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ENHANCING TELECOMMUNICATIONS COMPETITION THROUGH EXEMPT TELECOMMUNICATIONS COMPANIES REGULATION: THE AFFILIATE TRANSACTION PROBLEM

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Introduction

The Telecommunications Act of 1996 was enacted with great promise and expectation. Politicians and pundits alike promised that all consumers would benefit from competitive telecommunications and information services. For the most part, however, these promises have remained unfulfilled. One culprit is the lack of sufficient facilities-based entry into the markets. Without such facilities-based entry, the promised new competitive services can only be provided on the resold or leased property of incumbent providers through resale of the same services or in combination with unbundled network elements.[1] Without facilities-based entrants, the economic benefits commonly associated with competition and good market performance; that is, declining prices and additional new services and products, appear to be quite limited. Only so many economic benefits can be squeezed out of existing facilities. Without new facilities, so-called competitive services can be discounted only so far and only so much can be gained from repackaging of existing services or piggybacking onto them. One potential facilities-based entrant is the local electric or gas company.

Certainly changes in federal law contained in the 1996 Act offered a significant opportunity for this sort of entry and apparently many electric and gas utilities have responded. These changes, however, come with some concerns. As recognized in the changes to federal law, there remains a significant regulatory problem when regulated and unregulated companies are commonly owned. The holding company structure creates incentives to shift costs in ways

[1] The Telecommunications Act provided for three methods of competitive entry: interconnection of facilities-based carriers, resale, and access to unbundled network elements, 47 U.S.C. § 251.

that may be detrimental to both customers and other competitors. Although regulators retain a significant interest in insuring neutrality, neither the regulatory structure within a state or among states within a region should deter the desired competitive entry. Thus, a careful balance must be struck between two legitimate and potentially competing interests.

The analysis of the existing legal and regulatory structures for dealing with gas and electric company entry into telecommunications suggest several potential actions that attempt to strike that balance. These steps include careful definition of state requirements for that entry, rule neutrality, expedited review processes, and regional coordination. State regulators have many of the necessary tools to accomplish these results already, and where they do not, legislators should be receptive to changes that will encourage competition that advances the goals of the 1996 Telecommunications Act.

Background

Freed from the limitations of federal law concerning holding companies and possessing substantial telecommunications assets embedded in existing control facilities, gas and electric companies have the potential and the inclination to make headway in the facilities-based telecommunications market. Currently, electric and gas companies own over 600,000 miles of high-capacity fiber-optic cable.[2] Indeed, it was estimated in 1997 that electric utilities already accounted for 12 percent of all telecommunications networks in the United States. Most of this telecommunications capacity is under- or unutilized. According to a 1997 study of the Electric Power Research Institute, electric utilities typically use only about 3 percent of their communications capacity for

[2] Electric Power Research Institute, *Powering Progress: The Electricity Technology Roadmap Initiative–Background Report: A Preliminary Vision of Opportunities* (1997), 2-6.

their own purposes. As one utility executive puts it, "we're sitting on a gold mine."[3] Nor is the fiber optics that runs along the utility transmission system the only potential utility for electric-telephone convergence. In addition, the power line can act as a narrowband medium at relatively low cost, with immediate potential applications, without compression, in remote meter reading, outage detection, real-time pricing, and load control.[4]

Further, these companies are already making substantial efforts in telecommunications, especially in the carrier to carrier market sector[5]. A 1999 survey indicated that thirty-nine of the sixty-seven energy companies surveyed were carrier-to-carrier providers. Some of these interests have been aggregated into substantially sized partnerships[6]. More importantly, a substantial portion were also serving as Internet, long distance, and local dial tone providers.[7] (See Table 1.) Plainly, these companies have both the assets and interest to serve as facilities-based providers of local services.

The convergence of telecommunications and energy providers is desirable for several reasons. Where two previously unrelated markets for services or

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[3]Electric Power Research Institute, "At Home with Telecommunications," *EPRI J.* (Jan./Feb. 1997) at 8.

[4]Id. at 9.

[5]In an interesting extension of this entry strategy, Montana Power chose to leave the electric business completely to focus on its telecommunications business. John Borland, Power Firm Pulls Plug, Bets on Telecom, http://home.cnet.com/category/0-1004-200-1596171.html (site visited Mar. 29, 2000).

[6]"Partners Create America's Fiber Network, A Super-Regional Fiber Optics Company," AEP Press Release, Mar. 21, 2000.

[7]Quarterly Supplement, *UT Digest* (Oct. 1999), at 9-18.

Table 1: Investor Owned Utilities with Telecommunications Subsidiaries

Total Companies Reported	67
Local Dial Tone Providers	22
Long Distance Providers	26
Internet Providers	25
Carrier to Carrier Providers	39

Source: Quarterly Supplement, *UT Digest* (Oct. 1999), at 9-18.

products come together through advances in technology, the synergies brought about by the newly available technology can make available traditional services at a lower cost, add value to traditional services, and lead to new products and services that increase consumer value. Examples of reducing the utility's cost of servicing the customer include automatic meter reading, automated billing, remote connection or disconnection, theft and tampering detection, and outage detection and handling. Examples of increasing the value of traditional electric service include providing real-time pricing, energy information and education, bill feedback, energy and demand management, energy and customer monitoring, and power quality monitoring. Just a few examples of the new non-energy products and services that could be offered include educational programming, telephone service, data and information servicing (including Internet access), entertainment service, home and business security and fire protection, videoconferencing, telemedicine, interactive television, and distance learning. Most of these are made possible by two-way interactive communications.

