrangement that would permit a creditor, upon default, to have recourse to the assets of a public utility company; and

(4) shall conduct all transactions with the public utility company of which it is an associate on an arm's length basis with any such transactions reduced to writing and available for public inspection.

"(A) are separate from any operating company entity that is subject to the requirements of section 251(c); and
"(B) meet the requirements of subsection (b).

In addition, sec. 272(b) [47 USC 272(b)] established the following structural and transactional requirements:

"(b) STRUCTURAL AND TRANSACTIONAL REQUIREMENTS.--The separate affiliate required by this section--

"(1) shall operate independently from the Bell operating company;

"(2) shall maintain books, records, and accounts in the manner prescribed by the Commission which shall be separate from the books, records, and accounts maintained by the Bell operating company of which it is an affiliate;

"(3) shall have separate officers, directors, and employees from the Bell operating company of which it is an affiliate;

"(4) may not obtain credit under any arrangement that would permit a creditor, upon default, to have recourse to the assets of the Bell operating company; and

"(5) shall conduct all transactions with the Bell operating company of which it is an affiliate on an arm's length basis with any such transactions reduced to writing and available for public inspection.

Similar provisions are contained elsewhere in the Telecom Act. For example, separation is required under new setion 273(d)(3)(A) and (B) of the 1934 Act [47 USC 273(d)(3)] dealing with manufacturing by BOCs:

"(3) MANUFACTURING SAFEGUARDS.--*(A) Except as prohibited in paragraph (1), and subject to paragraph (6), any entity which certifies telecommunications equipment or customer premises equipment manufactured by an unaffiliated entity shall only manufacture a particular class of telecommunications equipment or customer premises equipment for which it is undertaking or has undertaken, during the previous 18 months, certification activity for such class of equipment through a separate affiliate.*

"(B) Such separate affiliate shall--

"(i) maintain books, records, and accounts separate from those of the entity that certifies such equipment, consistent with generally acceptable accounting principles;

"(ii) not engage in any joint manufacturing activities with such entity; and

"(iii) have segregated facilities and separate employees with such entity.

New section 274 of the 1934 Act [47 USC 274 (b), et seq.] also requires separation with respect to BOC affiliates engaged in electronic publishing. The relevant portion of that section reads:

"SEC. 274. ELECTRONIC PUBLISHING BY BELL OPERATING COMPANIES.

"(a) LIMITATIONS.--No Bell operating company or any affiliate may engage in the provision of electronic publishing that is disseminated by means of such Bell operating company's or any of its affiliates' basic telephone service, except that nothing in this section shall prohibit a separated affiliate or electronic publishing joint venture operated in

accordance with this section from engaging in the provision of electronic publishing.

"(b) SEPARATED AFFILIATE OR ELECTRONIC PUBLISHING JOINT VENTURE REQUIREMENTS.--A separated affiliate or electronic publishing joint venture shall be operated independently from the Bell operating company. Such separated affiliate or joint venture and the Bell operating company with which it is affiliated shall--

"(1) maintain separate books, records, and accounts and prepare separate financial statements;

"(2) not incur debt in a manner that would permit a creditor of the separated affiliate or joint venture upon default to have recourse to the assets of the Bell operating company;

"(3) carry out transactions (A) in a manner consistent with such independence, (B) pursuant to written contracts or tariffs that are filed with the Commission and made publicly available, and (C) in a manner that is auditable in accordance with generally accepted auditing standards;

"(4) value any assets that are transferred directly or indirectly from the Bell operating company to a separated affiliate or joint venture, and record any transactions by which such assets are transferred, in accordance with such regulations as may be prescribed by the Commission or a State commission to prevent improper cross subsidies;

"(5) between a separated affiliate and a Bell operating company--

"(A) have no officers, directors, and employees in common after the effective date of this section; and

"(B) own no property in common;

"(6) not use for the marketing of any product or service of the separated affiliate or joint venture, the name, trademarks, or service marks of an existing Bell operating company except for names, trademarks, or service marks that are owned by the entity that owns or controls the Bell operating company;

"(7) not permit the Bell operating company--

"(A) to perform hiring or training of personnel on behalf of a separated affiliate;

"(B) to perform the purchasing, installation, or maintenance of equipment on behalf of a separated affiliate, except for telephone service that it provides under tariff or contract subject to the provisions of this section; or

"(C) to perform research and development on behalf of a separated affiliate;

"(8) each have performed annually a compliance review--

"(A) that is conducted by an independent entity for the purpose of determining compliance during the preceding calendar year with any provision of this section; and

"(B) the results of which are maintained by the separated affiliate or joint venture and the Bell operating company for a period of 5 years subject to review by any lawful authority; and

"(9) within 90 days of receiving a review described in paragraph (8), file a report of any exceptions and corrective action with the Commission and allow any person to inspect

and copy such report subject to reasonable safeguards to protect any proprietary information contained in such report from being used for purposes other than to enforce or pursue remedies under this section.

3. NON-DISCRIMINATION

(d) **Fair Competition** - In its dealings with its subsidiary or affiliate as described in subsection (a) a public utility company -
(1) may not unfairly discriminate in favor of its subsidiaries or affiliates, and any other entity in the provision or procurement of, or access to, goods, services, facilities or systems, information, or in the establishment of standards, criteria, or in the referral of customers;
(2) may not provide information, including marketing leads, to such company, its subsidiaries or affiliates, unless such information is made available to other persons on reasonable and non-discriminatory terms and conditions; nor shall any utility provide, transfer, or permit the use of, or access to, tangible or intangible assets of the utility which were acquired with ratepayer funds unless such transfer, provision, or other use of such assets is fully compensated by the subsidiary, associate, or affiliated company;

3. NON-DISCRIMINATION

The potential of discriminatory abuse (i.e., the favoritism of affiliates over similarly situated competitors and the hoarding of essential information acquired via utility functions) was addressed in several provisions of the Telecom ct of 1996. Such provisions are set out at new section 260 (a)(2) with respect telemesaging services:"***(a) NONDISCRIMINATION SAFEGUARDS.***--*Any local exchange carrier subject to the requirements of section 251(c) that provides telemessaging service--*

"(2) shall not prefer or discriminate in favor of its telemessaging service operations in its provision of telecommunications services. "

Again, new section 272 (c) of the 1934 Act [47 USC 272(c)] provides:
*"**272 (c) NONDISCRIMINATION SAFEGUARDS.**--In its dealings with its affiliate described in subsection (a), a Bell operating company--*

"(1) may not discriminate between that company or affiliate and any other entity in the provision or procurement of goods, services, facilities, and information, or in the establishment of standards; and

"(2) shall account for all transactions with an affiliate described in subsection (a) in accordance with accounting principles designated or approved by the Commission.

Section 272(e) of the amended 1934 Act contains these provisions with respect to non-discrimination:
*"**(e) FULFILLMENT OF CERTAIN REQUESTS.**--A Bell operating company and an affiliate that is subject to the requirements of section 251(c)--*

"(1) shall fulfill any requests from an unaffiliated entity for telephone exchange service and exchange access within a period no longer than the period in which it provides such telephone exchange service and exchange access to itself or to its affiliates;

"(2) shall not provide any facilities, services, or information concerning its provision of exchange access to the affiliate described in subsection (a) unless such facilities, services, or information are made available to other providers of interLATA services in that market on the same terms and conditions. "

"(3) shall charge the affiliate described in subsection (a), or impute to itself (if using the access for its provision of its own services), an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service; and

"(4) may provide any interLATA or intraLATA facilities or services to its interLATA affiliate if such services or facilities are made available to all carriers at the same rates and on the same terms and conditions, and so long as the

costs are appropriately allocated."

New Section 273 of the 1934 [47 USC 273 (d)(3)(C)] Act similarly requires, with respect to manufacturing services:
"(C) Such entity that certifies such equipment shall--
"(i) not discriminate in favor of its manufacturing affiliate in the establishment of standards, generic requirements, or product certification."

