BEFORE THE
STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES

In the Matter of the Application of Verizon New Jersey Inc. For Approval (i) of a New Plan for an Alternative Form of Regulation and (ii) to Reclassify Multi-line Rate Regulated Business Service as Competitive Services, and Compliance Filing	: : : : : : :	BPU Docket No. TO01020095

Direct Testimony
on Structural Separation
of

SCOTT HEMPLING

On Behalf of the
New Jersey Division of the
Ratepayer Advocate

August 3, 2001

DIRECT TESTIMONY OF
SCOTT HEMPLING

Q. Please state your name and business address.

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

Q. Please state your educational background and professional qualifications.

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

I am the principal in a consulting firm which provides policy advice and legal representation related to regulated industries. I have advised the state commissions of Arkansas, Arizona, Connecticut, District of Columbia, Indiana, Kansas, Massachusetts, Michigan, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island and Virginia; the consumer counsels of Connecticut, Indiana, Nevada, New Jersey, Pennsylvania and Texas; the legislatures of South Carolina and Vermont; municipal systems in Connecticut and Iowa; associations of competitive generators, consumer representatives and public power entities; and public interest organizations. I have authored articles which have appeared in The Electricity Journal and Public Utilities Fortnightly.

I have testified before committees of the U.S. House of Representatives and the U.S. Senate on many occasions; before committees of the state legislatures of California, Maryland, Minnesota, Nevada, North Carolina, South Carolina and Vermont; and before the state commissions of Illinois, North Carolina, Texas, Vermont and Wisconsin. I am a frequent lecturer at professional conferences and training sessions, including sessions

sponsored by the U.S. Department of Energy and the National Association of Regulatory Utility Commissioners.

More detail on my professional background appears in attachment SH-1.

Q. On whose behalf are you testifying?

A. The New Jersey Division of the Ratepayer Advocate.

Q. What is the purpose of your testimony?

A. I offer principles which the Board should apply to the relationship between Verizon New Jersey, Inc. ("VNJ") and VNJ's competitive business activities in its review of the issue of structural separation. These principles should apply whether the Board adopts a full structural separation position, or whether the Board instead opts to allow VNJ to run both competitive and monopoly businesses from the same corporation. My testimony focuses on the separate affiliate situation, but the same principles apply equally where the same corporation provides both services (although where there is not structural separation, the principles may be more difficult for the Board to implement). Absent adoption of these principles, the relationship between VNJ and its competitive activities will afford the latter unearned advantages, to the detriment of VNJ customers and to the competitive process.

I base these principles on my experience in the electric industry, where I have done most of my work, most recently focusing on the restructuring efforts necessary to introduce generation competition and retail services competition. While there are legal, physical and economic differences between the electric industry and the telecommunications industry, the regulatory principles I support in this testimony relate to the relationship between a government-sanctioned, government-protected monopoly and

its competitive affiliate. That relationship, and the principles which should apply thereto, are common to both industries.

My testimony has three main parts:

Part I explains that in a newly developing competitive market, the continuing presence of an incumbent utility monopoly poses challenges to the goals of effective competition and consumer protection. The regulatory goal should be to remove the incumbent's unearned advantages so that competition can proceed on its merits.

Part II explains that in this context, principles for interaffiliate relations are necessary to prevent the incumbent's competitive affiliate from gaining preferential access to resources, where the value of those resources is attributable in part to the utility's historic government protection from competition and its role as sole supplier of certain services.

Part III addresses the Board's changing role, from a steward of a monopoly market to a promoter and protector of effective competition in the local exchange market. This changing role suggests a need for the Board to establish the principles of competition in advance, rather than rely on proposals from the incumbent to shape the discussion.

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

Q. In establishing standards for interaffiliate relations between monopoly and competitive businesses, what should be the Board's chief goals?

A. The standards should promote the development of an effectively competitive local exchange market, by preventing favorable access by some competitors to resources not available to others, where those resources are not the product of skill but of a utility's historic monopoly status.

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

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

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

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

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

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

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

1. No single firm, or group of firms acting in concert, large enough relative to the size of the relevant product and geographic markets to be able to

sustain a price above competitive levels, or withhold supply below competitive levels, for more than a short period.

