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John G. Strand

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**date:** December 23, 1998

**to:** Chairman Strand, Commissioner Svanda

**from:** J.C. Hanneman, Supervisor *JCH*  
Jurisdictional Issues Section

**subject: U-11290, Code of Conduct Paper**

On June 5, 1998, the Staff filed the "Market Power Discussion Paper" as directed in the Commission's June 5, 1997 electric restructuring order in Case No. U-11290. One of the market power mitigation actions recommended in the discussion paper was the establishment of a code of conduct governing the relationship between utility companies and their affiliates.

Maggie VanHaften has done further research into the subject of codes of conduct. The results of her work are summarized in the attached paper, "Developing and Implementing Codes of Conduct for the Retail Electric Industry".

The paper discusses the market context of codes, and how they have been employed by the Federal Energy Regulatory Commission for wholesale transactions and by the Michigan Public Service Commission for natural gas utilities. The paper looks at what additional provisions will be needed to appropriately cover retail competition in the electric industry. It illustrates this primarily through reference to codes adopted for use in the retail electric industry by other state legislatures and regulatory commissions.

I think you and other industry participants will find it a useful contribution to the electric restructuring debate. Therefore, we are filing it today in the U-11290 docket and, as soon as possible, will be posting it on the MPSC Web Page.

cc: U-11290 Docket File  
G. Kitts  
J. Abramson  
M. Hiser

**MICHIGAN PUBLIC SERVICE COMMISSION**

**Case No. U-11290  
Electric Restructuring**

**DEVELOPING AND IMPLEMENTING CODES OF CONDUCT  
FOR THE RETAIL ELECTRIC INDUSTRY**

Report filed by  
The Michigan Public Service Commission Staff  
December 23, 1998

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## DEVELOPING AND IMPLEMENTING CODES OF CONDUCT FOR THE RETAIL ELECTRIC INDUSTRY

### I. INTRODUCTION:

One major obstacle to the establishment of a successful competitive retail electricity market is an incumbent utility's opportunity to use market power to maintain its monopoly status. By exploiting its market power, the incumbent utility can limit market entry of potential competitors or gain an unfair market advantage over existing competitors. Lawmakers, regulatory agencies, and interested parties have acknowledged the concerns about market power and continue to investigate options for mitigating it. A variety of remedies have been considered, and several states involved in restructuring have implemented provisions to prevent or curb market power abuses. These mitigation techniques fall into two general categories: structural and behavioral remedies. One potential behavioral remedy is a Code or Standard of Conduct, rules of behavior by which each utility operating in the retail market would agree to abide.<sup>1</sup> Several states, as well as the Federal Energy Regulatory Commission (FERC), are employing codes of conduct as part of an overall strategy to dilute market power concerns. However, before a code is developed, there are a number of issues to be considered, including what provisions should be covered in the code, to whom should it apply, and how it should be enforced.

This paper examines the framework into which codes of conduct fit in a competitive electric generation market. It covers the advantages and disadvantages of structural and behavioral approaches to mitigation, discusses issues to be considered in developing a code of conduct including enforcement options, and provides examples of language used in codes that have been adopted by other state legislatures and commissions.

### II. BACKGROUND:

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<sup>1</sup>It should be noted that a Code of Conduct should not be confused with a Customer Bill of Rights. The primary purpose of a code of conduct is to prevent abuse of monopoly power.

The transition of the electric industry from one in which generation is a monopoly service provided under regulation to one in which generation is provided in the competitive market presents several problems which enhance the potential for abuse of market power. For example, in many instances competition is phased-in for retail customers. Thus some customers have the option to participate in the competitive generation market while others remain bundled customers of the regulated utility. The utility may be providing monopoly retail services at the same time that its marketing division and/or affiliate provides competitive retail services within the same service area. This hybrid structure, neither fully regulated nor fully competitive, can allow the utility to use its monopoly position to enhance its competitive position, for example by subsidizing competitive endeavors with ratepayer revenue or providing information on customers to marketing affiliates.<sup>2</sup> The utility also is generally the owner of the transmission and distribution systems, both of which will remain monopoly services and will continue, at least for the near future, to be regulated. This ownership enables the company to discriminate against its competitors and their customers in favor of its own affiliates and customers and to subsidize its own competitive activities with revenues from captive customers. These and other anticompetitive activities undermine the development of the competitive market and the benefits resulting from it. What can be left is an unregulated monopoly.

It is generally accepted that the most effective way to deal with the potential for market abuse is to build-in provisions prior to and during the restructuring process rather than waiting for the problems to develop and relying on after-the-fact adjustments or antitrust law to rectify the abuses.<sup>3</sup> Antitrust cases are costly and time-consuming; generally, the damage to the competitive market is difficult to reverse. However, dealing with the issues up-front requires anticipating and understanding not only how the market will work but also in what ways market power abuse can occur.

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<sup>2</sup> While audits may in some instances uncover cross subsidization, without enforcement authority there is no opportunity to remedy the problem unless there is a rate case in which recovery of costs can be denied.

<sup>3</sup> Refer to "The Michigan Public Service Staff Market Power Discussion Paper," filed June 5, 1998, p. 103, for additional discussion of this issue.

There are two primary methods for handling market power abuse: structural remedies and behavioral remedies.<sup>4</sup> Structural remedies change the characteristics of the market to significantly reduce or eliminate an incumbent's incentive to use its market power, thus "maintaining an industry structure that is conducive to competition."<sup>5</sup> Unlike the structural approach, behavioral remedies involve the establishment of rules governing conduct rather than removing the incentive to discriminate, cross-subsidize, or otherwise abuse market power.

Structural approaches focus on removing the utility's incentive to abuse market power.

Options include:

- The sale of generation facilities to reduce market concentration, or an equivalent activity -- For example, in California, Pacific Gas and Electric (PG & E) and Southern California Edison were encouraged to sell generation facilities as a way to reduce their market concentration.<sup>6</sup> If it is believed that a utility's market power will exist only temporarily while the market develops, market power could be mitigated by requiring companies to enter long-term contracts to sell capacity or energy for the appropriate period of time.<sup>7</sup>
- The divestiture of generation or transmission facilities to eliminate the potential for affiliate transaction abuses -- A substitute for divestiture, although not without challenges, is the establishment of an Independent System Operator (ISO), an entity independent of the transmission owners organized to operate the transmission grid, minimizing the opportunity for affiliate discrimination.
- The structural separation of regulated and nonregulated services, both during a

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<sup>4</sup> Baer, William J. "FTC Perspectives on Competition Policy and Enforcement Initiatives in Electric Power." Presented at "Antitrust and Anticompetitive Behavior" Conference, Sponsored by Infocast, Washington, D.C., December 4-5, 1997, p. 13.

<sup>5</sup>*id*, p. 13.

<sup>6</sup> Binz, Ronald J. and Mark W. Frankena. "Addressing Market Power." A Policy Paper of the Competitive Policy Institute, Washington, D.C., p. 48.

<sup>7</sup>*id*, p. 48.

phase-in period and during full-scale retail competition -- This structural separation reduces, but does not necessarily prevent, the opportunity for cross-subsidization.

- Pricing transmission to broaden the geographic market and therefore, reducing concentration.<sup>8</sup>

Because of the legal and economic implications, structural remedies are complicated and time-consuming to carry out, have the potential to be contentious, and often require legislative authorization to implement. Additionally, these remedies may result in the loss of efficiencies gained through integration of generation and transmission. However, once the structural change has been accomplished, many of the incentives and opportunities to abuse market power are eliminated and there is little need for ongoing regulatory oversight.<sup>9</sup>

Behavioral remedies do not change the structure in which market power thrives, but rather attempt to prevent utilities from behaving in anticompetitive ways.<sup>10</sup> Behavioral remedies require ongoing oversight and enforcement to ensure that there is compliance. Perhaps two of the more visible examples of a behavioral remedy are FERC's Open Access Orders 888 and 889, which require utilities to unbundle transmission and generation and to provide competitors with service comparable to that which the utility provides itself.<sup>11</sup> Behavioral remedies are generally rules and regulations, including:

- Dominant firm regulation, which can be used to limit prices charged by dominant

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<sup>8</sup>*id.*, p. 48.

<sup>9</sup> Divestiture will not prevent the opportunity for cross subsidization between the regulated and nonregulated generation services during the phase-in of competition.