Elsewhere in section 273, [47 USC 273 (e)(1)the Act provides: ***"(e) BELL OPERATING COMPANY EQUIPMENT PROCUREMENT AND SALES.--***
"(1) NONDISCRIMINATION STANDARDS FOR MANUFACTURING.--In the procurement or awarding of supply contracts for telecommunications equipment, a Bell operating company, or any entity acting on its behalf, for the duration of the requirement for a separate subsidiary including manufacturing under this Act-
"(A) shall consider such equipment, produced or supplied by unrelated persons; and
"(B) may not discriminate in favor of equipment produced or supplied by an affiliate or related person.
"(2) PROCUREMENT STANDARDS.--Each Bell operating company or any entity acting on its behalf shall make procurement decisions and award all supply contracts for equipment, services, and software on the basis of an objective assessment of price quality, delivery, and other commercial factors.
"(3) NETWORK PLANNING AND DESIGN.--A Bell operating company shall, to the extent consistent with the antitrust laws, engage in joint network planning and design with local exchange carriers operating in the same area of interest. No participant in such planning shall be allowed to delay the introduction of new technology or the deployment of facilities to provide telecommunications services, and agreement with such other carriers shall not be required as a prerequisite for such introduction or deployment.
"(4) SALES RESTRICTIONS.--Neither a Bell operating company engaged in manufacturing nor a manufacturing affiliate of such a company shall restrict sales to any local exchange carrier of telecommunications equipment, including software integral to the operation of such equipment and related upgrades.

Nondiscrimination provisions also appear in section 274(d) of the 1934 Act, as amended. These deal with electronic publishing by BOCs. That section [47 USC 274(d)] provides:
"(d) BELL OPERATING COMPANY REQUIREMENT.--A *Bell operating company under common ownership or control with a separated affiliate or electronic publishing joint venture shall provide network access and interconnections for basic telephone service to electronic publishers at just and reasonable rates that are tariffed (so long as rates for such services are subject to regulation) and that are not higher on a per-unit basis than those charged for such services to any other electronic publisher or any separated affiliate engaged*
in electronic publishing."

New section 275 (b) of the 1934 Act [47 USC 275 (b)] provides, with respect to alarm monitoring services:
(b) NONDISCRIMINATION.*--An incumbent local exchange carrier (as defined in section 251(h)) engaged in the provision of alarm monitoring services shall--*

"(1) provide nonaffiliated entities, upon reasonable request, with the network services it provides to its own alarm monitoring operations, on nondiscriminatory terms and conditions; and

"(2) not subsidize its alarm monitoring services either directly or indirectly from telephone exchange service operations.

Safeguards against discrimination also appear in new section 271 (c)(2)(B) [47 USC 271 (c)(2)(B), et seq.] with respect to InterLATA services:
"(B) COMPETITIVE CHECKLIST.*--Access or interconnection provided or generally offered by a Bell operating company to other telecommunications carriers meets the requirements of this subparagraph if such access and interconnection includes each of the following:*

"(i) Interconnection in accordance with the requirements of sections 251(c)(2) and 252(d)(1).

"(ii) Nondiscriminatory access to network elements in accordance with the requirements of sections 251(c)(3) and 252(d)(1).

"(iii) Nondiscriminatory access to the poles, ducts, conduits, and rights-of-way owned or controlled by the Bell operating company at just and reasonable rates in accordance with the requirements of section 224.

"(iv) Local loop transmission from the central office to the customer's premises, unbundled from local switching or other services.

"(v) Local transport from the trunk side of a wireline local exchange carrier switch unbundled from switching or other services.

"(vi) Local switching unbundled from transport, local loop transmission, or other services.

"(vii) Nondiscriminatory access to--

"(I) 911 and E911 services;

"(II) directory assistance services to allow the other carrier's customers to obtain telephone numbers; and

"(III) operator call completion services.

"(viii) White pages directory listings for customers of the other carrier's telephone exchange service.

"(ix) Until the date by which telecommunications numbering administration guidelines, plan, or rules are established, nondiscriminatory access to telephone numbers for assignment to the other carrier's telephone exchange service customers. After that date, compliance with such guidelines, plan, or rules.

"(x) Nondiscriminatory access to databases and associated signaling necessary for call routing and completion.

"(xi) Until the date by which the Commission issues regulations pursuant to section 251 to require number portability, interim telecommunications number portability through remote call forwarding, direct inward dialing trunks,

4. ASSET TRANSFER VALUATION

(3) shall account for all transactions with a subsidiary described in subsection (a) in accordance with generally accepted accounting principles and shall fully value any assets, whether tangible or intangible, that are transferred directly or indirectly from the public utility company to its affiliates, subsidiaries or associate companies, and shall record such transactions, in accordance with such regulations as may be prescribed by the State commission to prevent improper cross subsidies or cost-shifting;

or other comparable arrangements, with as little impairment of functioning, quality, reliability, and convenience as possible. After that date, full compliance with such regulations.

"(xii) Nondiscriminatory access to such services or information as are necessary to allow the requesting carrier to implement local dialing parity in accordance with the requirements of section 251(b)(3).

"(xiii) Reciprocal compensation arrangements in accordance with the requirements of section 252(d)(2).

"(xiv) Telecommunications services are available for resale in accordance with the requirements of sections 251(c)(4) and 252(d)(3).

Finally, section 276 [47 USC 276 (a)(2)] regarding payphone service has this language: *"(2) shall not prefer or discriminate in favor of its payphone service."*

4. ASSET TRANSFER VALUATION

Proper asset valuation is necessary to prevent cross-subsidization and impermissible cost shifting. References to asset valuation are contained in several provisions of the 1996 Telecom Act.

New section 274(b)(4) of the 1934 Act [47 USC 274 (b)(4)] requires:
"(4) value any assets that are transferred directly or indirectly from the Bell operating company to a separated affiliate or joint venture, and record any transactions by which such assets are transferred, in accordance with such regulations as may be prescribed by the Commission or a State commission to prevent improper cross subsidies"

New section 272 (c)(2) of the 1934 Act [47 USC 272(c)(2)] requires an accounting for transactions in accordance with the Commission's (FCC) accounting principles.[Those regulations stipulate that the higher of market value or fully distributed cost be use when valuing asset transfers from regulate operations to affiliates.]
The language of 272(c)(2) provides: *"(2) shall account for all transactions with an affiliate described in subsection (a) in accordance with accounting principles designated or approved by the Commission."*

Although it does not speak directly to full valuation of assets, section 272(e) referred to above with reference to non-discrimination has the same intent: to prevent the transfer of valuable assets to an affiliate at less than market value thereby undercutting private sector competitors. That language provides: *"(3) shall charge the affiliate described in subsection (a), or impute to itself (if using the access for its provision of its own services), an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service..."*

5. NAME, LOGO AND JOINT MARKETING.

5. NAME, LOGO AND JOINT MARKETING.

(4) the name, logo, service mark, trademark, or trade name of the separate subsidiary or affiliate of a public utility company shall not resemble the name, logo, service mark, trademark or trade name of the public utility company and neither the public utility company nor the separate subsidiary or affiliate may trade upon, promote, or advertise their affiliated or related status.

The Telecom Act created a new section 274(b)(6) in the 1934 Act [47 USC 274(b)(6) which provides that BOCs:
"(6) not use for the marketing of any product or service of the separated affiliate or joint venture, the name, trademarks, or service marks of an existing Bell operating company except for names, trademarks, or service marks that are owned by the entity that owns or controls the Bell operating company."

While other provisions in the Telecom Act do not directly prohibit the use of name and logo, they do restrict the ability of the BOC and its affiliate o engage in joint marketing.

With respect to InterLATA services, the 1996 Telecom Act provided:
"(1) JOINT MARKETING OF LOCAL AND LONG DISTANCE SERVICES.--
Until a Bell operating company is authorized pursuant to subsection (d) to provide interLATA services in an in-region State, or until 36 months have passed since the date of enactment of the Telecommunications Act of 1996, whichever is earlier, a telecommunications carrier that serves greater than 5 percent of the Nation's pre-subscribed access lines may not jointly market in such State telephone exchange service obtained from such company pursuant to section 251(c)(4) with interLATA services offered by that telecommunications carrier." [47 USC 271(e)]

Section 272 contains another prohibition on joint marketing by BOCs on local exchange services. That provision states:
"(g) JOINT MARKETING.--
"(1) AFFILIATE SALES OF TELEPHONE EXCHANGE SERVICES.--A Bell operating company affiliate required by this section may not market or sell telephone exchange services provided by the Bell operating company unless that company permits other entities offering the same or similar service to market and sell its telephone exchange services.
"(2) BELL OPERATING COMPANY SALES OF AFFILIATE SERVICES.--A Bell operating company may not market or sell interLATA service provided by an affiliate required by this section within any of its in-region States until such company is authorized to provide interLATA services in such State under section 271(d)."