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

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

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

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

1. a brand name associated in the public's mind with long-term, reliable service and with government approval;

2. a monthly bill, providing an opportunity to communicate with customers and thereby build and cement loyalty;

3. skilled, loyal employees trained with funds whose recovery was largely assured by the government;

4. intimate knowledge of the service territory and its usage patterns;

5. economic, professional, social and political relationships with important components of the local economy, such as banks, major manufacturers, and local and state government officials;

6. a corporate support infrastructure built with funds whose recovery is largely assured by the government.

It is natural for a utility to want to preserve these advantages, and to use them in its new competitive ventures. In an effectively competitive market, where all competitors

have access to comparable resources and options, actions by a competitor to preserve and exploit its advantages can be harmless, and in fact can promote effective competition by inducing other competitors to increase their efficiencies. In a market which begins as a monopoly market, however, and in which the incumbent has a set of resources not initially available to its competitors, the behavior can result in entry barriers.

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

Q. Why do you describe these advantages as unearned advantages?

A. By unearned advantage, I do not mean that VNJ has made no effort to create the resources at issue. VNJ has been a regulated utility. As such, what it has earned through its efforts is a reasonable opportunity to recover its costs and receive a fair return. What it has not earned is the competitive advantage it holds. It has not earned this competitive advantage because it has not achieved its vertically integrated status (and the efficiences that go with that status) through competition. It has achieved that status due to an historic government decision which excluded competitors and which mandated that

customers cover VNJ's costs. In that environment, customers had no choice but to pay for these vertically integrated resources and had no choice but to buy them from the incumbent. Because these advantages were not earned by VNJ through competition, they should not be available exclusively for VNJ in competition. Now that public policy has reversed the previous policy of excluding competitors, the advantages associated with vertical integration, obtained by the incumbent under the previous regime, must be shared with the competitors.

Q. Do the incumbent utilities' advantages require Board action?

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

Part II
Adjustments to Interaffiliate Relationships Are Necessary to Prevent Preferential Utility Access to Resources Whose Value Is Attributable to Government Protection from Competition

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

A. In **Part II.A.**, I address several adjustments that a regulator should make to the relationship between the incumbent monopoly and its competitive affiliate, to assure that the competitive affiliate does not enter the market with unearned advantages. The same

principles should apply if the monopoly and competitive businesses occur within the same corporation. The areas requiring adjustment include:

1. Affiliate use of corporate name
2. Affiliate access to incumbent's monthly bill
3. Affiliate access to incumbent's customer information
4. Employee transfers between incumbent and affiliate
5. Incumbent referrals of business leads to the competitive affiliate
6. Joint marketing
7. Processing of requests for service
8. Variations in price and quality

Before discussing this list, I will respond to the generic argument that requirements like those recommended here are inefficient because they prevent the incumbent from realizing economies of scope and scale.

Then, in **Part II.B.**, I will discuss methods of enforcing the standards which the Board should apply to this area.

1. Preservation of Organizational Efficiencies

Q. VNJ has argued that imposition of structural separation requirements will cause it to sacrifice "organizational efficiencies." What is your response?

A. This argument makes three errors.

First, the argument incorrectly assumes that if we do make the judgment that economies of scale and scope should be preserved, these economies should be available to the incumbent only. To the extent that these are economies of scope and scale inherent in combining the various telecommunications services, no particular legal, economic or policy principle requires that those economies be available to the government protected incumbent alone. To preserve these economies may serve the public interest; to preserve them for one competitor only will not. If regulators choose to preserve certain economies

of scope and scale, they can do so by requiring the incumbent to share access to those economies with all its competitors; or, alternatively, they can allow competitors to compete for the right to be the sole entity permitted to exploit the economies. To treat the incumbent as entitled to the economies merely because the incumbent happened to control them, due to past government protection from competition, at the time these economies became competitively valuable, is a position without a factual or logical basis.