Economies of scale also tend to favor, in the long-run, the installation of fiber optic technology for two-way interactive communications. However, there is a high initial cost of fiber optic technology, primarily concerning its installation.

As such, fiber optics tends to be installed only where there is sufficient demand to justify the cost of installation. Many electric utilities, however, have already invested in fiber optics for the real-time control and operation of their transmission systems. For these electric utilities, the cost of existing fiber optics is already embedded, with zero marginal capital costs.

So what are the barriers to electric-telecommunications convergence? Section 103 of the Telecommunications Act of 1996 eliminates the *federal* barrier of entry faced by electric and gas companies entering the telecommunications field. Section 103 permits both registered and exempt holding companies under the Public Utility Holding Company Act of 1935 (PUHCA) to provide telecommunications and other information services to the public by means of wholly-owned subsidiaries, each organized exclusively for this purpose and designated an Exempt Telecommunications Company (ETC) by the Federal Communications Commission (FCC).

As such, the ETC holding company exemption provides electric utilities with an opportunity to diversify their activities into telecommunications services. Further, electric utilities can establish a quick presence in an otherwise unfamiliar market through a merger, joint venture, or a strategic alliance. Such an approach might especially appeal to electric utilities that are facing retail electric competition because they can gain form the marketing experience that a telecommunications firm can offer.

Yet, electric-telecommunications convergence raises legitimate state concerns. These concerns are reflected in the substantial express authority that is left with state and federal energy and telecommunications regulators. In particular, there are important costing issues that remain when an unregulated subsidiary is paired with a regulated one. In the case of ETCs, that situation will necessarily be the case even in those states that have begun electric deregulation. In those states, transmission remains regulated and will remain so for the foreseeable future. Thus, concerns about the appropriate treatment of costs to and from the regulated entity will remain an important state concern.

The direction of regulation thus becomes important. It has the potential of protecting energy utility consumers but also making competitive entry more difficult. Especially given the diversity of potential standards associated with affiliate transaction reviews at the state level, there is a real concern that regulation will not promote the outcomes contemplated by the changes initiated in 1996.

Given the level of apparent investment in telecommunications subsidiaries that has already occurred, it may seem that this concern is overstated. Nonetheless, it is also apparent that the regulatory process can be used by competitors as a barrier to entry, a result not likely to benefit customers. To that end, regulatory authorities might wish to consider some simple approaches to ETC regulation that are likely to assist entry while protecting ratepayers. These steps include carefully articulated affiliate rules, even-handed standards, templates, and consistent application within a state or region.

Federal Regulation of Exempt Telecommunications Companies

Holding company requirements would prevent registered holding companies from seeking to enter the telecommunications business if there were no exemption in the 1996 Act. The 1935 Public Utility Holding Company Act's requirement that the business of the holding company be limited to a single integrated system constrains the sorts of business the holding company could enter. Further, the Securities and Exchange Commission's enforcement of the original exemption provisions appeared to prevent entry into telecommunications.

The Holding Company Act Limitations Prior to the 1996 Act

Under section 11 of the Holding Company Act, a holding company and its subsidiary companies are limited to providing utility services. The Act provides:

(b) Limitations on operations of holding company systems

It shall be the duty of the Commission, as soon as practicable after January 1, 1938:

> (1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system ... .[8]

Through this provision, the holding company is narrowly constrained in the types of activities it may undertake. The SEC adopted a two-part test in its application of this provision. First, the holding company must demonstrate the business is functionally related to the public utility system. Second, it must show that the integration was in the public interest.[9]

There is a strong indication in the cases seeking relief from the line-of-business restriction that full ownership of a telecommunications company would

[8] 15 U.S.C. § 79k(b)(1).

[9] Douglas W. Hawes, Utility Holding Companies § 3.05[1] (1987).

not meet the test. In one case, Southern Company was permitted to acquire a minority interest in a telecommunications company to research to perfect two-way communications over electric lines.[10] The actual communications business, however, was ruled out of bounds in a case affecting Mississippi Power and Light. In that case, the SEC concluded that cable operations were not related to the electric business even if the lines were used for two-way communications for the electric utility.[11] Thus, absent an exemption, a registered holding company[12] could not engage in the provision of communications services.

Section 103 of the Telecommunications Act of 1996

The constraints imposed by the Public Utilities Holding Company Act of 1935 were largely lifted in 1996. Section 103 of the Telecommunications Act of 1996[13] provided an additional exemption that specifically permitted the creation of telecommunications subsidiaries not governed by the Holding Company Act. The exemption, however, is relatively complex and retains substantial state and federal regulatory authority over the ETC.

An ETC is defined as a company that has filed with the FCC for a determination that it is an exempt company and is exclusively in the business of

[10]Southern Servs., SEC Holding Co. Act Rel. No. 23440 (Oct. 1, 1984).

[11]Mississippi Power and Light Co., SEC No-Action Letter [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,382. For a discussion of the standard and its application, see Hawes, supra note 9.

[12]Companies that are exempt from registration did not appear to be subject to these limitations. The argument, at least in the late 1980s, however, was not free from doubt. See Hawes, supra note 9, § 3.05[2].