Again, at new section 274(c)(1)(A) of the 1934 Act [47 USC 274(c)(1)(A)]: *"(A) a Bell operating company shall not carry out any promotion, marketing, sales, or advertising for or in conjunction with a separated affiliate; and*
"(B) a Bell operating company shall not carry out any promotion, marketing, sales, or advertising for or in conjunction with an affiliate that is related to the provision of electronic publishing."

6. PROTECTION OF PROPRIETARY INFORMATION.

Statutory protection for customer proprietary information

6. PROTECTION OF PROPRIETARY INFORMATION.

(e) **Proprietary Information.** -
(1) In complying with the requirements of this section, each public utility company and any subsidiary, affiliate, or associate company of such public utility company shall have a duty to protect the confidentiality of propriety information of competitors and customers. A public utility may not share customer proprietary information in aggregate form with its subsidiaries, affiliates or associate companies unless such aggregate information is available to other competitors or persons under the same terms and conditions. Individually identifiable customer proprietary information and other proprietary information may be -

(A) shared only with the written consent of the person to which such information relates or from which it was obtained; or
(B) disclosed to appropriate authorities pursuant to court order.

(2) **Exceptions.** - Paragraph (1) does not limit the disclosure of individually identifiable customer proprietary information by each public utility as necessary -

(A) to initiate, render, bill, and collect for the service or products requested by a customer; or
(B) to protect the rights or property of the public utility, or to protect users of any of those services from fraudulent, abusive, or unlawful use of any such service.

was established in several provisions contained in the 1996 Telecom Act. In new section 273 of the 1934 Act [47 USC 273(d)(2)], it is provided that "***(2) PROPRIETARY INFORMATION***.*--Any entity which establishes standards for telecommunications equipment or customer premises equipment, or generic network requirements for such equipment, or certifies telecommunications equipment or customer premises equipment, shall be prohibited from releasing or otherwise using any proprietary information, designated as such by its owner, in its possession as a result of such activity, for any purpose other than purposes authorized in writing by the owner of such information, even after such entity ceases to be so engaged.* "

Later in that same section, the Act provides: "*(C) Such entity that certifies such equipment shall--*

"*(ii) not disclose to the manufacturing affiliate any proprietary information that has been received at any time from an unaffiliated manufacturer, unless authorized in writing by the owner of the information...*"[47 USC 273(d)(3)(C)(ii)]

With respect to manufacturing activities, the 1996 Act created a new section to the 1934 Act which stipulates: ***(5) PROTECTION OF PROPRIETARY INFORMATION***.*--A Bell operating company and any entity it owns or otherwise controls shall protect the proprietary information submitted for procurement decisions from release not specifically authorized by the owner of such information.*" 47 USC 273(e)(5)]

Elsewhere, in new section 275 of the 1934 Act, it is provided in connection with alarm monitoring services that: "***(d) USE OF DATA***.*--A local exchange carrier may not record or use in any fashion the occurrence or contents of calls received by providers of alarm monitoring services for the purposes of marketing such services on behalf of such local exchange carrier, or any other entity. Any regulations necessary to enforce this subsection shall be issued initially within 6 months after the date of enactment of the Telecommunications Act of 1996.*

7. IMPLEMENTATION AND ISSUANCE OF REGULATIONS

(f) **Implementation** --
Each State commission, for each public utility company under its jurisdiction which is not a registered holding company, shall:

(A) Hold a hearing and make a determination based on evidence presented in the record as to what rules, procedures, or other actions are necessary to implement the safeguards set forth in subsections (a) -

7. IMPLEMENTATION AND ISSUANCE OF REGULATIONS

Several sections of the 1996 Telecom Act clearly establish the continuing authority of regulatory authorities to issue rules designed to carry out the objectives of the Act. Typical of such provisions is new section 273(g) of the 1934 Act [47 USC 273(g)], which, in connection with manufacturing by BOCs, reads: "***(g) ADDITIONAL RULES AND REGULATIONS***.*--The Commission may prescribe such additional rules and regulations as the Commission determines are necessary to carry out the provisions of this section, and otherwise to prevent discrimination and cross-subsidization in a Bell operating company's dealings with its affiliate and with third parties.*"
However, other portions of the Act went further. With respect to the provision of payphone service, the FCC was directed under newly created section 276 [47 USC 276(b)] to

(e) of this Section; and
(B) promulgate any regulations necessary to implement those sections within one year from the date of enactment of this Act.

prescribe new and additional regulations. The language of the Act required: "*(1)* ***CONTENTS OF REGULATIONS***.*--In order to promote competition among payphone service providers and promote the widespread deployment of payphone services to the benefit of the general public, within 9 months after the date of enactment of the Telecommunications Act of 1996, the Commission shall take all actions necessary (including any reconsideration) to prescribe regulations that--*

"(A) establish a per call compensation plan to ensure that all payphone service providers are fairly compensated for each and every completed intrastate and interstate call using their payphone, except that emergency calls and telecommunications relay service calls for hearing disabled individuals shall not be subject to such compensation;

"(B) discontinue the intrastate and interstate carrier access charge payphone service elements and payments in effect on such date of enactment, and all intrastate and interstate payphone subsidies from basic exchange and exchange access revenues, in favor of a compensation plan as
specified in subparagraph (A);

"(C) prescribe a set of nonstructural safeguards for Bell operating company payphone service to implement the provisions of paragraphs (1) and (2) of subsection (a), which safeguards shall, at a minimum, include the nonstructural safeguards equal to those adopted in the Computer Inquiry-III (CC Docket No. 90-623) proceeding;

"(D) provide for Bell operating company payphone service providers to have the same right that independent payphone providers have to negotiate with the location provider on the location provider's selecting and contracting with, and, subject to the terms of any agreement with the location provider, to select and contract with, the carriers that carry interLATA calls from their payphones, unless the Commission determines in the rulemaking pursuant
to this section that it is not in the public interest; and

"(E) provide for all payphone service providers to have
the right to negotiate with the location provider on the location provider's selecting and contracting with, and, subject to the terms of any agreement with the location provider, to select and contract with, the carriers that carry intraLATA calls from their payphones."

105TH CONGRESS
2ND SESSION

H.R. ______

IN THE HOUSE OF REPRESENTATIVES

______ introduced the following bill: which was referred to the Committee on the ______

A BILL

To prohibit anticompetitive practices involving energy related and other services by gas and electric utilities using ratepayer-based assets.

Be it enacted by the Senate and the House of Representatives of the United States of America in Congress assembled.

SECTION 1. SHORT TITLE.

This Act may be cited as the "Fair Competition Act of 1998".

SECTION 2. FINDINGS.

The Congress finds and declares that:

(a) The practice of cross-subsidization between electric and/or gas utilities and their affiliates impairs the development of an efficient competitive market both for utility services and in markets served by utility affiliates;

(b) Electric and gas utilities have utilized affiliate relationships and transactions to leverage their market power and other assets to the detriment of small business and consumer interests;

(c) Such anticompetitive practices have increased as the various States and the Congress have considered deregulation of the electric power industry;

1 (d) Therefore, in order to maintain a vigorous competitive environment, the Congress finds
2 that it is necessary to prohibit cross-subsidization as provided herein.

3 SECTION 3. DEFINITIONS.

4 For purposes of this Act:

5 (1) AFFILIATE means an entity that, directly or indirectly, owns or controls, is owned
6 or controlled by, or is under common ownership and control with, an electric and/or gas utility or
7 any of its subsidiaries, or by that electric and/or gas utility's controlling corporation or any of its
8 subsidiaries.