<sup>10</sup> *id.*, p. 50.

<sup>11</sup> Federal Energy Regulatory Commission. Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities. Order No. 888A, Docket Nos. RM95-8-001 and RM94-7-002; 78 FERC 61,220 (1997); issued March 4, 1997; and Open Access Same-Time Information System and Standards of Conduct. Order No. 889A; Docket No. RM95-9-001; 78 FERC 61,221 (1997) issued March 4, 1997.

- firms even if nondominant firms are not bound by the same limitations.
- Restrictions on a utility's use of its transmission facilities to ensure competitors have access.
  - Codes of conduct or standards of behavior, which establish guidelines for the utility's activities and its relationship with its nonregulated affiliates. Codes of conduct "may restrict permissible organizational forms in order to separate monopoly and competitive activities; prohibit self-dealing; prescribe transfer pricing and other accounting methodologies to limit cross-subsidies; prohibit sharing of certain types of information; and mandate disclosure, reporting and equal access to information to facilitate oversight and prevent discrimination."<sup>12</sup>

Behavioral remedies are generally easier to implement than structural approaches, however they can be evaded. As previously mentioned, if they are to be effective, they require long-term oversight and enforcement.<sup>13</sup> Thus, while costs are reduced on the front-end, oversight costs will continue until structural changes are made or the utility ceases all monopoly operations. Behavioral remedies, especially codes of conduct, present additional challenges: it is difficult to develop rules that include all potential contingencies; a significant amount of time must be spent initially to consider as many options as possible. Those developing the code must reach a balance between being overly broad and restrictive and being too narrow or lenient, and thus ineffective.<sup>14</sup>

The Federal Trade Commission (FTC) favors structural remedies as the most effective method of curbing market power abuses.<sup>15</sup> The FERC, however, has declined to require

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<sup>12</sup> Binz and Frankena, *supra*, p. 51.

<sup>13</sup> Baer, *supra*, p. 14

<sup>14</sup> *id.*, p. 15. Baer cites the rules governing access to local exchange facilities in telecommunications as an example of rules that are complex and not necessarily effective.

<sup>15</sup> In its "Comment of the Staff of the Bureau of Economics of the Federal Trade Commission Before the Michigan Public Service Commission, Case No. U-11290, Electric Restructuring," the FTC staff stated that "Affiliate codes of conduct, like functional separation, are likely to be a reasonable first step, but not necessarily a sufficient step toward effective competition. A variety of competitive concerns can arise in

structural changes in the bulk power market at this time. Instead, it is relying on open access tariffs, functional unbundling of generation and transmission operations from wholesale marketing functions of public utilities, a code of conduct, and encouraging establishment of ISOs.<sup>16</sup> It should be noted that FERC Chairman James Hoecker has indicated his intention "to initiate and complete a generic proceeding that will vastly accelerate the establishment of ISOs or transcos, as appropriate, in every region of the country."<sup>17</sup> Binz and Frankena conclude that:

The choice between structural and behavioral remedies is not a pure one. The issue is largely the extent to which reliance is placed on behavioral remedies. Even if primary reliance is placed on structural remedies, there may be little alternative to reliance on behavioral remedies to deal with residual market power, including some problems that arise from monopolies over transmission and distribution.<sup>18</sup>

### III. CODES OF CONDUCT:

Codes or standards of conduct have been developed and put in place in several industries.<sup>19</sup> FERC has established codes of conduct in two applications: a code of conduct for affiliated power marketers and standards of conduct covering the interactions between employees of transmission utilities and their merchant employees. Several states have implemented codes of conduct in conjunction with the transition to a competitive retail electricity market and standards of conduct have been approved for several natural gas

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affiliate relationships. Favoritism toward affiliates in purchasing decisions and cross-subsidization of affiliates are among the most prominent." Also, see Baer, *supra*, p. 15.

<sup>16</sup> FERC Order 889, *supra*, F(2), Section 37.5.

<sup>17</sup> Hoecker, James J. "Electric Competition Revolution: The Sequel." Remarks presented at the Sixth DOE/NARUC National Electricity Forum, Houston, Texas, September 17, 1998, p. 17.

<sup>18</sup> Binz and Frankena, *supra*, p. 51.

<sup>19</sup> A code of conduct is one of many market power mitigation tools. Refer to the "Staff Market Power Discussion Paper," *supra*, for seven recommended mitigation measures, one of which is the establishment of a code of conduct, p. 127.

utilities in Michigan by the Michigan Public Service Commission (Michigan Commission or MPSC).

A. The Federal Energy Regulatory Commission

In “Heartland Energy Services,” FERC adopted a code of conduct for affiliated power marketers seeking approval of market-based rates.<sup>20</sup> These standards covered:

- Generation dominance - The marketer must demonstrate that affiliates owning generating units have no generation dominance.
- Transmission market power - The marketer’s affiliated public utility must have an open access transmission tariff on file with the FERC.
- Other barriers to entry - If the public utility affiliate also sells and transports natural gas, it is prohibited from refusing to provide service or providing it at unreasonable or discriminatory terms to the marketer’s competitors.
- Affiliate abuse - An affiliated power marketer must agree not to sell power to or buy power from its affiliated public utility unless the FERC approves the transaction in a separate rate filing and it must obtain transmission services from its affiliated public utility under that utility’s open access transmission tariff.
- Brokering to affiliates - The affiliated utility can only use its affiliate broker if there is no brokering fee.
- Reporting requirements - FERC established reporting requirements: quarterly reports detailing the purchase and sale transactions undertaken in the prior quarter and changes in status that would reflect a change in the characteristics on which the Commission depended in approving the market-based rates.<sup>21</sup>

In Order 889, FERC required transmission providers to establish or participate in an Open

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<sup>20</sup> “Heartland Energy Services, Inc.” 68 FERC 61,223 (1994).

<sup>21</sup> *id.*

Access Same-Time Information System (OASIS).<sup>22</sup> As part of the order, FERC established standards of conduct governing the behavior between the employees of a transmission utility and its merchant employees. These rules apply to all transmission services offered under the Open Access Tariff. While at times confused with the code of conduct established in "Heartland," the OASIS standards are less strict and not substitutable for those required in "Heartland."<sup>23</sup> Through implementation of these standards, FERC intended to accomplish four objectives:

- Prohibit Transmission Providers engaged in wholesale merchant functions "from giving preferential access to information related to transmission prices and availability to employees of the public utility or any affiliate engaged in wholesale merchant functions." FERC accomplishes this by: "(a) requiring that transmission-related information be made available to all customers (including employees of the public utility, and any affiliate, engaged in wholesale merchant functions) through OASIS postings available at the same time and on an equal basis and (b) prohibiting the employees of Transmission Providers and any affiliates from disclosing or obtaining non-public transmission-related information through communications not posted on the OASIS."<sup>24</sup>
- Mandate that "employees engaged in system operations and reliability functions must treat all customers in a fair and impartial manner and may not give any preferential treatment to the company's (or its affiliate's) employees conducting wholesale merchant functions."<sup>25</sup>
- Require "the functional unbundling of the transmission operations and wholesale merchant functions of public utilities and their affiliates so that those employees

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<sup>22</sup> Federal Energy Regulatory Commission. "Open Access Same-Time Information System and Standards of Conduct," *supra*.

<sup>23</sup> Quint, Arnold H. "Sharing of Information Among Affiliates." Presented at "Antitrust and Anticompetitive Behavior" Conference Sponsored by Infocast, Washington, D.C., December 4-5, 1997, p. 5.

<sup>24</sup> Federal Energy Regulatory Commission. "Open Access Same-Time Information System and Standards of Conduct, Part II," *supra*.