[13]Codified as 15 U.S.C. § 79-5c. For the text of the Section 103, see Appendix A.

providing telecommunications services, information services, or other services subject to the jurisdiction of the FCC, or that are related or incidental to telecommunications or information services. The ETC is deemed to be qualified for the exemption with its filing and remains exempt as long as the FCC does not reject the application within sixty days.[14] Pursuant to rule, the FCC deems the application granted by its inaction after sixty days.[15]

There are significant advantages arising from the ETC designation. First, the act eliminates any ambiguity created by the prior statute and decisions concerning the right of exempt and nonexempt companies to own a telecommunications subsidiary.[16] Second, the holding company limitations defined by the line of business restrictions and geographic restriction in the Holding Company Act do not apply to an ETC. Further, the activities of the ETC would be considered reasonably incidental. Finally, the Holding Company Act is suspended for the registration and approval of issue and sale of securities or the guarantees of an ETC securities and generally there is no Holding Company Act jurisdiction of contracts among a holding company, an ETC, or other affiliates.[17]

On the other hand, Congress also acknowledged significant concerns with the operation of an ETC on the regulation of affiliate public utilities. To that end, the exemption provides for continued regulation by other state and federal regulatory authorities. (Table 2 sets out the continuing regulatory authority.)

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[14] 15 U.S.C. § 79-5c(a)(1).

[15] 47 C.F.R. § 1.5004 (1999).

[16] 15 U.S.C. § 79-5c(c) & (d).

[17] Id. § 79-5c(e).

Table 2: State and Federal Regulatory Authority under Section 103 of the Telecommunications Act of 1996

Agency	Authority	Section*
FERC	Review of costs recovered for purchased products for purposes of rate making	§ 79-5c(j)
FCC	Continuing regulation of telecommunications rates	§ 79-5c(n)
SEC	Disclosure rules	§ 79-5c(f)
States	Approval of sale of assets in rate base as of Dec. 19, 1995	§ 79-5c(b)
	Affiliate contracts are subject to review if required by state law; state may waive its authority	§ 79-5c(i)
	Review of costs recovered for purchased products for purposes of rate making	§ 79-5c(j)
	State may review books and records of public utility, ETC, and associate or affiliate of ETC selling to a public utility	§ 79-5c(l)
	State may order an audit of a public utility on matters related to transactions or transfers between the public utility and ETC	§ 79-5c(m)
	Continuing regulation of telecommunications rates	§ 79-5c(n)

* References are to 15 U.S.C. § 79-5c. For the text of the Section 103, see Appendix A.

For example, the statute provides for continuing rate authority by the Federal Energy Regulatory Commission, the FCC, and states over the public utilities and the ETCs.[18] Further, states retain authority over the transfer of assets and affiliate transactions between the ETC and a regulated public utility.[19] Finally, the state regulatory commissions may review books and records and conduct audits of public utilities concerning transactions and transfers between a public utility and an ETC.[20]

Congress also prohibited certain activities. The public utility cannot issue securities or guarantee the obligations of an ETC.[21] It also is prohibited from pledging or mortgaging assets on behalf of the ETC.[22] Thus, the ETC must operate within a detailed structure designed to address some of the basic regulatory concerns associated with affiliate relations so as to assure its exemption.

State Regulation: The Alternatives for Regulating Affiliate Transactions

The Holding Company Act exemption for ETCs clearly places a responsibility on the state commissions to prevent abusive behavior by ETCs and their affiliates. At the same time, the act also seeks to promote entry

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[18]Id. § 79-5c(j) & (n).

[19]Id. § 79-5c(b) & (i).

[20]Id. § 79-5c(l) & (m).

[21]Id. § 79-5c(g).

[22]Id. § 79-5c(h).

through facilities-based competitors. The problem then is finding the appropriate regulatory approach that meets both policy goals.

The Transfer Pricing Problem

Many of the problems of affiliate regulation arise in the context of transfer pricing: the exchange of goods or services between parts of a firm.[23] These intra-firm transactions operate outside the constraints of a price mechanism, but do constitute part of the factors of production (e.g., coordination or management) that a firm brings to its segment of the market.[24] When the firm is the entity that is operating in a competitive market, regulation is generally not in issue. When, however, a firm is regulated and its transactions are with an unregulated affiliate, problems can arise.[25]

The classic example of such a problem is the pricing of services from an unregulated affiliate to a regulated affiliate, as in service contracts. Writing of the excesses of the pre-Holding Company Act period, Charles Phillips has stated:

> Usually, annual fees were collected in the form of a certain percentage of the operating company's gross revenue, and the resulting fees bore little relationship to the costs of the services furnished. ... Since they were hidden in the costs of the operating companies, excessive fees were

[23]Kenneth W. Costello, "A Pricing Rule for Affiliate Transactions: Room for Consensus," *Elec. J.* (Dec. 1998), 59 (prices charged by one segment of an organization for a product or service that it supplies to another segment of the same organization).

[24]R.H. Coase, *The Firm, the Market and the Law* (1988), 35-36.

[25]Costello, supra note 23.

> covered in setting electric rates and thus paid by the consuming public.[26]

Plainly there could be a motive to move costs to the regulated subsidiary to better assure their recovery. Additionally, the holding company may seek to transfer costs away from the unregulated affiliate to make it appear more competitive (even though its costs have not changed). In effect, the competitive affiliate would engage in a form of unfair competition.[27] In either case, "management will have an incentive to use the transfer prices as a means of manipulating the income or expenses of the segment being evaluated."[28]

Of course the failure to identify the excessive fees in theory could be corralled by careful regulation of the operating company's rates, but practice is often quite different. "In the real-world situation where detection is difficult and uncertain, ... regulators believe they need to establish rules or policies up front that would mitigate undesirable behavior, including transfer pricing abuse."[29]

Thus, it has long been understood that pricing abuse can occur when part of the firm is regulated and another part is not. To avoid abuse, regulators will scrutinize the pricing of transfers between the firms to assure that customers of the regulated entity are not paying for costs that they should not and, more recently, that competitive firms are not facing unfair competition.