9 (2) ANTITRUST LAWS has the meaning given it in subsection (a) of the first section
10 of the Clayton Act (15 U.S.C. § 12(a)), except that such term includes the Act of June 19, 1936 (49
11 Stat. 1526; 15 U.S.C. § 13 *et seq.*), commonly known as the Robinson Patman Act, and section 5
12 of the Federal Trade Commission Act (15 U.S.C. § 45) to the extent that such section 5 applies to
13 monopolies, attempts to monopolize and unlawful restraints of trade.

14 (3) CROSS-SUBSIDIZATION means the use of funds, personnel or other assets derived
15 from or paid for by regulated service activities to reduce the cost of nonregulated services provided
16 by an affiliate of the electric or gas utility;

17 (4) ELECTRIC AND/OR GAS UTILITY means an electric or gas utility subject to the
18 jurisdiction of a state public utility commission or the Federal Energy Regulatory Commission;

19 (5) NONREGULATED SERVICES means services provided by a regulated gas or electric
20 utility through a subsidiary or affiliate not subject to the jurisdiction of a state public utility
21 commission or the Federal Energy Regulatory Commission;

22 (6) REGULATED SERVICES means electric and/or gas utility services subject to the
23 jurisdiction of a state public utility commission or the Federal Energy Regulatory Commission;

24 (7) SERVICE means both products and services;

25

26

27

1 SECTION 4. PROHIBITION OF ANTICOMPETITIVE CROSS-SUBSIDIES.

2 An electric and/or gas utility or its affiliate shall not, directly or indirectly, use proceeds
3 obtained from providing regulated service or assets obtained with such proceeds to subsidize
4 nonregulated services. Specifically,

5 (a) COMMON EQUIPMENT—An electric and/or gas utility and its affiliate shall not share
6 common vehicles, service tools, and instruments, nor shall the electric and/or gas utility provide the
7 affiliate with such assets obtained, directly or indirectly, from providing regulated service;

8 (b) NAMES, LOGOS AND JOINT MARKETING—An electric and/or gas utility shall not allow
9 the name, logo, service mark, trademark, or trade name of a separate subsidiary or affiliate to
10 resemble the name, logo, service mark, trademark, or trade name of the utility, nor shall the electric
11 and/or gas utility or its affiliate trade upon, promote, or advertise their affiliate or related status.
12 This section expressly prohibits the providing of marketing leads, solicitation of business, joint
13 advertising or joint marketing by the electric and/or gas utility and its affiliate; and

14 (c) CUSTOMER AND MARKETING INFORMATION, BILLINGS—An electric/and or gas utility
15 shall not provide any affiliate, subsidiary or other commercial entity with advertising space in its
16 billings or with the use of its mailing lists, marketing an d other customer related information, unless
17 the use of such assets is available to all commercial businesses on a nondiscriminatory basis.

18 SECTION 5. NON-DISCRIMINATION.

19 (a) GENERAL—Neither an electric and/or gas utility nor its affiliate shall represent or
20 suggest that the affiliate will receive different treatment due to their affiliated status. Nor shall an
21 affiliate receive such preferential treatment, including, but not limited to, terms, conditions and
22 pricing;

23 (b) TYING OF SERVICES PROHIBITED—An electric and/or gas utility shall not condition
24 or otherwise tie the provision of service or the availability of discounts, rebates or special terms of
25 service to the taking of any service from an affiliate; and

1 (c) PREFERENTIAL REFERRALS PROHIBITED—An electric and/or gas utility shall not
2 provide advice to customers regarding its affiliates nor shall it provide preferential referrals to
3 affiliates.

4 SECTION 6. SEPARATION OF REGULATED AND NON-REGULATED ENTITIES.

5 (a) SEPARATE CORPORATE ENTITIES—A gas and/or electric utility and its affiliates shall
6 be separate corporate entities;

7 (b) BOOKS AND RECORDS—Affiliates shall maintain separate books, records, and
8 accounts from those of the electric and/or gas utility with which it is associated. The books and
9 records of the electric and/or gas utility as well as those of the affiliate shall be open to inspection
10 by the state commission with jurisdiction over the electric and/or gas utility; and

11 (c) OFFICERS, DIRECTORS AND EMPLOYEES—Affiliates shall have separate corporate
12 officers, directors and employees from the electric and/or gas utility with which it is associated.
13 This section shall be construed to require that there be no sharing of officers, directors, employees,
14 or costs, salaries and benefits attributable thereto; and

15 (d) FINANCING—An affiliate shall not obtain credit under any arrangement that would
16 permit a creditor, upon default, to have recourse to the assets of an affiliated electric and/or gas
17 utility.

18 SECTION 7. ENFORCEMENT.

19 Any state commission with jurisdiction over an electric and/or gas utility may require that
20 said utility have performed, no more frequently than on an annual basis, an independent audit to
21 ensure compliance with this Act. Such audit shall be performed by an independent auditor selected
22 by the state commission. The audits shall be conducted at the expense of the electric and/or gas
23 utility.

24 SECTION 8. RELATIONSHIP TO OTHER LAWS.

25 (a) ANTITRUST LAWS—Nothing in this Act shall be construed to modify, impair, or
26 supersede the applicability of any other antitrust law;

1 (b) FEDERAL, STATE AND LOCAL LAW—This Act shall not be construed to modify, impair,
2 or supersede any other Federal, State or local law except to the extent that such law would impair
3 or prevent the operation of this Act.

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MEMORANDUM

October 8, 1998

RE: Constitutional Analysis of Name/Logo Issue

As you are aware, utilities have begun asserting both in state regulatory proceedings and here on Capitol Hill that restrictions on the use of the utility name or logo by unregulated affiliates would pose an unconstitutional limitation on commercial speech under the First Amendment and possibly constitute a "taking" of a vested property right. This memorandum provides a brief analysis of the relevant constitutional considerations involved in the commercial speech issue.

Commercial Speech

Utilities have raised the argument that any restrictions on the ability of utility affiliates to use the name or logo of their parent utility constitute an impermissible violation of the utility's First Amendment rights. To date, proposals to address the unfair competitive consequences of affiliate use of the utility's name or logo have consisted of either an outright ban, an appropriate disclaimer to accompany use of the logo, or imposition of a royalty on the use of the logo by the affiliate.

The leading case governing the regulation of commercial speech is *Central Hudson Gas & Electric Corp. v. Public Service Commission of New York*, 447 U.S. 557 (1979). At issue in *Central Hudson* was an order of the New York Public Service Commission requiring electric utilities in New York State to cease all advertising promoting the use of electricity in response to anticipated shortages during the winter. In striking down the Commission's order, the Supreme Court enunciated the following four-part test:

(1) Is the expression protected by the First Amendment? In order to be protected, it must be lawful and not be misleading.
(2) Is the governmental interest in the regulation substantial?

(3) Does the regulation in question directly advance the government interest asserted?

(4) If so, is the regulation more extensive than is necessary to address that interest?

The Court reasoned that the advertising in question was neither unlawful nor misleading and recognized as well that the State had a substantial government interest in energy conservation. However, the Court struck down the order on the grounds that the State's interest in energy conservation could not justify suppression of information on energy services that would not cause an increase in energy use, and therefore the order was broader than necessary to achieve the State's interest.

The situation presented by regulation of the use of utility trade names and logos by utility affiliates providing unregulated services is distinguishable in several regards. Applying the *Central Hudson* test, it should first be noted that the basis cited for the regulation of affiliate use of trade names and logos has been that the potential to mislead consumers. Among the problems caused by the use of a shared logo are: (1) the risk of consumer confusion that unregulated services are regulated utility services; (2) the false impression created that the unregulated services are backed by the assets of the utility; and (3) the potential for implicit tying arrangements leading consumers to believe that acceptance of the unregulated service is somehow tied to the ability to receive the regulated utility service.

Turning to the second element of the test, the states clearly have a legitimate government interest in protecting their consumers from potentially misleading uses of utility names and logos. Therefore, the operative question is whether a particular regulation is narrowly tailored to address that interest. Certainly, the requirement that the utility affiliate utilize a disclaimer when using the shared name or logo is narrowly tailored to avoid uses that would tend to mislead consumers.