<sup>25</sup> *id.*

charged with system operations and reliability would be free to operate the system impartially for the benefit of all customers, including the Transmission Provider itself.”<sup>26</sup>

- Ensure that “the OASIS Final Rule would not compromise reliability,. . . by creating an exemption, in emergency circumstances affecting system reliability, that allows system operators to take whatever steps are necessary to keep the system in operation.”<sup>27</sup>

These FERC standards can, to some extent, be applied to the retail market since the focus on preventing discriminatory behavior is also relevant to the retail market. However, FERC codes do not go far enough to prevent some specific types of market power abuse characteristic of the retail market, including the numerous types of cross-subsidization and transfers of information that can occur in a hybrid regulated-competitive utility structure. **To be effective in the retail environment, FERC’s code and standards must be expanded.**

In 1997, a subcommittee of the National Association of Regulatory Utility Commissioners (NARUC) issued a White Paper entitled “Tools and Conditions Needed to Prevent Cost Shifting and Cross Subsidies Between Regulated and Non-Regulated Affiliates.” At its 1998 Winter Meetings, NARUC adopted a resolution urging that NARUC members:

[C]onsider implementing regulatory tools, such as those discussed in the white Paper (sic), that will allow for reasonable and appropriate continued regulation of monopoly utility services, including (1) policies to ensure non-discriminatory access to essential facilities, (2) financial controls to prevent cross-subsidies between regulated and competitive activities, and (3) policies to ensure non-discriminatory access to market information that are essential to the functioning of efficient markets.<sup>28</sup>

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<sup>26</sup> *id.*

<sup>27</sup> *id.*

<sup>28</sup> “Resolution Regarding Tools to Protect Pricing and Tools Needed to Prevent Cost Shifting and Cross Subsidies Between Regulated and Non-Regulated Affiliates.” Adopted by the National Association of Regulatory Utility Commissioners at its 1998 Winter Committee Meetings. See Attachment A for White

## B. Other States

Several states are employing behavioral methods to avoid the abuse of market power in retail markets. Some state commissions have developed codes of conduct, either at the explicit direction of the legislature or based on their existing authority. Other codes have been built into state restructuring legislation, either specifically identified as a code or built into other provisions of the legislation. For example, Illinois state restructuring legislation directs the Illinois Commerce Commission to initiate a rulemaking establishing standards of conduct; in June 1998, the Commission issued an order in that proceeding.<sup>29</sup> Nevada Assembly Bill 366 requires that the Public Service Commission establish standards of conduct and penalties for violations.<sup>30</sup> In Maine, restructuring legislation contains specific provisions to govern the relationship and transactions between large investor-owned transmission and distribution utilities and their affiliates and requires the Commission to adopt rules to enforce the provisions and to determine the extent of separation necessary to avoid cross-subsidization and market power abuses. A Commission inquiry was initiated April 7, 1998.<sup>31</sup> In Rhode Island, the restructuring legislation defines standards of conduct for affiliated generating and distribution companies.<sup>32</sup> The California Commission conducted an extensive investigation into establishment of standards of conduct, resulting in an order issued in December, 1997 and a modifications order in August, 1998.<sup>33</sup> The Pennsylvania Public Utilities Commission has issued an interim code of conduct and is

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Paper.

<sup>29</sup> "Illinois Commerce Commission On Its Own Motion, Implementation of Section 16-121 of the Public Utilities Act." 98-0035, June 12, 1998.

<sup>30</sup> "Nevada Assembly Bill No. 366 - Committee on Government Affairs," Approved July 16, 1997.

<sup>31</sup> "Utility Requirements for Non-Core Activities and Transactions Between Affiliates." Chapter 820.

<sup>32</sup> "An Act Relating to the Utility Restructuring Act of 1996." 96-H 8124B, Approved August 7, 1996.

<sup>33</sup> "Opinion Adopting Standards of Conduct Governing Relationships Between Utilities and Their Affiliates." D.97-12-088, December 16, 1997.

conducting a rulemaking into the development of an enduring code.<sup>34</sup> The Public Service Commission of Wisconsin is conducting an investigation into the development of standards of conduct.<sup>35</sup>

C. The Michigan Public Service Commission:

Codes or standards of conduct monitoring affiliate transactions, a primary focus of a code of conduct, are not new issues to the Michigan Commission. As the result of a Commission approved settlement agreement in Case No. U-11220, SEMCO Energy Gas Company (SEMCO Energy) agreed to adhere to transportation standards of conduct.<sup>36</sup> Similar standards were also adopted by Wisconsin Public Service Corporation,<sup>37</sup> Consumers Energy,<sup>38</sup> and Michigan Consolidated Gas Company.<sup>39</sup> The provisions focus on preventing discrimination by the utility in favor of its affiliates and requiring separation of the utility's operating employees from those of its marketing affiliates:

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<sup>34</sup> "Application of Metropolitan Edison Company for Approval of Restructuring Plan Under Section 2806 of the Public Utility Code." R-00974008. R-00974008C001, June 30, 1998.

<sup>35</sup> "Investigation on the Commission's Own Motion Into Utility Business Activities and Into Transactions and Relationships of Utilities and Their Affiliates During the Transition to Restructured Electric and Gas Industries; Potential Effects of Increased Competition on Markets and Consumers." 05-BU-101, May 26, 1998.

<sup>36</sup> "In the matter of the application of Michigan Gas Company and Southeastern Michigan Gas Company for authority to merge and increase rates for the sale and transportation of natural gas and related approvals." Case No. U-11220, Opinion and Order, October 29, 1997.

<sup>37</sup> "In the matter of the application of Wisconsin Public Service Corporation for authority to revise its tariff rules and implement a new customer attachment program," Case No. U-11621, Order Approving Settlement Agreement, April 14, 1998.

<sup>38</sup> "In the matter of the application of Consumers Energy Company for approval of an experimental pilot program for expanded gas customer choice, including an expanded gas transportation program, a suspension of its gas cost recovery clause, a moratorium on non-GCR rate adjustment, an earnings sharing mechanism, and related relief," Case No. U-11599, Order Approving Application, December 19, 1997.

<sup>39</sup> "In the matter of the application of Michigan Consolidated Gas Company for approval of an experimental pilot program for expanded gas customer choice, including an expanded gas transportation program, a transportation aggregation tariff, an earnings sharing mechanism, a suspension of its gas cost recovery clause, a moratorium on non-GCR rate adjustments, and related relief," Case No. 11682, Order Approving Application, April 28, 1998.

Transportation Standards of Conduct (as adopted by the MPSC in U-11220):

This rule is intended to promote fair competition and a level playing field among all participants involved in transportation within SEMCO Energy Gas Company's ("SEMCO Energy") regulated service territory. SEMCO Energy will conduct its business to conform to the following standards of conduct:

- a. SEMCO Energy will apply any tariff provision relating to transportation service in the same manner without discrimination to all similarly situated persons.
- b. SEMCO Energy will not give its marketing affiliate or customers of its affiliate preference over non-affiliated gas marketers or their customers in matters relating to transportation service including, but not limited, nominating, balancing, metering, billing, storage, standby service, curtailment policy, or price discrimination.
- c. SEMCO Energy will not communicate to any customer, supplier or third parties that any advantage may accrue to such customer, supplier or third party in the use of SEMCO Energy's services as a result of that customer, supplier or other third party dealing with its marketing affiliate and shall refrain from giving any appearance that it speaks on behalf of its affiliate.
- d. SEMCO Energy will process all similar requests for transportation service in the same manner and within the same period of time.
- e. If a customer requests information about marketers, SEMCO Energy will provide a list of all marketers operating on its system, including its affiliate, but will not promote its affiliate.
- f. To the extent SEMCO Energy provides to its marketing affiliate a discount or information related to the transportation, sales or marketing of natural gas, including but not limited to SEMCO Energy's customer lists, that is not readily available or generally known to any other marketer or supplier, it will provide details of such discount or provide the information contemporaneously to all potential marketers on its system that have requested such information.

- g. SEMCO Energy will not condition or tie its agreement to release interstate pipeline capacity to any agreement by a gas marketer, customer or other third party relating to any service in which its marketing affiliate is involved.
- h. SEMCO Energy will not condition or tie an agreement to provide a transportation discount to any agreement by a marketer, customer or other third party relating to any service in which its marketing affiliate is involved.
- i. SEMCO Energy's operating employees and the operating employees of its marketing affiliates will function independently of each other, be employed by separate corporate entities, and reside in separate offices.
- j. SEMCO Energy will keep separate books of accounts and records from those of its marketing affiliate.<sup>40</sup>

Prior to approving these standards, the Commission had adopted guidelines covering affiliate transactions in several proceedings.<sup>41</sup> In the December 7, 1989 order in Case Nos. U-8678, U-8924, and U-9197, a gas rate case, the Commission imposed several conditions on Consumers Power Company related to the provision of books and records. Included in the conditions were requirements that Consumers provide the Commission access to the books and records of its holding company, CMS Energy Corporation (CMS) and each of Consumers's corporate affiliates, subsidiaries, and joint ventures, including the Midland Cogeneration Venture Limited Partnership (MCV). The "Guidelines for Affiliate Transactions" focus on maintenance and provision of books and records, stating:

1. That the utility ensure that the Commission has access to books and records for the holding company and each of its affiliates and their joint ventures. Any objections to not (sic) providing all books and

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<sup>40</sup> U-11220, *supra*, Attachment D.