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[26] Charles Phillips, *The Regulation of Public Utilities*, 2d ed. (Arlington, Virginia: Public Utility Reports, 1988), 579.

[27] Costello, supra note 23, at 60.

[28] Robert E. Burns et al., *Regulating Electric Utilities with Subsidiaries* (Columbus, Ohio: NRRI, 1986), 160.

[29] Costello, supra note 23, at 60.

Section 103 Affiliate Transaction Provisions

Two sections explicitly govern inter-affiliate transfers. One provides a restriction on the transfer of assets that were in rate base on December 19, 1995. The other provides coverage for contracts for services from the unregulated affiliates. In addition, there are several areas which seem to imply additional state regulation.

Section 103(b) requires state commission approval for transfers of assets that were in rate base as of December 19, 1995. Further it recognizes the continuing authority of state commissions to regulate such transfers.[30]

Section 103(i) extends state commission authority to the regulation of affiliate sales of telecommunications services to a regulated utility affiliate. Each state with jurisdiction over retail rates of the utility must approve such transactions. For those states without jurisdiction over retail rates of the utility, the transaction is exempt from approval if it is not either directly or indirectly resold to an affiliate or associate company. If the telecommunications services

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[30]Section 103(b) provides:

> If a rate or charge for the sale of electric energy or natural gas (other than any portion of a rate or charge which represents recovery of the cost of a wholesale rate or charge) for, or in connection with, assets of a public utility company that is an associate under the laws of any State as of December 19, 1995, the public utility company owning such assets may not sell such assets to an exempt telecommunications company that is an associate company or affiliate unless State commission having jurisdiction over such public utility company approve such sale. Nothing in this subsection shall preempt the otherwise applicable authority of any State to approve or disapprove the sale of such assets. The approval of the Commission under this Act shall not be required for the sale of assets as provided in this section.

are resold to an affiliate or associate company, then each state commission with jurisdiction over the retail rates of the affiliate or associate company must approve the transaction. The section, however, also provides that a state may waive the granted review authority.[31]

Several other provisions recognize the continuing role of state authorities to regulate affiliate relationships and utility rates. For example, subsection (j) maintains any existing state authority to review transactions that might have an effect on regulated rates. Subsection (l) provides for access to books and records of the utility, the ETC, and affiliate and associate companies for the purpose of monitoring rates. Subsection (m) creates a state right to order an audit. Finally, subsection (n) authorizes the FCC and state commissions to regulate the activities of the ETC.

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[31] Section 103(i) provides:

> A public utility company may enter into a contract to purchase services or products described in subsection (a)(1) [telecommunications services] from an exempt telecommunications company that is an affiliate or associate company of the public utility company only if–
> (1) every State commission having jurisdiction over the retail rates of such public utility company approves such contract; or
> (2) such public utility company is not subject to State commission retail rate regulation and the purchased services or products–
> (A) would not be resold to any affiliate or associate company; or
> (B) would be resold to an affiliate or associate company and every State commission having jurisdiction over the retail rates of such affiliate or associate company makes the determination required by subparagraph (A).
> The requirements of this subsection shall not apply in any case in which the State or the State commission concerned publishes a notice that the State or State commission waives its authority under this subsection.

In summary, the ETC amendment to the PUHCA recognizes an important and ongoing role for state (and federal) regulation. The theory behind the regulation appears to be based on the basic concerns inherent in the holding company structure. In place of federal regulation, however, the states are placed in the role of protecting local energy utility customers from the adverse effects that might occur through the holding company structure. In practice, that regulation can point in a number of different directions for the transfer pricing problem.

State Regulatory Approaches to Transfer Pricing: Some Examples

As provisions of Section 103 make clear, the states have a continuing regulatory role in the approval and the review of the rate effects of transfer pricing between an ETC and its utility associate or affiliate. The statute does not prescribe the method of regulation, leaving to the state law those difficult responsibilities. As both past and recent NRRI research has demonstrated, there is substantial variation in the manner in which states address transfer pricing questions.[32]

A 1986 NRRI report on the regulation of electric utilities with subsidiaries provides one of the more comprehensive reviews of state practices for pricing affiliate transfers.[33] Through a detailed state survey, the report's authors identified a variety of processes and pricing rules used to assess affiliate

[32]For a summary of the following discussion, see Appendix B.

[33]Robert E. Burns et al., supra note 28.

transaction.[34] As noted in the text of the report, states use standards ranging from market-based assessments to cost assessments with alternative measures used to calculate the appropriate rate of return imputed to the price.

One approach uses market pricing to determine the reasonableness of the transfer pricing. This approach involves a comparison of the price actually paid by the utility to an affiliated supplier with the price the utility could have paid to a nonaffiliated supplier under similar terms and conditions. Costs in excess of the market price benchmark are not recoverable for rate making purposes.

The market price approach is premised on the concept that the utility's subsidiary is an "independent entity"–separate and apart from the utility. The market price approach is consistent with the approach for allocating financial capital costs which calls for the elimination of all investments in non-utility businesses from the equity component of the consolidated company's capital structure. The market price approach thus treats the subsidiary as an independent entity and does not attempt to regulate its profits or rate of return.

One of the practical drawbacks of the market price standard is that it presumes the existence of a competitive market for the good being transferred. The test will not be effective if the affiliate exercises sufficient oligopolistic or monopolistic power to be able to influence prices for the good being sold. If this were the case, the market price test would be little more than a meaningless comparison between a price set directly by the subsidiary (the transfer price) and an array of market prices indirectly influenced by the subsidiary due to its dominance in the market.