However, other applicable Supreme Court precedent suggests that a ban on affiliate use of utility name or logo would be sustained as well. In *Friedman v. Rogers*, 440 U.S. 1 (1979), the Supreme Court upheld a provision of the Texas Optometry Act that prohibited the use of trade names by optometrists practicing in the state as permissible under the First Amendment. In *Friedman*, the Court noted that the use of trademarks by optometrists had the potential to mislead consumers and that the state had a legitimate interest in protecting the public from deceptive and misleading uses of trade names. More importantly, however, the Court noted that trade names were different for commercial speech purposes than other forms of advertising conveying information about services, price, etc. In particular, the Court explained:

"A trade name is, however, a significantly different form of commercial speech...In those cases, the State had proscribed advertising by pharmacists and lawyers that contained statements about the products or services offered and their prices. These statements were self-contained and self-explanatory. Here, we are concerned with a form of commercial speech that has no intrinsic meaning. A trade name conveys no information about the price and nature of the services offered by an optometrist until it acquires meaning over a period of time by associations formed in the minds of the public between the name and some standard of price or quality. Because these ill-defined associations of trade names with price and quality information can be manipulated by the users of trade names, there is a significant possibility that trade names will be used to mislead the public."

Id. at 440 U.S. 12-13 (footnote omitted) (emphasis added).

The reasoning applied by the Court in *Friedman* is directly applicable to the regulation of the use of utility trade names and logos by unregulated affiliates, including bans on such use. The trade name itself conveys no information regarding the quality or price of the service being provided by these affiliates, and creates the misimpression that these services are being provided by a regulated entity or backed by the assets of such an entity. Moreover, the distinction between trade names or logos and other forms of commercial speech recognized in *Friedman* suggests that such regulations would be upheld as sufficiently narrowly tailored to address the legitimate governmental interest in consumer protection.

IMPACTS OF UTILITY ENTRY INTO
AIR CONDITIONING INSTALLATION AND MAINTENANCE

FOR

AIR CONDITIONING CONTRACTORS OF AMERICA

BY

RICHARD C. CARLSON
CHAIRMAN, SPECTRUM ECONOMICS

MAY 6, 1998

EXECUTIVE SUMMARY

If done properly, electric deregulation promises to create a competitive market for retail sales of electricity which should lead to substantial energy cost savings for most consumers. However, early experience with deregulation has demonstrated that there are several substantial, unexpected problems. One such problem is the cross-subsidization of utility affiliates in unregulated service industries which threatens to undermine competition in these service industries as well as to reduce cost savings to consumers of electricity. The current pattern of electric deregulation creates strong economic incentives for such cross-subsidized market entry.

The most obvious example of cross-subsidized utility entry into new markets is the move of several utilities into the heating, ventilation, air-conditioning and refrigeration (HVACR) market. Members of the HVACR service industry have witnessed an unprecedented and growing incursion into the HVACR service market by utility affiliates in recent years. In a few states, such as Delaware and Maryland, utility affiliates have used their market power and cross-subsidies to suddenly gain over a 20% share of the HVACR market. These affiliates have enjoyed substantial cross-subsidies from their related utilities in the form of free advertising, free marketing, free customer information, free or reduced cost employees and free equipment. These cross-subsidies impose costs on the electric consumer and are contrary to the goals of open competition on which deregulation is premised.

This report, prepared by Spectrum Economics of Palo Alto, California examines the issue of cross-subsidization of utility affiliates in the HVACR market and its potential implications for deregulation of the electric power industry. The key issues explored and conclusions reached are as follows:

- **Deregulation and Cross-Subsidization:** This section reviews the long history of the problems of cross-subsidization created by earlier deregulation of other industries such as natural gas and long-distance service. In all of these industries, strict safeguards against cross-subsidization were required.

- **Cross-Subsidization Defined:** The National Regulatory Research Institute has defined cross-subsidization and demonstrated how regulation creates incentives for cross-subsidization.

- **Utility Cross-Subsidization of HVACR Affiliates and Its Public Policy Implications:** Examines why deregulation creates incentives to cross-subsidize unregulated affiliates and the forms of cross-subsidization. Partial deregulation encourages cross-subsidization because subsidy costs can be hidden in regulated operations and passed on to consumers. Such subsidies both increase costs to electric consumers and in the long run would lead to high price monopolies in the unregulated HVACR business.

- **Utility Entrants into HVACR Markets and Regulatory Responses:** Surveys the entry of utility affiliates into the HVACR market as well as regulatory responses in seven key states: New York, Nevada, Colorado, Maryland, Virginia, Ohio and Michigan. Among these states, the strongest utility HVACR programs are in Maryland and Ohio. Many states are considering tough rules to prohibit cross-subsidies, but Minnesota has enacted the toughest regulations.

- **Impacts of Cross-Subsidization on Competition:** The California PUC has found that cross-subsidies in California alone are approaching over $100 million per year. This would translate into a national consumer loss of over $2 billion per year. Short term job loss to existing workers could reach 60,000.

The report concludes that legislation to deregulate electric generation must address the issue of cross-subsidization in order to avoid substantial harm to competition and consumers.

I. INTRODUCTION

The U.S. heating, ventilation, air conditioning and refrigeration (HVACR) industry has revenues of over $67 billion per year and employs over 530,000 people .1 2 About 70% of the employees work for small contractors who employ less than 50 people, and almost half work for employers with less than 10 employees.3 The industry pays high wages to its employees, who average about $17 per hour and provides independent livelihood to over 53,000 small business owners and their families. 4 5

Increasingly, the future of these independent contractors is threatened by anticompetitive practices associated with the entry of large electric and gas utilities into the HVACR industry through unregulated affiliates. About 42% of utilities are now active in the HVACR business, but most of their activity is recent.6 In the early 1990s only two major utilities, Consumer's Power of Michigan and Public Service of Colorado, had major HVACR businesses. By 1997, the number of utilities in the HVACR market had grown to over 50. The change in utility participation in the HVACR business is shown in Chart 1. This report examines some of the reasons for utility entry into the HVACR market, the potential for cross-subsidization of unregulated affiliates in the HVACR market, how this development threatens to reduce consumer savings in the soon-to-be deregulated electric power market, and utility actions and regulatory responses in seven states: Nevada, Colorado, Ohio, Michigan, New York, Maryland and Virginia.

II. DEREGULATION AND CROSS-SUBSIDIZATION

1Projected from 1992 Census of Construction Industries output of $41 billion, based on recently released 6 digit SIC detail. HVACR includes SIC 17111, SIC 171116 (mechanical), SIC 171118 (Refrigeration), SIC 171122 (Combination), and N.S.K (Other). Projection based on growth in earnings and employment through 1997.

2Employment and Earnings, Nov. 1997, Table B-12, HVACR is 66% of SIC 171, Plumbing, Heating and air-conditioning.

3U.S. Bureau of the Census, County Business Patterns, U.S. Summary, 1995, p.7

4 Employment and Earnings, Nov. 1997, Table B-15, data is for SIC 171

5 Op.cit.., County Business Patterns, p.7

6 1996 data from Energy Users News, July 1997.

Recent U.S. efforts to deregulate major industries such as airlines, trucking, railroads and natural gas have by and large led to more competition and lower prices for most consumers. It is anticipated that deregulation of electric generation will produce many of the same benefits for consumers of electric power. However, if the transition to competition is not properly handled, deregulation could result in new economic inefficiencies both in the market for electric power and in related markets such as HVACR services. The recent and sudden expansion of electric utilities into the HVACR business is the leading edge of the potential for large energy supply and service conglomerates that could achieve near monopoly status in some industries. While integrated conglomerates are not in themselves problematic, the potential for anticompetitive impacts contrary to the intent of deregulation arises from the potential for utilities to use cross-subsidies from their regulated business to enter into and unfairly dominate other related but unregulated industries.

In contrast to European and Asian encouragement of industrial consolidation, the United States has historically sought to prevent monopolies. When industrial consolidation went too far, the government broke up such near monopolies as Standard Oil, IBM and AT&T. Today Microsoft has come under increasing government scrutiny for allegedly monopolistic actions. Active U.S. enforcement of antitrust laws, in contrast to European and Asian protection of inefficient industrial giants, is one of several reasons for the relatively greater economic success of the United States. Where monopoly was thought to be inevitable, the U.S. has traditionally regulated such "natural monopolies" as water, electricity, gas and communications. Through regulation, monopolies prices were constrained, but they were also protected against competition. Thus regulated monopolies were both restricted and protected by their regulators.