<sup>41</sup> See, for example, U-8679, U-8924, and U-9197 regarding Consumers Power Company (December, 1989); U-9323 regarding Michigan Gas Company (June, 1990); and U-9346 regarding Consumers Power Company (May, 1991).

records must be raised before the Commission and the burden of showing that the request is unreasonable or unrelated to the proceeding is on the respondents.

2. Each utility, holding company, and each of its subsidiaries and the joint ventures of the holding company and/or its subsidiaries shall employ accounting and other procedures and controls related to cost allocations and transfer pricing to ensure and facilitate full review by the Commission and to protect against cross-subsidization of non-utility activities by the utility's customers.
3. The holding company and each of its subsidiaries and the joint ventures of the holding company and/or its subsidiaries shall keep their books in a manner consistent with general accounting principles and, where applicable, consistent with the Uniform System of Accounts.
4. The utility shall furnish the Commission with:
  - The quarterly and annual financial statements of the consolidated utility and/or its parent holding company;
  - Annual statements concerning the nature of intercompany transactions concerning the utility and a description of the basis upon which cost allocations and transfer pricing have been established in these transactions;
  - Annual balance sheets and income statements of the non-regulated subsidiaries of the utility and/or the non-consolidated subsidiaries of the holding company;
  - An annual report of its transactions between the utility and its non-utility affiliates;
  - An annual report on its federal income tax on a consolidated or non-consolidated basis depending on filing.
5. The utility shall avoid a diversion of management talent that would adversely affect the utility. An annual report identifying personnel transferred from the utility to non-utility subsidiaries is required.
6. The utility shall file an annual report regarding any transfer to non-utility affiliates of any utility assets or property exceeding a fair market value of \$100,000.

7. Market, technological, or similar data transferred, directly or indirectly, from the utility to a non-utility affiliate shall be transferred at the higher of cost or fair market value.<sup>42</sup>

In approving these measures, the Commission directed CMS and the Consumers affiliates and subsidiaries to use specific accounting methods and to keep the books in a manner consistent with general accounting procedures. MCV and Consumers appealed the Commission's decision on various points, including the requirements placed on the MCV by the Commission.<sup>43</sup>

The Court of Appeals held that Section 5 of the Public Utilities Commission Act, MCL 460.55; MSA 22.5, authorizes the Commission to require a regulated utility to provide information on its parent company and nonregulated affiliates "where such information is reasonably necessary for the performance of the commission's regulatory duties."<sup>44</sup> Additionally, Section 6 of the Act authorizes the MPSC to "examine any books, accounts, and records kept on behalf of a utility subject to its jurisdiction and to require the production of any books, paper or records relating to the management or operation of the utility."<sup>45</sup> The Court also held that there exists statutory authority for the MPSC to require Consumers to:

[E]nsure that the PSC has access to the books and records of its parent company, affiliates, and joint ventures, to the extent Consumers has the ability to do so.<sup>46</sup>

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<sup>42</sup> "In the matter, on the Commission's own motion, of the rates and tariffs of Consumers Power Company regarding gas transportation service and related matters," U-8678, U8924, U9197. Opinion and Order Revision Depreciation Practices, December 7, 1989, p. 175.

<sup>43</sup> *Midland Cogeneration Venture Limited Partnership v Public Service Commission, and Consumers Power Company v Public Service Commission*. 199 Mich App 286 (April 1993).

<sup>44</sup> *id*, p. 297.

<sup>45</sup> *id*, p. 298, citing MCL 460.56, MSA 22.6.

<sup>46</sup> MCL 460.4; MSA 22.13(4).

However, the Court was unable to find statutory authority enabling the MPSC to require specific accounting and bookkeeping requirements for the MCV, based, in part, on its status under the Public Utility Regulatory Policies Act of 1978 (PURPA).<sup>47,48</sup> It appears this exception is limited, however, since the Court expressed “no opinion with respect to the validity of conditions 2 and 3 to the extent they apply to Consumers’ other affiliates and joint ventures not represented in this appeal.”<sup>49</sup>

Section 5 of the Public Utilities Commission Act authorizes the MPSC to make rules and regulations binding on “all persons dealing with the commission or interested in any matter or proceeding pending before it.”<sup>50</sup> The Court states that this provision:

[A]rguably allows the PSC to impose conditions on nonregulated entities to facilitate relevant discovery in cases before it. However, in *Union Carbide*, . . . the Supreme Court indicated that this statute refers to rules and regulations that have been properly promulgated by the PSC, as opposed to conditions imposed in the final order of the PSC in a contested case.<sup>51</sup>

This raises two questions: (1) Does a code of conduct imposed by the Michigan Commission in an order also apply to the affiliates of the utility, or just the utility and, (2) in order to employ a code of conduct that applies to both the utility and its affiliates, is the Commission obligated to promulgate a rulemaking?

The “Guidelines for Affiliate Transactions” have been included in several MPSC orders, including Case Nos. U-10149 and 10150, Michigan Consolidated Gas Company proceedings.

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<sup>47</sup> 199 Mich App 286 (300), *supra*.

<sup>48</sup> 16 USC 823a *et seq*.

<sup>49</sup> 199 Mich App 304 (footnote #5).

<sup>50</sup> MCL 460.55; MSA 22.5.

<sup>51</sup> *Midland Cogeneration Venture Limited Partnership v Public Service Commission, and Consumers Power Company v Public Service Commission*, *supra*, p. 302.

Natural gas utilities in Michigan have agreed to standards that could serve as a foundation for developing a code of conduct for electric utilities as they enter the competitive era. However, because of differences in the two industries, gas standards do not include all of the provisions necessary to mitigate potential abuses in the electric industry. There are added historical incentives and structural opportunities for electric utilities to take advantage of their existing market power.

In the natural gas industry, producers, pipelines, and local distribution companies (LDCs) are separate companies. The electric utility is generally vertically integrated. The utility owns transmission, distribution, and generation facilities. Also, delivering reliable electricity requires tight coordination between generation and transmission/distribution services, even though these have begun to be functionally separated to ensure nondiscriminatory transmission service. Consequently, until a competitive electricity market matures and new systems and alternative suppliers have a reliable track record, there is an actual operational incentive for electric utilities to have less than an "arm's length" distance between the regulated and nonregulated activities to maintain previous levels of electricity reliability. Therefore, it is important to consider additional provisions for inclusion in a code of conduct for the electric industry.

#### IV. OPTIONS FOR CODES OF CONDUCT:

In this context, a code of conduct is written to establish guidelines governing the interactions between a utility and its affiliates marketing energy and energy-related products and services. Provisions of the code should, as completely as possible, prevent opportunities for the utility to abuse its market power especially by subsidizing affiliate activities with revenues from regulated services and engaging in self-dealing or discriminatory actions. Any code of conduct must be accompanied by an authority for ongoing oversight and enforcement. Suggested guidelines are outlined below.

##### A. Guidelines

1. Uniformity:

A code of conduct should be uniform and consistent for all of the state's electric utilities participating in the competitive retail market. Utilities should not be required to meet different standards of compliance. Affiliates of one utility should not have an unfair advantage over affiliates of another utility based upon application of different codes of conduct.

2. Applicability:

Generally, codes are applied to the activities of the regulated utility and its transactions with its affiliates. Provisions should include guidelines for maintenance and availability of records for affiliate transactions and access to relevant affiliate books and records.

3. Enforceability:

Codes of conduct serve little purpose if there are no commensurate provisions to effectively enforce compliance. The ability to enforce the code includes the appropriate authority to oversee and investigate potential violations, a complaint procedure, a hearing process, and the funding and staffing to adequately carry out the responsibility. Enforcement also includes the authority to swiftly assess meaningful penalties for noncompliance.<sup>52</sup> These provisions should be included in the code and clearly understood by all involved parties. Enforceability is one of the characteristics that highlights the differences between structural and behavioral approaches to mitigating market power, and it cannot be emphasized enough: behavioral remedies require on-going oversight and effective enforcement, including the assessment of meaningful penalties, if they are to ensure the development of the competitive market.