Another key assumption underlying the use of the approach is that the utility's investment in the subsidiary is financed entirely out of the utility's

[34] Id. at 241-61.

retained earnings and not from contributions from ratepayers. If this implicit assumption is violated, the market price approach may not be preferred. Then it may be argued on fairness grounds that the ratepayers should be allowed to benefit from any cost savings resulting from this investment.

A corollary of the assumption that the utility's original investment in the subsidiary was not underwritten by ratepayer contributions is the implicit assumption that there is no cross-subsidization of the subsidiary by the utility in its day-to-day operations. If ratepayer contributions were being routed to the subsidiary, then the argument could be made on fairness grounds that ratepayers should be allowed to share in the benefits of these reduced costs.

The market price approach is conceptually appealing from an economic point of view since the market price reflects the relative scarcity or opportunity cost of the good in question. The competitive market price standard therefore encourages the best use of scarce resources. Further, the approach encourages the efficient allocation of the utility's resources. To the extent that the utility's investment in a related business activity does result in some form of synergistic benefit, the market price approach encourages utilities to invest in them.

One of the practical advantages of the market price test is that it does not require a detailed cost of service study. On the other hand, the market price standard may be difficult to apply effectively if two basic conditions do not exist. First, the affiliate must not be large enough to control prices. Second, it may be practically difficult to define the appropriate market for making the comparison.[35]

As an alternative to the market price approach, state commissions have used cost-plus alternatives to value transactions. One approach looks at the profit comparison. Under the profit comparison approach, the subsidiary's rate of return is compared with the rate of return for similar firms in the same

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[35]Id. at 165-72.

industry. If the subsidiary's rate of return exceeds that of similar firms, the transfer price is deemed to be excessive even though it may be less than or equal to the competitive market price.

The profit comparison test is based on the assumption that the subsidiary's profits are the result of either synergistic benefits from the parent utility relationship, or some kind of implicit subsidization of the subsidiary by the utility. For example, some would argue that a captive subsidiary benefits from the utility-subsidiary relationship more so than the utility because the captive subsidiary has an assured market for its product. This assured market, which is a result of the utility-subsidiary relationship, shifts a portion of the subsidiary's riskiness onto the utility. Proponents of the profit comparison approach argue that the ratepayers should be allowed to benefit from this synergism in the form of reduced rates, particularly if the subsidiary's profitability may be due to some form of implicit cross-subsidy from the utility.

One drawback associated with the profit comparison approach is that it does not lend itself to a consistent application in all transfer pricing situations. Although application of the profit comparison approach results in lower rates for ratepayers in cases when the subsidiary is more profitable than most of the firms in its industry, the application of this standard in cases when the subsidiary's rate of return is less than average would result in higher rates for the ratepayer than if the utility had purchased from a non-affiliated supplier. Thus, if the profit comparison approach were used on a consistent basis, both ratepayers and stockholders would benefit from the subsidiary's profitability, but they would also bear the risk of the subsidiary being unprofitable. Rather than applying the profit comparison approach in all cases, regulators are inclined to switch to a market price standard when the subsidiary is inefficient and charges more than the market price for its product, and to switch to the profit comparison approach if the subsidiary is profitable. Such treatment allows the utility to recover from customers only the lower of market price or cost of production and would therefore discourage utility diversification. On the other hand, application of the profit comparison approach in all cases could encourage the continued operation of inefficient subsidiaries and would provide little incentive for efficiency on the part of the utility or the subsidiary.

A variant of the profit comparison test is the utility rate of return approach. Like the profit comparison approach, the rate of return approach examines the subsidiary's rate of return using the rate of return allowed to the utility. Concerns similar to those associated with the profit comparison test arise in the rate of return approach.

Individual State Approaches

The diversity of approaches is apparent in a small sample of states actual and expected treatment of affiliate transactions by ETCs. Some states remain uncertain of the regulatory direction; others intend to apply or have applied particular approaches to the problem. In those states that have indicated a rule choice, there already appears to be variety in that choice. (See Table 3.)

A related concern is the treatment of the same assets or contracts that involve multiple jurisdictions. One example of this concern involved the transfer of assets, leases, service contracts between AEP utility and ETC affiliates. The transactions were reviewed by the Ohio and West Virginia commissions, which came to different results.

In filings to both the Ohio and West Virginia commissions, AEP sought authority for the transactions implicating several different issues. Initially, AEP sought approval for the lease of communications fibers running between Columbus, Ohio, and Charleston, West Virginia. Second, it sought either a waiver of review or approval of a services agreement for telecommunications services from the ETC to the utilities. Third, it sought approval for the sharing of

Table 3: Selected State Approaches to ETC Affiliate Transactions

State	Utility to Affiliate	Affiliate to Utility Contracts
Arkansas	TBD	TBD
Ohio	Greater of book or market for asset transfer	At tariff or approved contract rate or market for nontariffed
Maine	FMV	FMV
Wisconsin	Higher of FMV or Cost	Lower of FMV or Cost

Abbreviations: TBD: To Be Decided
FMV: Fair Market Value

Sources: Arkansas: Email from Art Stuenkel to Frank Darr (Jan. 19, 2000); Ohio: In the matter of the Joint Application for Approval of Certain Transactions Between Ohio Power Company, Columbus Southern and AEP Communications, LLC, Finding and Order, Case No. 97-748-EL-ATR (Feb. 12, 1998), revised in part, Entry on Rehearing (Apr. 9, 1998); Maine: 35-A Maine Rev. Stat. Annot. §§ 503, 707, 708, 713, 714, and 715 and related rules; Wisconsin: Wis. Stat. §§ 196.52 and 196.795.