Regulated firms generally were subject to another restriction: they were rarely allowed to enter unregulated businesses. This restriction was put in place to prevent these regulated monopolies from subsidizing their entry into new businesses using assets paid for by the ratepayers or from shifting part of that cost to consumers in the regulated industry. However, changing telecommunications and energy markets have led to partial deregulation first of natural gas and long-distance service, then of electricity generation. Partial deregulation of these industries has led to a "mixed-market" environment in which portions of the industry have been opened to competition while other portions have remained subject to regulation.

As part of this deregulation process, utilities have been allowed to establish unregulated subsidiaries, but initially only under carefully controlled conditions. The first major utility deregulation effort, that of long-distance rates, required AT&T to divest its regulated regional

Bell operating companies (RBOC's) and limited its entry into a variety of information publishing sectors.[7] [8]

III. WHAT IS CROSS-SUBSIDIZATION?

Cross-subsidization is one of the key problems created by a mixed market environment. Concern about the potential for cross-subsidization prompted many of the restrictions described above and has posed a persistent problem for regulators. Cross-subsidization occurs when an affiliate in an unregulated market is able to price its product or services below cost due to its relationship with a regulated entity. Whether this cross-subsidy takes the form of covering the affiliates losses with revenues from the regulated utility or arises from the use of assets of the regulated entity to reduce the cost of providing service, the unregulated affiliate enjoys a competitive advantage due to its relationship with the regulated monopoly. This internal subsidy is borne, directly or indirectly, by the consumers of the regulated entity.

The result of this cross-subsidy is both inefficiency in the regulated market and a skewing of competition in the unregulated market as the affiliate is able to drive out otherwise efficient rivals through below cost pricing. The cross-subsidy enjoyed by the affiliate may allow the affiliate to offer prices far enough below its cost to allow it not only to drive out competitors but to prevent new entrants into the market. Once competition is eliminated, prices in the unregulated market will rise and the threat of predatory pricing will be sufficient to dissuade potential new entrants. Obviously, cross-subsidies pose adverse consequences for consumers and competitors alike.

IV. UTILITY CROSS-SUBSIDIZATION OF HVACR AFFILIATES AND ITS PUBLIC POLICY IMPLICATIONS

A. Why Deregulation Creates Incentives For Utilities To Cross-Subsidize Their Entry Into The Market for HVACR Services

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7See 47 U.S.C., Sections 272 (separate affiliates for competitive activities, 274 (separate affiliate for electronic publishing), 275 (delayed entry into alarm monitoring services).

8 For an excellent discussion of the economic theory of why regulated firms should be kept out of unregulated markets, see Timothy Brennan, "Why Regulated Firms should be Kept Out of Unregulated Markets: Understanding the Divestiture in United States v. AT&T, The Antitrust Bulletin, Fall 1987, P. 741 to 793.

The utility industry is a huge industry undergoing the stress of market change and deregulation. The $213 billion electric utility industry dwarfs the $67 billion air conditioning installation and maintenance business.9 Several individual electric utilities are larger than an entire state's HVACR industry. Natural gas utilities are "only" a $60 billion industry. The relative sizes of the HVACR, Electric Utility and Gas Utility industries are shown in Chart 2.

Deregulation creates powerful incentives for gas and electric utilities to move into HVACR installation and service. The key incentive shared by all utilities and created by deregulation is the search for long-range profits. By hiding part of the costs of establishing themselves in the unregulated HVACR business, utilities can force their electric customers to help finance corporate expansion. In the long-run, after competitors are driven out by predatory pricing unregulated monopoly profits can be earned in the new business.10

The second reason is bundling: using service contracts bundled with gas or electric purchases to encourage customers not to shift to new, more cost-competitive energy supplies. Fearful that they will be unable to compete on price alone due to stranded costs and other factors, utilities are hoping to retain customers by offering services like HVACR installation and service along with the base gas or electric service as a single package. Alternate suppliers of cheap gas and electricity can compete on price more easily than they can compete on service. Many utilities believe that they have a better chance of retaining consumer loyalty for their base electric and gas products by providing a bundle of energy services, including HVACR and appliance services, at a single package price. These utilities are deliberately under-pricing service contracts as loss leaders, to convince customers to accept long-term electric or gas purchase contracts. The main incentive to do this is that many utility costs are largely fixed, so that the loss of a small number of customers can significantly reduce profits.

9Monthly energy review, December 1997, KWH sales times average price.

10 For an analysis of the economic and regulatory incentives for cross-subsidies see Jaison Abel, An Economic Analysis of Marketing Affiliates in a Deregulated Electric Power Industry, National Regulatory Research Institute, Ohio State University, Feb. 1998

Under deregulation both electric and gas utilities share another powerful reason for diversifying into HVACR installation and service: institutional survival. Their existing businesses are slow growing, and new competitors will almost surely take some of that current business. Established organizations generally try to avoid staff cuts. Most utilities must cut staff to remain competitive in their core business, but they are desperate to shift these workers to new business to avoid the organizational morale and political problems of significant layoffs. Many utilities will grasp at any possibility to maintain the size of the organization, even if it will not be immediately profitable. Regulatory politics encourages such investments. Electric deregulation and general rate freezes are occurring at a time of declining interest rates and declining fuel prices. These fortuitous circumstances make many utilities potentially so profitable that they risk a political backlash against deregulation. After languishing for most of the last five years, utility earnings per share growth rates are expected to more than double from 2.5% per year to almost 6% per year in the next five years under deregulation. 11 The decision facing utility executives is simple: If they don't take the diversification risk, their own jobs are at risk, and the profits saved from utility staff cuts may be recaptured by regulators in any case. If utility executives do invest in risky, initially money losing diversification, their jobs are saved and they are effectively risking the money of their regulated customers, not their shareholders.

Avoiding layoffs through diversification only works if the utility can be cost competitive in the new business or if it can use cross-subsidization to kill competitors. Utilities cannot be cost competitive in the HVACR business with their existing staff -- their wages are too high. Thus, utilities must either cross-subsidize or use non-union contractor personnel in the new HVACR enterprises: They must choose between an economic problem and a political one.
However, many utilities are doing so by utilizing their ratepayer-based assets to cross-subsidize their entry into the market for HVACR services. Through cross-subsidization, the affiliate's costs are lower than other participants in the market for HVACR services and are able to use their cost difference to force out current HVACR service providers and discourage new market entrants. Thus, while the initial result of cross-subsidization may be to lower the cost of HVACR services, these prices will surely rise as competition is eliminated. In addition, the cost of providing these below-cost services is actually being paid by the customers of the regulated part of the utility.

B. Utility Cross-Subsidization and Public Policy

Both gas and electric utilities have many ways to cross-subsidize their HVACR affiliates. Some key cross-subsidies include providing the following services to unregulated affiliates at low or no cost:

- **Customer Data:** Utilities have amassed large volumes of information on their customers and those customers' usage patterns during their tenure as monopoly utility service providers. Obviously, this type of information becomes extremely valuable in a competitive marketplace. By sharing this data with its unregulated affiliate, the utility provides the affiliate with a substantial competitive advantage.

- **Employees and Employee Benefits:** Costs associated with employees and employee benefits are substantial, and the potential for cross-subsidization arises when employees are shared between the utility and its affiliate.

- **Finance:** Regulated entities generally receive a lower costs of capital than firms in competitive markets. If this advantage is passed on to the unregulated affiliate, that entity enjoys lower costs of capital than similarly placed independent firms solely by virtue of its relationship with the

11 Zack's Earnings forecasts, April 24, 1998

utility. Borrowing for these unregulated subsidiaries raises interest costs paid by general utility customers.

- **Shared Logos or Trademarks:** The "name brand" recognition possessed by utility logos and trademarks is the result of their monopoly status and should be considered to be a ratepayer asset in a competitive environment. Allowing unregulated affiliates to advertise, trade upon, or promote their affiliation with the utility through the use of shared logos or trademarks results in a ratepayer asset being used to create an unfair competitive advantage in the market for HVACR services.