4. Fairness to Affiliates and Other Competitors:

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<sup>52</sup> For example, the California Public Utilities Commission (CPUC) recently fined the Pacific Gas and Electric Company (PG & E) \$1.68 million for violating the Affiliate Transaction rules. The CPUC found PG & E had allowed an affiliated electric service provider to misuse the parent company's name and logo in its marketing activities. California Public Utilities Commission Docket No. D98-11026, November 5, 1998.

The purpose of a code of conduct is to ensure that utility affiliates do not have an unfair advantage over nonaffiliate competitors. In the same manner, the code should not unfairly disadvantage utilities; it should establish as completely as possible a level playing field.

5. Definitions:

The code of conduct should include definitions of terms relevant to the code. The definitions should be consistent for all participants. Confusion develops when parties employ different meanings for common terms.

B. Basic Standards:

A code of conduct should contain provisions which clearly separate regulated and competitive activities and prevent discrimination and discriminatory sharing of certain types of information between the utility and its affiliates (or the regulated portion of the utility and the competitive portion of the utility). This section includes provisions which should be considered for inclusion in a code of conduct and examples of language from other codes in use by other states. The examples are offered for illustrative purposes only. **If considered for adoption, the provisions should be viewed in the context of the entire code from which they were drawn.**

1. Separation Standards:

The code should contain provisions requiring separation of regulated monopoly services from the utility's nonregulated competitive operations and its affiliate's competitive activities.<sup>53</sup> Emphasis on establishing effective separation standards initially can reduce time spent tracking affiliate transactions. Without enforced separation standards, the

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<sup>53</sup> In its comments to the Commission in Case No. U-11290, *supra*, the Staff of the Bureau of Economics of the Federal Trade Commission stated that "Functional separation of the regulated from the competitive segments of traditionally vertically integrated utilities may be a plausible first step in introducing competition. . . however, functional separation may turn out not to be sufficient because it leaves in place the incentives to discriminate and cross-subsidize in an industry in which detection and documentation of violations may be difficult." p. 5.

opportunities for subsidization of competitive endeavors by monopoly ratepayers and the discriminatory transfer of restricted information increase. However, separation standards should not be confused with divestiture. Separation standards do not eliminate the incentive to use market power; rather they attempt to curb the utility's ability to do so and the affiliate's ability to benefit unfairly from it. Ideally, nonregulated competitive activities should be offered through affiliates, rather than separate utility divisions, to avoid some of the more subtle and difficult-to-track types of cross-subsidization and information sharing. Separation standards should be accompanied by associated guidelines for maintaining separate records of transactions between the utility and its affiliates and provide for Commission access to those documents. Several issues regarding separation should be considered for inclusion in the code:

#### Separation of Core and Non-Core Services:

When utilities offer both regulated and competitive services, the opportunities for abuse of market power, especially through cross subsidization and discriminatory transfer of restricted information, increase substantially. Consideration should be given to requiring the utility and its affiliates to function as separate corporate entities and to prohibit utilities from directly marketing energy and energy-related products and services in the competitive market.<sup>54</sup>

#### ! Examples of language:

A utility may not offer core and non-core services through the same corporate entity. A utility must establish a separate corporate entity to offer non-core services. (Maine, Chapter 820, 3-A)

The Commission shall prohibit a provider of a noncompetitive service from providing a potentially competitive service, except through an affiliate of the provider. (State of Nevada, Assembly Bill 366, Section 41(1))

#### Sharing of Services and Facilities:

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<sup>54</sup> See the Michigan Public Service Commission "Transportation Standards of Conduct," *supra*, Section "I" for a similar provision.

Affiliate use of utility assets, including plant, facilities, and office equipment should be restricted or prohibited in the code. Sharing of such resources can provide affiliates with access to otherwise protected information, giving them an unfair advantage over nonaffiliated competitors. Additionally, sharing of resources also can provide the affiliate with ratepayer subsidized benefits unavailable to nonaffiliated competitors. The trade-off for these restrictions is a loss of certain economic efficiencies. Limitations could include exceptions for affiliates established to provide corporate support rather than competitive services.

! Example of language:

Except in relation to corporate support and emergency support, electric utilities and affiliated interests in competition with [alternative retail electric suppliers] that provide services to customers within the utility's service territory shall function independently of each other and shall not share services or facilities. (Illinois, 98-0013, 11, Section 450.100)

Sharing Employees:

In establishing the code, consideration should be given to including limitations on employee sharing between the utility and its marketing affiliates. Employee sharing provides the opportunity for direct or indirect subsidization of competitive activities by ratepayers as well as the transfer of otherwise protected information.

! Examples of language:

Except in relation to corporate support and emergency support, electric utilities and their affiliated interests in competition with alternative retail electric suppliers shall not jointly employ or otherwise share the same employees. (Illinois, 98-0013, 12, Section 450.110 (a))

Electric utilities shall not jointly employ or otherwise share employees engaged in providing delivery services with their affiliated interests in competition with alternative retail electric suppliers. (Illinois, 98-0013, 12, Section 450.110 (b))

Employee Transfers:

Transferring employees from the utility to the competitive affiliate can result in ratepayer subsidization of the affiliate employees' training; employee transfers represent a loss to the

utility and a gain to the affiliate. Codes can be written to limit the transfers or to establish a transfer fee.<sup>55</sup>

! Examples of language:

Once an employee of a utility becomes an employee of an affiliate, the employee may not return to the utility for a period of one year. This Rule is inapplicable if the affiliate to which the employee transfers goes out of business during the one-year period. In the event that such an employee returns to the utility, such employee cannot be retransferred, reassigned, or otherwise employed by the affiliate for a period of two years. Employees transferring from the utility to the affiliate are expressly prohibited from using information gained from the utility in a discriminatory or exclusive fashion to the benefit of the affiliate or to the detriment of other unaffiliated service providers. (California D.97-12-088, V. Separation, G.2b)

A utility shall track and report to the Commission all employee movement between the utility and affiliates. The utility shall report this information annually. . . (California D.97-12-088, V. Separation, G.2(a))

Information Transfers:

A parallel to the transfer of employees is the transfer of otherwise restricted information which can accompany the employee. This can be minimized by writing the code to contain provisions preventing a transferred employee from taking otherwise restricted information to the affiliate.

! Example of language:

Any employee hired by an affiliate shall not remove or otherwise provide information to the affiliate which the affiliate would otherwise be precluded from having pursuant to these Rules. (California D.97-12-088, V. Separation, G.2(d))

Joint Purchasing:

Utilities and their affiliates have traditionally made joint purchases to gain efficiencies. In writing a code, there should be consideration given to what extent, if at all, the utility and

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<sup>55</sup> See Michigan Public Service Commission "Guidelines for Affiliate Transactions," *supra*, Section 5 for a similar provision.

its competitive affiliates should be permitted to share costs savings from joint purchases and economies of scale. There is a need to prevent the utility from providing direct or indirect competitive advantages to the affiliate not available to other competitors, especially when those advantages are subsidized by ratepayers.

! Example of language:

To the extent not precluded by any other Rule, the utilities and their affiliates may make joint purchases of good (sic) and services, but not those associated with the traditional utility merchant function. For purpose of these Rules, to the extent that a utility is engaged in the marketing of the commodity of electricity or natural gas to customers, as opposed to the marketing of transmission and distribution services, it is engaging in merchant functions. Examples of permissible joint purchases include joint purchases of office supplies and telephone services. Examples of joint purchases not permitted include gas and electric purchasing for resale, purchasing of gas transportation and storage capacity, purchasing of electric transmission, systems operations, and marketing. The utility must insure that all joint purchases are priced, reported, and conducted in a manner that permits clear identification of the utility and affiliate portions of such purchases, and in accordance with applicable Commission allocation and reporting rules. (California D.97-12-088, V. Separation, A)

#### Corporate Support Services:

Permitting sharing of corporate support services, including payroll, legal services, insurance, and financial reporting provides the opportunity for cross subsidization. If such sharing is permitted, the code should contain limitations on the types of services that can be shared and under what conditions. For example, it might be possible to limit shared services to those unrelated to marketing or regulatory issues to prevent the exchange of otherwise restricted information.