If economies of scale and scope are valuable to consumers, the public policy should be to maximize that value. Regulators can maximize that value not by allowing the incumbent exclusive access to these economies, but by giving all possible competitors an opportunity to use these economies. Competition then can reward those competitors that use them most wisely. Allowing the incumbent to use them exclusively sacrifices this benefit.

The argument that economies of scale and scope should remain exclusively with the incumbent fails for another reason: the primary significant contributor to these economies has been the ratepayer, whose stable source of funds has gone to the incumbent exclusively because of a government policy of excluding competition. Those funds, and the relative certainty of their arrival, month after month, enabled the incumbent to achieve its present economies of scale by building an infrastructure sized to serve its entire territory; the funds also have permitted the incumbent to achieve its present economies of scope by researching and developing, and obtaining approval to sell, the variety of services customers now come to expect in their telephone service. Having been required to finance these economies by government policy, ratepayers now should be able to benefit from a

market made competitive by the availability of these economies to all competitors. Otherwise, ratepayers would have carried the burden while the incumbent receives the exclusive benefit. Given the fact of ratepayer-funded economies of scale and scope, it is inconsistent with effective competition to make those economies available to one competitor only. In short, VNJ seeks to claim an advantage that it has not earned.

Second, if economies of scope are valuable, then the company with access to them will have the advantage of an entry barrier: a difference in cost between incumbent and new entrant. If we are going to tolerate markets that are defective due to entry barriers (and we should not), at least the advantage should go to the company which earns it on the merits; not the company which has controlled the entry barrier historically as a result of government preference. Otherwise, at the very outset of competition we would have an exception from competition: an advantage accruing due to government favor. It would be no less arbitrary, and no less inconsistent with the principles of competition, to hand the exclusive right to exploit certain economies of scope to the incumbent as it would be to award the right to a competitor at random. To give competitors a chance to share these advantages is not to favor the new entrants but to eliminate a favor for the incumbent.

Third, VNJ's policy is inefficient. Assisted by economies of scope and scale to which no other competitor has access, the incumbent can actually operate less efficiently than its less well-endowed competitors, but still offer a lower price. If it offers this lower price for a sufficiently long period of time, it can deter entry by others, and thereby succeed "competitively" despite being less efficient than its departing or discouraged competitors.

Q. VNJ has argued that requiring VNJ to sacrifice its "organizational efficiencies" would be unfair because affiliates of vertically integrated ILECs from other states will be able to use their organizational economies in New Jersey. What is your response?

A. There are two problems with this argument. First, the argument confuses vertical economies with horizontal economies. ILECs from other states who come to compete in New Jersey will be making use primarily of horizontal economies: the economies associated with being a telecommunications provider in many states. The vertical economies associated with being an ILEC occur in the state in which the ILEC is the provider of the monopoly service, not in the states in which the company is acting as a CLEC. Structural separation aims at vertical relationships; it does not affect VNJ's ability to realize horizontal economies across Verizon's operations in many states.

In any event, if VNJ is concerned that ILEC's based in other states will be able to exploit their vertical economies in New Jersey, the solution I propose above -- namely, that VNJ can have access to its vertical economies as long as it makes that same access available to the CLECs -- addresses its concern.

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

To summarize: Embedded in VNJ's concern that it would be disadvantaged, relative to vertically integrated companies based elsewhere, is an important concession: access to economies of scale and scope made possible by a competitive company's

affiliation with a monopoly provider has significant competitive value. If the Board intends to implement effective competition, and that competitive value of affiliation is not readily replicable by the new competitors, the Board should make the value available to all on nondiscriminatory terms, or to no one. VNJ's approach fails this test.

2. Competitive Affiliate Use of Corporate Name

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

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

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

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

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

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

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

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

Thus even excellence in service is not attributable only to management decisions and shareholder risk, but is attributable at least in part to the history of government protection.

Q. What are some solutions?

A. Where the utility's competitive affiliate is permitted to sell within the incumbent's service territory, the solution most likely to prevent undue competitive advantage is to prohibit the affiliate from using the corporate name or in any way associating itself with the distribution affiliate. This prohibition would apply to joint advertising and any claim that the affiliate is better because of its connection with the monopoly supplier. This approach places the incumbent's competitive affiliate on the same competitive footing as its new competitors, in terms of name recognition with the public. The alternative solution would be to require the competitive affiliate to pay a royalty to the incumbent utility and, where rates are set by pre-existing price cap, treat the royalty payment as an exogenous factor and flow it through to the ratepayer. The royalty concept is discussed further in the next paragraph.