utility employees with the ETC. Finally, it sought some specialized transaction reporting and related annual reporting.[36]

Both state commissions approved the transactions but under different conditions.[37] On the asset lease, Ohio valued the transaction at the greater of book or market, with any gain going to pay down regulatory assets; West Virginia left the valuation issue to the next rate review. On the contracts for communications services, Ohio approved the contracts if they were set at tariff or approved contract rate, or at market; West Virginia applied a FCC rule that allowed lowest market prices if fifty percent or more of the ETC's revenues came from third parties, but allowed the lower of cost or market if less than fifty percent of revenues came from third parties. On the lending of employees, the Ohio commission required that the use be fully costed with overheads; the West Virginia commission approved without making a valuation determination. There was a plain difference in approach on each of the issues: Ohio set the terms that would appear in any future rate setting; West Virginia left that matter to another day.

Similar problems have arisen in the application of codes of conduct.[38] In these situations, the utility may face very different marketing rules in each state

[36] For a description of the request, see In the matter of the Joint Application for Approval of Certain Transactions Between Ohio Power Company, Columbus Southern and AEP Communications, LLC, Finding and Order, Case No. 97-748-EL-ATR, slip op. at 3-4 (Feb. 12, 1998)

[37] In the matter of the Joint Application for Approval of Certain Transactions Between Ohio Power Company, Columbus Southern and AEP Communications, LLC, Finding and Order, Case No. 97-748-EL-ATR (Feb. 12, 1998), revised in part, Entry on Rehearing (Ohio Pub. Util. Comm'n Apr. 9, 1998); AEP Communications et al., Case No. 97-0872-ET-PC (W.Va. Pub. Serv. Comm'n Dec. 16, 1997).

[38] Christie Leiser, Address to ICM Conference (Feb. 9, 2000) (noting the various state rules governing marketing by an ETC in the Connetiv service territory).

in which it is seeking to provide service. These rules are likely to cause additional costs that raise the cost of entry.

Whether these problems are significant to the development of competition in the retail telecommunications market, of course, is the interesting question. These transactions have gone forward even with the inconsistent treatment. AEP's recent partnership with several other carriers in the carrier-to-carrier market suggests that the problems may not be significant in the wholesale market. But they at least raise the question whether a tighter or more uniform regulatory regime may be more appropriate.

Next Steps: Balancing the Promotion of Competition and Regulatory Concerns about the Affiliate

The potential for competitive entry by ETCs in the retail market, given their existing facilities, interest, and expertise, warrants careful consideration of the appropriate methods for regulating in a manner that meets the potentially conflicting goals of promoting new entry and ratepayer protection. Several steps can be taken to harmonize those interests.

First, states should have a well-defined set of rules for dealing with the basic transactional questions. For example, rules or decisions concerning affiliate conduct, and affiliate transactions valuation and reporting should be reviewed and updated, if necessary. To the extent that state law is incomplete, commissions should consider asking for any necessary authority and be prepared to demonstrate both the need and the appropriate balance that should be struck.

Second, states should consider what sort of incentives should be included in these standards so as to encourage facilities-based entry. Rules that discourage entry, whether in the form of asymmetric valuations or heavily procedural reporting requirements (to name a few) should probably be avoided unless there is a strong demonstration for their need. The regulatory goal should be to make the competitive playing field as neutral as possible, not to provide advantages one way or another. Likewise, the focus should be on consumer protection. Rules that handicap entry may dissuade entry that is necessary for there to be competition.

Third, the states may want to consider some sort of expedited review process, a so-called rocket docket. To accomplish such a result, the state could consider developing a baseline filing for particular sorts of transactions. If the applicant complied with the baseline, short comment periods could replace extended filings and hearings. The applicant then could elect either to file under the baseline requirements or file outside the baseline if it needed to do so to meet its particular needs. The commission would review those filings that sought expedited approval to determine if they met the base guidelines and quickly approve those that did. If the application fell outside the guidelines, the normal review process would apply. (See Appendix C.) Again, individual states might need to seek legislative authority to accomplish such a result.

Fourth, states should consider consistent treatment of similar problems across a multi-state region. Such coordination is often warranted because the communications systems themselves may cross state boundaries. Regional coordination, thus, may provide an added benefit for the development of competitive entry.

The problem, as always in regulation, is in setting the appropriate balance between the competitive goals enshrined in the Telecommunications Act and the historical concerns, such as consumer protection, associated with affiliate transactions. Careful consideration of the competing concerns, however, should result in a balanced set of rules that will permit and even encourage entry from a potentially important player into the local telecommunications markets. That entry is a common goal that regulators can nurture through effective regulatory approaches.

Appendix A: Section 103 of the Telecommunications Act of 1996

SEC. 103. EXEMPT TELECOMMUNICATIONS COMPANIES.

The Public Utility Holding Company Act of 1935 (15 U.S.C. 79 and following) is amended by redesignating sections 34 and 35 as sections 35 and 36, respectively, and by inserting the following new section after section 33:

SEC. 34. EXEMPT TELECOMMUNICATIONS COMPANIES.

(a) DEFINITIONS- For purposes of this section–

(1) EXEMPT TELECOMMUNICATIONS COMPANY- The term ‘exempt telecommunications company’ means any person determined by the Federal Communications Commission to be engaged directly or indirectly, wherever located, through one or more affiliates (as defined in section 2(a)(11)(B)), and exclusively in the business of providing—

(A) telecommunications services;
(B) information services;
(C) other services or products subject to the jurisdiction of the Federal Communications Commission; or
(D) products or services that are related or incidental to the provision of a product or service described in subparagraph (A), (B), or (C).