! Example of language:

As a general principle, a utility, its parent holding company, or a separate affiliate created solely to perform corporate support services may share with its affiliates joint corporate oversight, governance, support systems and personnel. Any shared support shall be priced, reported and conducted in accordance with the Separation and Information Standards set forth

herein, as well as other applicable Commission pricing and reporting requirements.

As a general principle, such joint utilization shall not allow or provide a means for the transfer of confidential information from the utility to the affiliate, create the opportunity for preferential treatment or unfair competitive advantage, lead to customer confusion, or create significant opportunities for cross-subsidization of affiliates. In the compliance plan, a corporate officer from the utility and holding company shall verify the adequacy of the specific mechanisms and procedures in place to ensure the utility follows the mandates of this paragraph, and to ensure the utility is not utilizing joint corporate support services as a conduit to circumvent these Rules.

Examples of services that may be shared include: payroll, taxes, shareholder services, insurance, financial reporting, financial planning and analysis, corporate accounting, corporate security, human resources (compensation, benefits, employment policies), employee records, regulatory affairs, lobbying, legal, and pension management.

Examples of services that may not be shared include: employee recruiting, engineering, hedging and financial derivatives and arbitrage services, gas and electric purchasing for resale, purchasing of gas transportation and storage capacity, purchasing of electric transmission, system operations, and marketing. (California D.97-12-088, V. Separation, E)

#### Joint Marketing:

One of the most contentious issues in developing a code of conduct is to what degree, if at all, should the utility and its competitive affiliate be permitted to jointly market their services. Objections are based on the concern that customer identification of the utility's name, and the associations made with the name, can provide an unfair advantage to the utility's marketing affiliate. Additionally, joint marketing can inaccurately convey a message that competitive services might be bundled to the utility's service or be more reliable because of the affiliate's tie to the regulated utility. This, of course, can work to the affiliate's disadvantage if the utility does not have a respectable reputation with

customers. This issue can arise in a number of situations. For example, when the utility receives requests for information about competitive service providers, it is possible for the utility to respond with information favorable to the affiliate, giving preferential treatment and subsidizing the affiliate's marketing by a utility. The code should establish to what degree, if at all, the utility and its affiliates can jointly market services.<sup>56</sup>

! Examples of language:

The Distribution Company shall not engage in joint advertising or marketing programs of any sort with its Competitive Energy Affiliate, nor shall the Distribution Company directly promote or market any product or service offered by any Competitive Affiliate.  
(Massachusetts, D.P.U./D.T.E. 97-96, 12.03(12))

Except as otherwise provided by these Rules, a utility shall not . . . give the appearance that the utility speaks on behalf of its affiliates or that the customer will receive preferential treatment as a consequence of conducting business with the affiliates; or give any appearance that the affiliate speaks on behalf of the utility. (California D.97-12-088, III. Nondiscrimination E 6-7)

Use of Utility Name and Logo:

Closely tied to joint marketing is the degree to which the affiliate can draw on the utility name and logo, using the customers' familiarity with the name and logo to create an unfair

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<sup>56</sup> See the Michigan Public Service Commission "Transportation Standards of Conduct," *supra*, Section "e" for a similar provision.

market advantage.<sup>57</sup> Unrestricted use of the logo presents opportunities for cross-subsidization.<sup>58</sup>

! Examples of language:

. . .[A] Distribution Company may allow an Affiliate, including a Competitive Energy Affiliate, to identify itself, through the use of a name, logo, or both, as an Affiliate of the Distribution Company, provided that such use by a Competitive Energy Affiliate shall be accompanied by a disclaimer that shall state that no advantage accrues to customers or others in the use of the Distribution Company's services as a result of that customer or others dealing with the Competitive Energy Affiliate, and that the customer or others need not purchase any product or service from any Competitive Energy Affiliate in order to obtain services from the Distribution Company on a non-discriminatory basis. The disclaimer shall be written or spoken, or both, as may be appropriate given the context of the use of the name or logo. (Massachusetts, D.P.U./D.T.E., 97-96, 12.03(13))

A utility shall not trade upon, promote, or advertise its affiliate's affiliation with the utility, nor allow the utility name or logo to be used by the affiliate or in any material circulated by the affiliate, unless it discloses in plain legible or audible language, on the first page or at the first point where the utility name or logo appears that:

- ! the affiliate "is not the same company as. . .the utility,";
- ! the affiliate is not regulated by the California Public Utilities Commission; and
- ! "you do not have to buy [the affiliate's] products in order to continue to receive quality regulated services from the utility. (California D.97-12-088, V. Separation F(1))<sup>59</sup>

#### Tying of Regulated and Unregulated Services:

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<sup>57</sup> In its comments to the Commission in Case No. U-11290, *supra*, the Staff of the Bureau of Economics of the Federal Trade Commission stated that "One example of improper cross-subsidization is the use of the logo of the regulated parent firm by unregulated affiliates. This novel form of cross-subsidization may create incentives for the regulated firm to overinvest in reputation-building activities. In addition, use of the regulated firm's logo by affiliates also may raise issues of deceptive advertising that the MPSC may wish to address." p. 14.

<sup>58</sup> See the Michigan Public Service Commission "Transportation Standards of Conduct," *supra*, Section "c" for a similar provision.

<sup>59</sup> As previously noted, the CPUC recently fined PG & E \$1.68 million for violating this provision.

Consideration should be given to including provisions preventing the utility from directly or indirectly tying the provision of a regulated service to the purchase of a nonregulated service, an anticompetitive practice. For example, tying distribution reliability to the purchase of the affiliate's energy, or to remaining a customer of the regulated utility, should be prohibited. While tying arrangements are a violation of Federal antitrust laws, relying on antitrust laws to provide relief may not be an efficient approach, and inclusion of anti-tying language may be useful.<sup>60</sup>

! Example of language:

Except for services that have been declared competitive. . . electric utilities shall not tie or otherwise condition the provision of any services, discounts, rebates, fee waivers, or waivers of the electric utilities' ordinary terms and conditions of service, including but not limited to tariff provisions, to the taking of any goods and services from the electric utilities' affiliated interests. (Illinois, 98-0013, 4, Section 450.40)

Transfer of Goods and Services:

The code should contain provisions covering the transfer of goods and services between the utility and its affiliates to prevent subsidization of the affiliate by the utility's ratepayers. For example, guidelines could include provisions that goods and services provided by the utility to its affiliates be priced at the fair market value when the goods and services are offered for sale and available to all on a nondiscriminatory basis, and otherwise as a fully loaded cost plus an adder to labor costs. Goods and services offered by the affiliate to the utility not offered for sale to others should be priced at the lower of fair market value or fully loaded cost. These provisions will assist in preventing cross subsidization.

! Examples of language:

Transactions between an electric utility and its affiliated interests shall not be allowed to subsidize the affiliated interests. (Illinois, 98-0013, 13 Section 450.120(a))

Transactions between a utility and its affiliates shall be limited

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<sup>60</sup> See the Michigan Public Service Commission "Transportation Standards of Conduct," *supra*, Sections "g" and "h" for similar provisions.

to tariffed products and services, the sale or purchase of goods, property, products or services made generally available by the utility or affiliate to all market participants through an open, competitive bidding process . . . (California D.97-12-088, III Nondiscrimination, B.)