Where a utility's competitive affiliate also sells in service territories outside the territory controlled by the monopoly affiliate , the corporate name still has value. In this situation it is appropriate to require the affiliate to pay a royalty to the monopoly distribution company, which then should pass the payment on to the ratepayers. In this way the ratepayers are compensated for their contribution to the value of the name. That contribution is based on the ratepayers' historic financial support of the incumbent, which support enabled the incumbent over many years to remain financially viable, to train its workers, to grow roots in the community and now to enjoy a reputation for stability.

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

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

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

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

3. Competitive Affiliate's Access to the Incumbent's Monthly Bill

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

A. Yes. The monthly bill gives any merchant the opportunity to communicate easily with customers, whether for purposes of marketing new services or bolstering its reputation. The incumbent also has the advantage of being able to bill for competitive services together with regulated services on one consolidated bill, which is a possible convenience to customers.

The incumbent's monthly bill goes to every customer in the service territory. It is one piece of mail opened by every customer. The costs associated with the bill (at least those costs which are necessary to the provision of the monopoly service) are assured recovery by virtue of government decision. No competitor enjoys this benefit. Consequently, the Board must take care that access to the incumbent's billing process is not available preferentially to the incumbent's competitive affiliate but not to other competitors.

Q. Are there possible solutions?

A. Yes. The Board should preclude the incumbent from allowing its competitive affiliate preferential access to the billing process. The Board instead can state that the competitive affiliate may have access to the billing envelopes if other competitors are offered the same access on the same terms and conditions. See California Standards, supra at *94-95 (Rule V.F.3).

4. Competitive Affiliate's Access Customer Information

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

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

Q. Are there possible solutions to this problem?

A. Yes. In the electric industry, several state commissions have addressed the issue. The New York Public Service Commission, for example, directed utilities to make 24 months of usage data available with the customers' consent at no charge. Id. Furthermore, the California commission ordered the creation of a nonconfidential database, consisting of zip codes, rate categories, monthly usage, meter reading dates and billing cycles. This nonconfidential database will include the last 12 months of data and will not identify the customer. There also will be an "opt-in" database with confidential information about

customer usage, not to be released except at a customer's request. 1997 Cal. PUC LEXIS 960 (Oct. 9, 1997). See also 1997 Cal. PUC LEXIS 341; 177 P.U.R.4th 1 (May 6, 1997) (establishing that customer information must be made available using the same "procedures" for affiliates and non-affiliates):

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

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

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

5. Transfers of Utility Employees

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

A. Yes. Experienced utility staff, trained through ratepayer dollars, are an important asset. In the developing competitive markets, the government must be seen as choosing no favorites. If the perception is that employees are trained at the incumbent monopoly, and training costs are recovered under monopoly regulation, and that highly trained employees are then assigned to the competitive affiliate, under circumstances in which the

competitive affiliate and the employee expect that if sufficient business does not develop the employee can return to the incumbent monopoly, the perception will be that the utility's competitive affiliate has access to resources that its competitors do not.

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

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

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

6. Other Important Prerequisites for Effective Competition

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

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

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

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

California Standards, supra at *67.

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

> Joint marketing by a utility and affiliate creates opportunities for cross-subsidization, and also has the strong potential to mislead the consumer, for example, by implying that taking affiliate services is somehow related to the provision of the monopoly utility service. Joint marketing opportunities, especially when coupled with the joint use of a name and logo, will promote customer confusion by allowing affiliates to capitalize on the public perception that their products are closely associated with the regulated utility's. For

> example, the utility advertisements set forth in our discussion on the use of name and logo, above, demonstrate that juxtaposing discussions about the affiliates and utility's services, even if factually correct, inappropriately blurs the separation between the affiliate and utility.