- **Bill Inserts:** Direct mail advertising is expensive. Many utilities provide free advertising to their affiliates by allowing them to insert advertising in the utility's monthly billings.

- **Preferential Referrals:** Many consumers call their utility when they experience problems with major appliances or HVACR systems. Often utilities refer these callers only to their unregulated affiliate rather than informing them of the existence of numerous qualified service providers.

While requesting the freedom to subsidize their own entry into the HVACR business through their affiliates, electric utilities have at the same time opposed subsidies to their competitors. Investor owned utilities have spent over 50 years fighting subsidized public power projects. They objected to the public power industry receiving subsidies from taxpayers in form of below market interest rates, low or no taxes and free administrative support. The Edison Electric Institute, a coalition of investor-owned utilities, was formed over 50 years ago to fight public power subsidies. These public power subsidies are similar to the utility's cross-subsidies of their unregulated affiliates.

Many of these same utilities are currently proposing new subsidies to themselves. These proposed subsidies would require customer payment for so-called "stranded costs" (e.g., unsuccessful past investments which firms in normal competitive industries would be forced to write off). These proposed stranded cost assessments amount to a subsidy to electric utilities of between $100 and $160 billion. 12 While the utilities plead financial necessity to obtain stranded cost recovery, many of these same utilities are pouring tens of millions of dollars into entering the HVACR business.

12A. Thierer, "Electricity Deregulation: Separating Fact From Fiction in the Debate Over Stranded Cost Recovery", March 1997, The Heritage Foundation, Washington D. C.

The economic and public policy reasons for limiting cross-subsidization of unregulated affiliates in the HVACR industry are well described in a recent report issued by the National Regulatory Research Institute entitled, "The Problem of Regulating Utility Affiliate Interactions in a Mixed Market Environment" by Kenneth Costello and Robert Graniere. 13 The Institute is supported by the National Association of Regulatory Utility Commissioners (NARUC). The report makes the following key points:

- Cost shifting from unregulated affiliate to regulated utility can be accomplished in myriad ways;
- Cost based regulation provides a substantial economic incentive for such cost shifting;
- The regulatory challenge of reviewing such cost shifting is difficult, if not impossible;
- Cost shifting is economically inefficient: it taxes utility customers to finance unfair competition by the unregulated affiliate; and
- In the long run, the potential for cost-shifting limits competition in the industry entered by the utility's unregulated affiliate.

13For a detailed review of how utilities can cross subsidize, see Costello and Graniere, "The Problem of Regulating Utility-Affiliate Interactions in a Mixed Market Environment, National Regulatory Research Institute, April 1997.

The ability of regulated utilities to leverage their market power into closely related sectors such as HVACR service through cross-subsidization of unregulated affiliates presents significant problems for both regulators and competitors in these unregulated industries. Even Robert Pitofsky, Chairman of the Federal Trade Commission and one of the top government officials charged with enforcing the antitrust laws, concedes: "[cross-subsidization] is one of the most difficult issues to deal with in antitrust enforcement, because the books are in the hands of the person who is doing the cross-subsidizing, and the allocation problems are enormously difficult."14 Even where regulators have attempted to maintain effective regulations against subsidized utility entry into new market, detailed controls against cross-subsidies have been difficult to implement. California has imposed stringent controls on utilities' affiliate transactions, including corporate separation, and has tried to closely monitor these relationships for such giant utilities as Pacific Gas and Electric. Nevertheless, a late 1997 audit of PG&E's subsidiaries found cross-subsidiaries amounting to $33.7 million dollars. California PUC staff projected that PG&E subsidies to its unregulated subsidiaries were growing at such a rate that they could amount to $300 million over the next three years. Unfortunately, no other PUC has completed such a study of the actual costs of cross-subsidies. Projecting the California PUC results for PG&E to a national level, however, the annual national cost for these cross-subsidies would amount to approximately $2 billion per year. The estimated cross-subsidy cost to utility consumers by state is shown in Table 1.

V. A SAMPLING OF UTILITY ENTRANTS INTO THE HVACR MARKET AND REGULATORY RESPONSES IN MAJOR STATES

A. Overview

Utility participation in the HVACR market has taken a variety of forms, including:

- contractor certification programs;
- sales of referrals for customers seeking HVACR service;
- sales of HVACR maintenance plans (either directly or through an affiliate); and
- general HVACR maintenance and contracting.

In response to this development, many state regulatory commissions have begun crafting standards of conduct to govern utility affiliate transactions, particularly those states moving towards a deregulated market. Among these states, many are moving towards stricter requirements of physical and financial separation for electric utilities and their non-regulated affiliates. New Hampshire and California have required that the utilities and their affiliates be separate corporate entities. Iowa, while not requiring complete separation, has prohibited the sharing of vehicles, service tools and other assets between the utility and its unregulated affiliates. Minnesota probably enacted the strictest rules: it required that unregulated affiliates pay a 1% of revenues franchise fee to the regulated utility. (This was later overturned by state courts.) Many other states are currently considering similar rules including charges for shared data processing and administrative support, permitting sharing of marketing and other data only if it is available to all competitors on a nondiscriminatory basis, and other rules to prevent abuse of utility market

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14Antitrust Aspects of Electricity Deregulation before the House Committee on the Judiciary, 105th Congress, 1st Session, at 68 (1997) (statement of the Honorable Robert Pitofsky, Chairman, Federal Trade Commission).

power. The degree to which such rules are enacted and effectively enforced will determine whether HVACR service remains a bastion of small business.

B. Status In Key States

The nation's most aggressive utility moves into air-conditioning installation and maintenance are in Maryland, Virginia, and Colorado.

Maryland -- Baltimore Gas and Electric is moving aggressively into the HVACR business. Through their Home Products and Services division , formed in 1994, BG&E sells HVACR and appliance service contracts, repairs and installs HVACR systems, and sells appliances. BG&E's Commercial Building Systems division designs, finances and supervises the installation of commercial HVACR systems. BG&E clearly cross-subsidizes its affiliates, which pay nothing for such vital services as advertising, data or customer referrals from the regulated utility.

Delmarva Power (recently renamed Connectiv), which supplies electricity to Delaware and Eastern Maryland, has been even more aggressive in the HVACR area. Delmarva/Connectiv has purchased several electrical contractors and now sells, finances and installs residential and commercial central air conditioning systems. Connectiv recently announced that its HVACR business tripled to $95 million in 1997. This amounts to a market share of over 20% in Connectiv's territory.

The Washington, D.C., area gas utility, Washington Gas, is also aggressively selling HVACR services. Its HVACR service programs go back at least to the early 1980's. They sell appliance and HVACR service contracts and finance purchases through a "Thrift Purchase Plan". The actual service work is done by a combination of Washington Gas staff and "Trade Associate" contractors. Washington Gas also operates a contractor referral program.

Several Maryland area utilities are not entering the HVACR business, as of late 1997. Allegheny Power, which services western Maryland, is not pursuing air conditioning installation and maintenance. Columbia Gas also has no major programs.

Maryland regulators and the Maryland legislature are currently debating how to regulate these utility programs. The staff of the Maryland PSC has recommended strict separation between BG&E and its affiliates, including competitive bidding for all utility contracts and open purchase of all utility services such as customer data. The legislature passed tight cost allocation rules for utility subsidiaries.

In nearby Delaware, the State Legislature passed a Joint Resolution establishing Fair Conduct rules for utility subsidiaries. Delmarva Power had bought several HVACR contractors and the utility was referring customers to these unregulated subsidiaries without informing the customers of the corporate relationship. The Delaware Public Service Commission examiner found Delmarva Power's actions to be in clear violation of the Code Of Conduct.[15]

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15 State News, October 19,1997

Virginia -- Virginia Power (VEPCO) had an aggressive HVACR program but is pulling back from this business as of late 1997. VEPCO designs, builds and manages commercial HVACR systems. It created a "Comfort Assured" Preferred Dealer Network to install and service residential heat pump systems and provides low interest loans through these contractors. VEPCO also bought an appliance and HVACR service contract and warranty business. Under significant legal and political pressure, VEPCO is now selling the warranty business and is reducing its other HVACR service business. Under intense pressure, VEPCO signed an agreement with the Virginia Coalition for Fair Competition to follow strict "standards of Conduct."16

Colorado -- Public Service of Colorado both services air conditioning systems and appliances and is constructing a large chilled water plant to provide cooling to downtown Denver. The plant will use off-peak power in the evening to chill water for day time use. PSC has reduced its once aggressive appliance service business to cover the Denver area only.