Costs associated with the transfer of goods and services between an electric utility and its affiliated interests, including affiliated interests in competition with alternative retail electric suppliers, shall be priced as specified in, and allocated pursuant to the Commission approved services and facilities agreement or affiliated interests agreement presented in the affiliated [alternative retail electric supplier] certification proceeding. Any transfer of goods and services between an electric utility and its affiliated interests, including affiliated interests in competition with alternative retail electric suppliers, that is not explicitly addressed in a Commission approved services and facilities or affiliated interests agreement is prohibited unless the transfer has been otherwise specifically approved by the Commission. . . (Illinois, 98-0013, 13, Section 450.120(c))

Access to Books and Records:

To effectively monitor compliance with the code, the Commission must have access to the books and records not only of the utility, but also the relevant books and records of its parent company, affiliates, and subsidiaries. It is also helpful if the Commission has access to company personnel knowledgeable about the books and records. In turn, the Commission should agree not to disclose sensitive competitive information to the public. The “Guidelines for Affiliate Transactions” adopted by the Commission in U-8678, et al., mentioned previously, can serve as a model. Additional language specific to the electric industry adds specificity.<sup>61</sup>

! Examples of language:

In connection with an application for a certificate of service authority filed by an affiliated interest of an electric utility. . . the affiliated interest shall provide a copy of a Commission approved services and facilities or affiliated interest agreement

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<sup>61</sup> See the Michigan Public Service Commission “Transportation Standards of Conduct,” *supra*, Section “j” and the “Guidelines for Affiliate Transactions,” Sections 1-4 for similar provisions.

that explicitly addresses the cost allocation and valuation methodology to be applied to any transfer of goods and services: between the electric utility and its affiliated interests in competition with [alternative retail electricity suppliers]; between the utility and its other affiliated interests; and between the utility's other affiliated interests and its affiliated interests in competition with [alternative retail electricity suppliers]. In the event that there is no Commission approved agreement addressing these issues, the applicant shall submit such an agreement for approval as part of its application. (Illinois, 98-0013,13, Section 450.120 (b))

An electric utility shall maintain books, accounts, and records separate from those of its affiliated interest." (Illinois, 98-0013, 15, Section 450.140 (a))

In connection with an application for a certificate of service authority filed by an affiliated interest of an electric utility. . . the affiliated interest shall provide a copy of a Commission approved services and facilities or affiliated interest agreement that explicitly sets forth both the cost allocation guidelines and the accounting conventions to be applied to any transactions: between the electric utility and its affiliated interests in competition with [an alternative retail electric supplier]; between the utility and its other affiliated interest and; between the utility's affiliated interests in competition with [an alternative retail electric supplier] and its other affiliated interests. In the event that there is no Commission approved agreement addressing cost allocation and accounting conventions, the applicant shall submit such an agreement for approval as part of its application. (Illinois, 98-0013,15, Section 450.140 (b))

Upon the request of the Commission, electric utilities shall make personnel available who are competent to respond to the Commission's inquiries regarding the nature of any transactions that have taken place between the electric utility and its affiliated interests, including but not limited to the goods and services provided, the prices, terms and conditions, and other considerations given for the goods and services provided." (Illinois, 98-0013, 15, Section 450.140(c))

Each electric utility shall maintain a log detailing: (i) each instance in which it exercised discretion in the application of tariff provisions; (ii) each instance in which it offered affiliated

interests or customers of affiliated interests services not governed by tariffs, except for corporate support transactions and services which have been declared competitive pursuant to . . . the Act; and (iii) each instance in which it offered affiliated interest or customers of affiliated interests a discount, rebate, fee waiver or waivers of the electric utility's ordinary terms and conditions in connection with services provided under tariffs on file with the Commission. The electric utility shall make such log available to the Commission upon request. The log shall contain the following information:

- ! the names of the affiliated interests and unaffiliated entities involved in the transaction;
  - ! a description of the transaction;
  - ! the time period over which the transaction applies; and
  - ! the quantities and locations involved in the transaction.
- (Illinois, 98-0013, 15, Section 450.140 (d))

A utility shall maintain contemporaneous records documenting all tariffed and nontariffed transactions with its affiliates, including but not limited to, all waivers of tariff or contract provisions and all discounts. A utility shall maintain such records for a minimum of three years and longer if this Commission or another government agency so requires. The utility shall make such records available for third party review upon 72 hours' notice, or at a time mutually agreeable to the utility and third party. (California D.97-12-088, IV. Disclosure and Information F)

## 2. Provisions to Prevent Discrimination:

Market power can be abused if the utility shows preference to its affiliates or its affiliates' customers over its competitors or the customers of competitors. The vertically integrated nature of the electricity industry, with the utility providing regulated generation, transmission, and distribution services along with a host of other nonregulated products and services, lends itself to discriminatory practices. In some instances, the utility also provides nonregulated retail generation services in the competitive market. Utility affiliates generally provide retail generation services within and outside of the utility's service territory. This structure provides an open invitation for discriminatory behavior. If transmission and distribution services are not separated structurally from generation

services, as would occur with divestiture, there is an incentive to favor affiliate customers. For example, a utility can process service requests for customers of its affiliates before those of the competitors. An effective code of conduct should contain provisions prohibiting discriminatory behavior and establishing safeguards supporting the prohibition.<sup>62</sup>

Comparable Access to Distribution Services:

Utilities should be prohibited from discriminating in the provision of monopoly services. For example, distribution services should be required to be provided to nonaffiliated marketers' customers under the same terms and conditions as they are provided to customers of affiliated marketers. The code should require the utility to process requests for distribution service for a competitor's customers with a timeliness equal to that of customers of affiliates.<sup>63</sup>

! Examples of Language:

Electric utilities shall not provide affiliated interests or customers of affiliated interests preferential treatment or advantages relative to unaffiliated entities or their customers in connection with services provided under tariffs on file with the Illinois Commerce Commission. . . . This provision applies broadly to all aspects of service, including but not limited to, responsiveness to requests for service, the availability of firm versus interruptible services, the imposition of special metering requirements, and all terms and conditions and charges specified in the tariff. (Illinois, 98-0013, 2, 450.20(a))

A utility shall process requests for similar services provided by the utility in the same manner and within the same time period for its affiliated interests in competition with alternative retail electric suppliers and for all similarly situated unaffiliated alternative retail electric suppliers and their respective customers. (Illinois, 98-0013, 2, 450.20(d))

Comparable Access to Non-Tariffed Utility Services:

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<sup>62</sup> See the Michigan Public Service Commission "Transportation Standards of Conduct," *supra*, Sections "a" and "b" for similar provisions.

<sup>63</sup> See the Michigan Public Service Commission "Transportation Standards of Conduct," *supra*, Section "d" for similar provision.

Utility provision of nontariffed services to affiliates or affiliates' customers allows the utility to subsidize the transactions with ratepayer funds, giving the affiliate a market advantage. In a code, it is possible to establish parameters aimed at preventing these transactions altogether, or to establish conditions to prevent or minimize the potential abuse. For example, utilities can be permitted to offer services or goods to the affiliate or the affiliate's customers if the goods or services are also offered to all "similarly situated" companies or customers simultaneously and on the same terms. The code can require that documentation of these transactions be available to the commission for compliance review, and can require that, if two different prices are provided to two different entities, the cost differential be documented and justified.<sup>64</sup>

! Example of language:

(a) If a Distribution Company offers its Competitive Energy Affiliate, or a customer of its Competitive Energy Affiliate, a discount, rebate or fee waiver for any product or service, it shall make the same available on a non-discriminatory basis to all Non-affiliated Energy Suppliers or customers.

(b) If a Distribution Company offers a Competitive Affiliate, or a customer of a Competitive Affiliate, a discount, rebate or fee waiver for any product or service that is subject to a tariff on file with the Department, it shall make the same available to all Non-affiliated Suppliers and their customers simultaneously, to the extent technically possible, on a comparable basis."(Massachusetts, D.P.U./D.T.E. 97-96, 12.03 (6)(a))

#### Comparable Access to Discounts:

Utilities should not be permitted to provide discounts to affiliates or customers of affiliates that are not provided to similarly situated nonaffiliates or their customers. In addition to being discriminatory, the discounts can be subsidized by ratepayers, compounding the anticompetitive impact of the transaction.

! Example of language:

If an electric utility offers affiliated interests or customers of affiliated interests a discount, rebate, fee waiver or waivers of

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<sup>64</sup> See the Michigan Public Service Commission "Transportation Standards of Conduct," *supra*, Section "f" for similar provisions.

its ordinary terms and conditions for services provided under tariffs on file with the Commission, it shall contemporaneously offer the same discount, rebate, fee waiver or waivers of its ordinary terms and conditions to all unaffiliated entities and customers of unaffiliated entities, to the extent consistent with the tariffs. If an electric utility offers affiliated interests or customers of affiliated interests services that are not governed by tariff sheets, except for corporate support transactions and services that have been declared competitive . . . it shall contemporaneously offer such services to all unaffiliated entities and customers of unaffiliated entities. Electric utilities shall maintain a log of such instance. (Illinois, 98-0013, 2, Section 450.140(f))

3. Disclosure and Information Standards:

The monopoly status of the regulated utility provides it with significant opportunity to use information to its own or its affiliates' advantage in a competitive market. For example, utilities possess data on customer usage which, if made available to marketing affiliates (or internal competitive marketing divisions) would provide a competitive edge over its competitors. Additionally, in carrying out its monopoly transmission and distribution responsibilities, the utility holds information on the transactions of nonaffiliated suppliers, which, if made available, could also benefit marketing affiliates. If the market is to be competitive, information obtained by the utility in its monopoly role should not be used to benefit the utility's affiliates in the competitive market unless the same information is shared with all competitors on the same basis. The code should include provisions covering what types of information are not to be shared and/or standards covering under what conditions information can be shared.