No person shall be deemed to be an exempt telecommunications company under this section unless such person has applied to the Federal Communications Commission for a determination under this paragraph. A person applying in good faith for such a determination shall be deemed an exempt telecommunications company under this section, with all of the exemptions provided by this section, until the Federal Communications Commission makes such determination. The Federal Communications Commission shall make such determination within 60 days of its receipt of any such application filed after the enactment of this section and shall notify the Commission whenever a determination is made under this paragraph that any person is an exempt telecommunications company. Not later than 12 months after the date of enactment of this section, the Federal Communications Commission shall promulgate rules implementing the provisions of this paragraph which shall be applicable to applications filed under this paragraph after the effective date of such rules.

(2) OTHER TERMS- For purposes of this section, the terms telecommunications services' and `information services' shall have the same meanings as provided in the Communications Act of 1934.

(b) STATE CONSENT FOR SALE OF EXISTING RATE-BASED FACILITIES- If
a rate or charge for the sale of electric energy or natural gas (other than any portion of a rate or charge which represents recovery of the cost of a wholesale rate or charge) for, or in connection with, assets of a public utility company that is an associate company or affiliate of a registered holding company was in effect under the laws of any State as of December 19, 1995, the public utility company owning such assets may not sell such assets to an exempt telecommunications company that is an associate company or affiliate unless State commissions having jurisdiction over such public utility company approve such sale. Nothing in this subsection shall preempt the otherwise applicable authority of any State to approve or disapprove the sale of such assets. The approval of the Commission under this Act shall not be required for the sale of assets as provided in this subsection.

(c) OWNERSHIP OF ETCS BY EXEMPT HOLDING COMPANIES- Notwithstanding any provision of this Act, a holding company that is exempt under section 3 of this Act shall be permitted, without condition or limitation under this Act, to acquire and maintain an interest in the business of one or more exempt telecommunications companies.

(d) OWNERSHIP OF ETCS BY REGISTERED HOLDING COMPANIES- Notwithstanding any provision of this Act, a registered holding company shall be permitted (without the need to apply for, or receive, approval from the Commission, and otherwise without condition under this Act) to acquire and hold the securities, or an interest in the business, of one or more exempt telecommunications companies.

(e) FINANCING AND OTHER RELATIONSHIPS BETWEEN ETCS AND REGISTERED HOLDING COMPANIES- The relationship between an exempt telecommunications company and a registered holding company, its affiliates and associate companies, shall remain subject to the jurisdiction of the Commission under this Act:
Provided, That–

(1) section 11 of this Act shall not prohibit the ownership of an interest in the business of one or more exempt telecommunications companies by a registered holding company (regardless of activities engaged in or where facilities owned or operated by such exempt telecommunications companies are located), and such ownership by a registered holding company shall be deemed consistent with the operation of an integrated public utility system;

(2) the ownership of an interest in the business of one or more exempt telecommunications companies by a registered holding company (regardless of activities engaged in or where facilities owned or operated by such exempt telecommunications companies are located) shall be considered as reasonably incidental, or economically necessary or appropriate, to the operations of an integrated public utility system;

(3) the Commission shall have no jurisdiction under this Act over, and there shall be no restriction or approval required under this Act with respect to

(A) the issue or sale of a security by a registered holding company for purposes of financing the acquisition of an exempt telecommunications company, or

(B) the guarantee of a security of an exempt telecommunications company by a registered holding company; and

(4) except for costs that should be fairly and equitably allocated among companies that are associate companies of a registered holding company, the Commission shall have no jurisdiction under this Act over the sales, service, and construction contracts between an exempt telecommunications company and a registered holding company, its affiliates and associate companies.

(f) REPORTING OBLIGATIONS CONCERNING INVESTMENTS AND ACTIVITIES OF REGISTERED PUBLIC-UTILITY HOLDING COMPANY SYSTEMS—

(1) OBLIGATIONS TO REPORT INFORMATION- Any registered holding company or subsidiary thereof that acquires or holds the securities, or an interest in the business, of an exempt telecommunications company shall file with the Commission such information as the Commission, by rule, may prescribe concerning–

(A) investments and activities by the registered holding company, or any subsidiary thereof, with respect to exempt telecommunications companies, and

(B) any activities of an exempt telecommunications company within the holding company system,

that are reasonably likely to have a material impact on the financial or operational condition of the holding company system.

(2) AUTHORITY TO REQUIRE ADDITIONAL INFORMATION- If, based on reports provided to the Commission pursuant to paragraph (1) of this subsection or other available information, the Commission reasonably concludes that it has concerns regarding the financial or operational condition of any registered holding company or any subsidiary thereof (including an exempt telecommunications company), the Commission may require such registered holding company to make additional reports and provide additional information.

(3) AUTHORITY TO LIMIT DISCLOSURE OF INFORMATION- Notwithstanding any other provision of law, the Commission shall not be compelled to disclose any information required to be reported under this subsection. Nothing in this subsection shall authorize the Commission to withhold the information from Congress, or prevent the Commission from complying with a request for information from any other Federal or State department or agency requesting the information for purposes within the scope of its jurisdiction. For purposes of section 552 of title 5, United States Code, this subsection shall be considered a statute described in subsection (b)(3)(B) of such section 552.