The most aggressive utility provider of HVACR services in Colorado and several nearby states is KN Energy, once mainly a gas transmission and distribution company. KN Energy provides appliance service (including HVACR), and appliance warranties along with a wide variety of gas and telecommunications services.

A nearby utility, NorAmEnergy, now part of Houston Industries, is aggressively expanding its appliance and air conditioning service business in Texas, Oklahoma, Arkansas, Louisiana and Minnesota and may soon enter the Colorado market.

Colorado's Public Utilities Commission is finalizing a modestly strict code of conduct rules for unregulated affiliates which require full payment to the utility for all data and other services.

New York -- New York utilities are discussing providing a variety of HVACR services but relatively few programs are being implemented as of late 1997. The most active program is that of Brooklyn Union Gas and their merger partner Long Island Lighting (LILCO) -- now Keyspan Energy. Brooklyn Union sells and installs gas air conditioning and sells gas appliance maintenance contracts. Any further Keyspan entry into the HVACR business is being held up by negotiations surrounding the merger.

The other major New York utilities, Niagra Mohawk, Consolidated Edison, Rochester Gas and Electric and New York State Electric and Gas are not aggressively pursuing the HVACR business.

The New York PUC has ordered all state utilities, including Brooklyn Union/Keyspan out of the HVACR business by 2000, unless the utilities can prove they are not cross-subsidizing. The April 4, 1997 PSC order requires that all utility HVACR services be provided by separate subsidiaries, that past expenditures be refunded to customers and that HVACR service prices be immediately raised to unsubsidized levels.

Michigan -- Consumers Power has been aggressively trying to enter the HVACR business for 15 years, but they have been held up by litigation and the Michigan Coalition for Fair Competition has continued to fight these utility HVACR programs. Consumers Power sells appliance and HVACR service contracts for residences and is discussing broader HVACR services. Consumers Power also has a referral program which includes a 10% kickback from the contractor.

16Lawrence DeSimone, Senior Vice President of Virginia Power, letter of Nov. 4, 1997

Detroit Edison sells appliance and HVACR service contracts. Detroit Edison is also installing its Liquid Pressure Amplification Pump as part of commercial refrigeration and air conditioning systems.

Michigan Consolidated Gas (part of MCN Energy) has expanded from servicing gas appliances to selling service contracts for central air conditioning systems in the Detroit and Grand Rapids areas. Michigan Consolidated advertises its"100 years of gas appliance service experience."

These utility programs and potential cross-subsidy problems would be severely limited, if not killed by pending Michigan legislation enacting utility standards of conduct. The proposed Michigan standards would prohibit unregulated subsidiaries using the utility's name, staff or data bases. The Michigan Alliance for Fair Competition has repeatedly sued successfully to limit regulated utility provision of HVACR services.

Ohio -- Ohio utilities are discussing entering many aspects of the HVACR business, but no programs were actively implemented until 1997. In 1997, Ohio Edison (now part of First Energy which includes Toledo Edison and Cleveland Electric Illuminating) bought two of the nation's largest mechanical contractors, Roth Brothers and RPC Mechanical, with combined revenues of over $90 million. Ohio Edison has announced that through these contractors it will supply the full spectrum of HVACR, roofing, and building services primarily to commercial and industrial customers. They are also starting a "one call" appliance service program. This dramatic move makes Ohio Edison/First Energy a major HVACR player.

American Electric Power is indirectly entering the HVACR business through its proposed 10 year guaranteed savings programs. For large customers willing to contract for buying electricity for 10 years, AEP guarantees cost savings and installs energy saving equipment, including HVACR equipment, for free. It is unclear how extensive these new power contracts will be and what their impacts will be on existing HVACR contractors.

Columbia Gas has an appliance warranty program in Ohio. Consolidated Natural Gas is experimenting with an appliance warranty program in nearby Pennsylvania, which may be extended to the territory of CNG's East Ohio Gas.

Neither of Ohio's other major electric utilities, Cincinnati Gas and Electric (now Cinergy) and Dayton Power and Light, are actively pushing air conditioning installation and maintenance programs.

The Ohio legislature is considering utility standards of conduct which would control these programs, but passage is uncertain.

Nevada -- Nevada Power proposed a preferred dealer network where it would sell referrals to selected contractors, but this program was effectively killed by PSC action. They are also planning a central chilled water cooling system for the Las Vegas "Strip." Having lost the dealer referral battle, Nevada Power is now entering the home and appliance warranty business (including HVACR) through an insurance affiliate, First Choice Insurance. This program is running into problems with the contractor's licensing board, as is a similar insurance program run by Old Republic. Sierra Pacific has no similar programs.

Southwest Gas has some contractor referral programs, but these are operated in cooperation with existing contractor organizations.

The Nevada Legislature passed a new law requiring that all unregulated work be run through separate affiliates, but the standards of conduct for these affiliates will be established as part of complex new laws and new rules for de-regulating electric power generation.

VI. POTENTIAL IMPACTS OF CROSS-SUBSIDIZATION ON LONG-TERM COMPETITION

Since electric and gas markets will continue to be partially regulated, the opportunities and incentives for cross-subsidization will also continue. The market power of existing regulated electric and gas monopolies may decline, but will not disappear. Therefore, careful regulation to prevent unfair cross-subsidization will continue to be

necessary in order to prevent diverting consumer savings from the electricity markets and causing substantial disruptions in unregulated markets such as HVACR services.

Consumers are harmed by cross-subsidization both in the market for electricity and in markets served by unregulated utility affiliates. The harm to the utility's customers lies in the fact that they bear, whether directly or indirectly, the cost of the internal subsidy to the utility's unregulated affiliate. The harm to consumers in the market for HVACR services arises from the inefficient skewing of that market caused by the cross-subsidy. Again, the utility affiliate's ability to price its services at below cost in order to gain market share allows it to drive other competitors from the market. New competitors will be discouraged from entry by the affiliate's ability to incur short-term losses to eliminate competition. Therefore, while consumers may initially benefit from lower prices, these prices will rise rapidly once long term competition has been reduced.

Utility takeover of the HVACR business would be disruptive to the lives of both existing contractors and their workers. Delmarva/Connectiv's gaining of over a 20% market share in less than five years demonstrates how a large utility with unlimited funds can quickly dominate the HVACR industry. If utilities takeover only 10% of the existing market, total national job loss among existing workers would be 60,000 jobs. About 5,000 existing contractors would close down at this level of utility expansion.

Utilities have argued against restrictions on affiliate cross-subsidies on the grounds that they should be allowed to achieve economies of scale like other large integrated entities. There is inevitably a tension in deregulating monopolies between allowing realization of the benefits of economies of scale and creating an environment in which the benefits of market competition can be fully realized. However, past deregulation efforts demonstrate that legislators and regulators have seen fit to balance these interests by imposing at least some restrictions on the incumbent monopolists' ability to utilize their accumulated market power. These restrictions are necessary in order to create a marketplace in which open competition can flourish.

In the long run, without restrictions, energy utilities will be able to gain monopoly level profits in related, unregulated service industries. Once cross-subsidies have been used to drive out existing competitors, prices can be raised to high levels, generating monopoly profits for the unregulated subsidiaries of the utilities. These high prices and profits can be maintained because potential new entrants will be frightened off by the risk of predatory low prices charged by the utilities.

Finally, allowing cross-subsidization of utility affiliates represents an unwise investment for utilities themselves. Utilities will face extremely difficult competitive forces in their core business in the coming years. Cross-subsidization diverts needed resources, that could be devoted to providing core utility services in the new competitive environment, to side ventures subsidized by the utility's customers.