Customer Information:

Customer information should not be provided to marketing affiliates for use in marketing their services unless it is provided to competitors on the same basis. Individual customer load profiles, billing histories, and other related information can benefit marketers. Codes should contain language prohibiting the exchange of this information with affiliates or internal competitive marketing divisions without appropriate customer authorization. The code should also establish guidelines governing how customer information will be provided

at the request of the customer on equal terms to affiliates and nonaffiliates. The code can also contain standards for the release of generic data on load shapes, usage, or other aggregated customer data, on equal terms to affiliates and nonaffiliates.

! Examples of language:

A Distribution Company shall not release any proprietary customer information to an Affiliate without the prior written authorization of the customer. (Massachusetts, D.P.U./D.T.E. 97-96, 12.03(9))

To the extent that a Distribution Company provides a Competitive Affiliate with information not readily available or generally known to any Non-affiliated Supplier, which information was obtained by the Distribution Company in the course of providing distribution service to its customers, the Distribution Company shall make that information available on a non-discriminatory basis to all Non-affiliated Suppliers transacting business in its service territory. This provision does not apply to customer-specific information obtained with proper authorization, information necessary to fulfill the provisions of a contract, or information relating to the provision of general and administrative support services. (Massachusetts, D.P.U./D.T.E. 97-96, 12.03 (10))

Except as otherwise provided by these Rules, a utility shall not . . . request authorization from its customers to pass on customer information exclusively to its affiliates. (California D.97-12-088, III. Nondiscrimination E 5)

Transmission and Distribution Information:

Transmission and distribution information can provide the recipients with a competitive edge. Employees of the affiliated marketer or other involved affiliates should not have preferential access to information about the transmission and distribution system that is not available at the same time and in the same manner to nonaffiliated service providers.

! Examples of Language:

Employees of the electric utility's affiliated interests shall not have preferential access to any information about the electric utility's transmission or distribution systems that is not contemporaneously and in the same form and manner available to an unaffiliated alternative retail electric supplier that has submitted a request pursuant to subsection (a) of this section. (Illinois, 98-0013, 6, Section 450.60(b))

An electric distribution company is responsible for ensuring that any employee of the electric distribution company may not disclose to employees of any affiliate engaged in a nonregulated power producer function any information concerning the distribution system of the electric distribution company or the distribution system of another (including information received from non-affiliated or information about distribution system operations, capability, price, curtailments, auxiliary services, and the like) through non-public communications that is not at the same time available to all nonregulated power producers without restriction. If an employee of the electric distribution company engaged in distribution system operations or reliability functions discloses information in a manner contrary to the requirements of the standards of conduct, the electric distribution company must immediately report such information to the commission. An electric distribution company may not share any market information, acquired from nonaffiliated, nonregulated power producers or developed in the course of responding to requests for distribution service, with any employee of an affiliate engaged in a nonregulated power producer function. (Rhode Island, Chapter 316, 96-H 8124B, 39-1-27.6, c(iv))

#### Information on Alternate Suppliers:

Utilities providing transmission and/or distribution services should be required to treat all information obtained from alternate suppliers as confidential, and should be prohibited from providing any information of that type to affiliated entities without the alternate supplier's authorization.

! Example of language:

Electric utilities shall treat all information obtained from an alternative retail electric supplier as confidential information, and shall not provide such information to its affiliated interests or to unaffiliated entities unless the alternative retail electric supplier provides authorization to do so. (Illinois, 98-0013, 10, Section 450.90))

4. Procedural Issues:

In a code of conduct, it is beneficial to include provisions dealing with how it will be implemented, including application, compliance, and enforcement.

### Applicability:

The code should clearly indicate to whom the code applies. Unless there is a specific reason to do otherwise, the same code should apply to all electric utilities regulated by the Commission.

! Example of language:

These Rules shall apply to . . . California public utility . . . electrical corporations, subject to regulation by the California Public Utilities Commission.

For purposes of a combined gas and electric utility, these Rules apply to all utility transactions with affiliates engaging in the provision of a product that uses gas or electricity or the provision of services that relate to the use of gas or electricity, unless specifically exempted below. For purposes of an electric utility, these Rules apply to all utility transactions with affiliates engaging in the provision of a product that uses electricity or the provision of services that relate to the use of electricity. . . . (California, D.97-12-088, II. Applicability. A-B)

### Compliance Plans:

The FERC and some states require the utility to file a compliance plan, demonstrating that they understand the code and have procedures in place to comply with its provisions.

! Example of language:

A. Compliance Plans: No later than December 31, 1997, each utility shall file a compliance plan demonstrating to the Commission that there are adequate procedures in place that will preclude the sharing of information with its affiliates that is prohibited by these Rules . . . .

B. New Affiliate Compliance Plans: Upon the creation of a new affiliate which is addressed by these Rules, the utility shall immediately notify the Commission of the creation of the new affiliate, as well as posting notice on its electronic bulletin board. No later than 60 days after the creation of this affiliate, the utility shall file an advice letter with the Energy Division of the Commission, served on the parties to this proceeding. The advice letter shall demonstrate how the utility will implement these Rules with respect to the new affiliate. (California, D.97-12-088, VI, Regulatory Oversight)

## Enforcement and Penalties:

The code should also contain provisions covering how possible code violations will be handled. It cannot be overemphasized that oversight and enforcement coupled with the ability to assess meaningful penalties when there are violations is essential to an effective code of conduct. A review process can be initiated by a complaint filed with the commission by a customer or nonaffiliated supplier. There have been indications that nonaffiliated suppliers may be hesitant to file complaints fearing retaliation by the utilities, given the fact that those with complaints are generally dependent upon the utility for transmission and distribution services. Therefore, Commission oversight can be considered a primary enforcement tool. The manner in which nonaffiliated supplier complaints are handled should take this concern into consideration.

- ! Example of language:  
[A]fter notice and hearing held on complaint or on the Commission's own motion, the Commission may:
  - 1) Order the affiliated alternative retail electric supplier to cease and desist, or correct, any violation of or nonconformance with the provisions . . .
  - 2) Impose financial penalties for violations of or nonconformance with the provisions . . . not to exceed (i) \$10,000 per occurrence or (ii) \$30,000 per day for those violations or nonconformance which continue after the Commission issues a cease-and-desist order; and
  - 3) Alter, modify or suspend the certificate of service authority of an electric utility's affiliated alternative retail electric supplier for substantial or repeated violations of or nonconformance with the provisions . . .  
.. (Illinois, 98-0013, 17, Section 450.160 (b))
- 5. Additional Consideration:

There is one issue not specifically mentioned in these codes that should be considered for inclusion in any code adopted: there have been instances in the natural gas industry in which the local distribution company (LDC) has, without proper authorization, canceled contracts between customers and nonaffiliated providers upon customer complaint to the LDC. Distribution companies, whether gas or electric, should be prohibited from using control of the distribution system to interfere in the contractual relationship between a

customer and its nonaffiliated provider.

## V CONCLUSION:

In the absence of structural remedies, an enforceable code of conduct is a critical behavioral tool to prevent abuse of the utility-affiliate relationship, thus curbing the opportunity to abuse market power. Mitigation of market power is a critical factor in the establishment of a working competitive market. To be effective, the code should be carefully crafted, comprehensive, and consistent for all of the state's electric utilities participating in the competitive retail market. The code should also be enforceable and strictly enforced on an ongoing basis with commensurate provisions to assess penalties as necessary and appropriate.

Since this application of codes is relatively new, there should be a procedure to evaluate the effectiveness of the code, performed separately from the ongoing enforcement process. This evaluation or audit would focus on examining to what extent the adopted code has been followed, if code provisions have been successful in preventing abusive affiliate transactions or relationships or if modifications are needed. Through an actual examination of the application of the code, and with the adoption of appropriate modifications, there is a greater possibility that the code will become an effective tool in curbing market power abuses.

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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 include 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.