(g) ASSUMPTION OF LIABILITIES- Any public utility company that is an associate company, or an affiliate, of a registered holding company and that is subject to the jurisdiction of a State commission with respect to its retail electric or gas rates shall not issue any security for the purpose of financing the acquisition, ownership, or operation of an exempt telecommunications company. Any public utility company that is an associate company, or an affiliate, of a registered holding company and that is subject to the jurisdiction of a State commission with respect to its retail electric or gas rates shall not assume any obligation or liability as guarantor, endorser, surety, or otherwise by the public utility company in respect of any security of an exempt telecommunications company.

(h) PLEDGING OR MORTGAGING OF ASSETS- Any public utility company that is an associate company, or affiliate, of a registered holding company and that is subject to the jurisdiction of a State commission with respect to its retail electric or gas rates shall not pledge, mortgage, or otherwise use as collateral any assets of the public utility company or assets of any subsidiary company thereof for the benefit of an exempt telecommunications company.

(i) PROTECTION AGAINST ABUSIVE AFFILIATE TRANSACTIONS- A public utility company may enter into a contract to purchase services or products described in subsection (a)(1) from an exempt telecommunications company that is an affiliate or associate company of the public utility company only if–

(1) every State commission having jurisdiction over the retail rates of such public utility company approves such contract; or

(2) such public utility company is not subject to State commission retail rate regulation and the purchased services or products–

(A) would not be resold to any affiliate or associate company; or

(B) would be resold to an affiliate or associate company and every State commission having jurisdiction over the retail rates of such affiliate or associate company makes the determination required by subparagraph (A).

The requirements of this subsection shall not apply in any case in which the State or the State commission concerned publishes a notice that the State or State commission waives its authority under this subsection.

(j) NONPREEMPTION OF RATE AUTHORITY- Nothing in this Act shall preclude the Federal Energy Regulatory Commission or a State commission from exercising its jurisdiction under otherwise

applicable law to determine whether a public utility company may recover in rates the costs of products or services purchased from or sold to an associate company or affiliate that is an exempt telecommunications company, regardless of whether such costs are incurred through the direct or indirect purchase or sale of products or services from such associate company or affiliate.
(k) RECIPROCAL ARRANGEMENTS PROHIBITED- Reciprocal arrangements among companies that are not affiliates or associate companies of
each other that are entered into in order to avoid the provisions of this section are prohibited.

(l) BOOKS AND RECORDS-

(1) Upon written order of a State commission, a State commission may examine the books, accounts, memoranda, contracts, and records of--
(A) a public utility company subject to its regulatory authority under State law;
(B) any exempt telecommunications company selling products or services to such public utility company or to an associate company of such public utility company; and
(C) any associate company or affiliate of an exempt telecommunications company which sells products or services to a public utility company referred to in subparagraph (A), wherever located, if such examination is required for the effective discharge of the State commission's regulatory responsibilities affecting the provision of electric or gas service in connection with the activities of such exempt telecommunications company.

(2) Where a State commission issues an order pursuant to paragraph (1), the State commission shall not publicly disclose trade secrets or sensitive commercial information.

(3) Any United States district court located in the State in which the State commission referred to in paragraph (1) is located shall have jurisdiction to enforce compliance with this subsection.

(4) Nothing in this section shall--

(A) preempt applicable State law concerning the provision of records and other information; or

(B) in any way limit rights to obtain records and other information under Federal law, contracts, or otherwise.

(m) INDEPENDENT AUDIT AUTHORITY FOR STATE COMMISSIONS-

(1) STATE MAY ORDER AUDIT- Any State commission with jurisdiction over a public utility company that--

(A) is an associate company of a registered holding company; and

(B) transacts business, directly or indirectly, with a subsidiary company, an affiliate or an associate company that is an exempt telecommunications company,

may order an independent 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: Provided , That such matters relate, directly or indirectly, to transactions or transfers between the public utility company subject to its jurisdiction and such exempt telecommunications company.

(2) SELECTION OF FIRM TO CONDUCT AUDIT-

(A) If a State commission orders an audit in accordance with paragraph (1), the public utility company and the State commission shall jointly select, within 60 days, a firm to perform the audit. The firm selected to perform the audit shall possess demonstrated qualifications relating to–

(i) competency, including adequate technical training and professional proficiency in each discipline necessary to carry out the audit; and

(ii) independence and objectivity, including that the firm be free from personal or external impairments to independence, and should assume an independent position with the State commission and auditee, making certain that the audit is based upon an impartial consideration of all pertinent facts and responsible opinions.

(B) The public utility company and the exempt telecommunications company shall cooperate fully with all reasonable requests necessary to perform the audit and the public utility company shall bear all costs of having the audit performed.

(3) AVAILABILITY OF AUDITOR'S REPORT- The auditor's report shall be provided to the State commission not later than 6 months after the selection of the auditor, and provided to the public utility company not later than 60 days thereafter.

(n) APPLICABILITY OF TELECOMMUNICATIONS REGULATION- Nothing in this section shall affect the authority of the Federal Communications Commission under the Communications Act of 1934, or the authority of State commissions under State laws concerning the provision of telecommunications services, to regulate the activities of an exempt telecommunications company.

Appendix B: Alternative Approaches to Transfer Pricing

Approach	Market	Cost-Plus
Description	Transfer price set at market analog	Transfer price set at cost plus either market or utility rate of return
Strengths	Increases affiliate incentives; rational distribution of goods; does not require use of cost of service study	Limits opportunity for cross-subsidy
Weaknesses	Definition of the market may be difficult to determine; market may not be fully developed; cross-subsidy may be difficult to monitor	Cost of service review; creates investment disincentives

Appendix C:
"Rocket Docket"