California Standards, supra at *92.

c. Processing of requests: Where a customer, or an unaffiliated competitor, requests services or information that is exclusive to the incumbent and which is not economically duplicable by competitors, the incumbent must process the request as rapidly and thoroughly as it does when the requestor is an affiliate.

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

C. Enforcement Issues

Q. Assuming the Board promulgates standards concerning interaffiliate transactions, do you have any recommendation concerning enforcement?

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

Q. Why is expedition necessary?

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

refund.) In a market where competition is first developing, anyone with advantages has incentive to exploit them.

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

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

Q. What types of sanctions would you recommend?

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

Structural sanctions should address the features of corporate structure which facilitate the improper behavior. Sanctions related to abuse of the affiliate relationship should focus on the source of the problem: the affiliate relationship. The incumbent monopoly has that status only because the government granted it the monopoly privilege. A privilege which is misused should be forfeited. Compliance with the affiliate rules therefore should be a

condition of continuing to have the right to be a utility. Conversely, violation of a rule could result in a ban on the competitive affiliate's entry into the retail competitive market.

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

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

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

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

California Standards, supra at *161.

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

A. The Board should have data in the detail necessary, and at the time necessary, to preclude the incumbent's competitive affiliate from gaining an improper advantage. The detail and the timeliness will vary depending on the type of data and the stage in competitive development. The Board will need flexibility. At the very least, data on affiliate transfers must be available as soon as they occur, if not before, and include the detail necessary to ensure compliance with the Board's pricing rules.

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

Q. Do you have any additional recommendations on enforcement?

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

The premise for this requirement is simple: there will be numerous opportunities to test and violate these rules. The Board and intervening parties will not be capable of detecting and preventing each one. The success of the rules will depend on a strong internal commitment. With the pressures toward profit induced by competition, there will

be conflicts within the organization between advancing the company's competitive position and complying with the rules. Someone inside the company must be responsible for identifying these conflicts and ensuring that they are resolved consistently with the Board's rules.

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

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

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

Q. Do you have comments on the regulatory role that the Board should play?

A. Yes. Some have argued that antitrust law can solve problems associated with affiliate relations; and that therefore the Board should stand back and "let the market work." Under the present facts, that approach will not work. The incumbent begins with almost 100 percent market share, may have access to resources not available to or replicable by its competitors, and owes this favored position in part to a history of government protection from competition.

Antitrust enforcement is not a tool for creating competition from scratch, after decades of dependence on a sole supplier. It is therefore appropriate for the Board to establish standards that will assist in the development of effective competition. Exclusive reliance on antitrust is inappropriate because the task is to create effective competition where none exists.

There is a gap between the behaviors which are the focus of antitrust law, and the behaviors which can preclude effective competition from developing. Failure to fill this gap means that no public entity will be responsible for protecting the public from certain types of harms. For example, when a company with 100% market share, attributable to a history of government protection, exploits its brand name, there is no violation of antitrust law. But the behavior heightens an entry barrier that can be detrimental to the development of effective competition. When the utility incumbent exploits its preferred

access to economies of scale and scope, there is not necessarily a violation of antitrust law (provided the incumbent is not denying access to a bottleneck facility); however, this activity again builds on an entry barrier and renders competition less effective.

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

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

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

A. Yes. The Board must foster effective competition where competition has not previously existed. This challenge requires affirmative steps to create the conditions essential to competition. These conditions may not emerge on their own, particularly where the entity

benefitting from a history of government protection from competition will be entering the competition against those who have lacked such advantages.

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

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

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

Conclusion

Q. Please summarize your testimony.

A. A successful transition to effective competition requires that the incumbent and its affiliated retail competitor have an arm's-length relationship. Incumbent resources attributable to its historic monopoly status, when shared with the affiliated competitor exclusively, creates an unearned advantage for the affiliated competitor that distorts competition by creating entry barriers for other competitors and by masking inefficiencies in the affiliated competitor.

Examples of such unearned advantages are the affiliated competitor's use of the incumbent's corporate name, access to incumbent's monthly bill and customer data, employee transfers, referrals of business leads, joint marketing, favorable processing of service requests and unjustified variations in price and quality.

Contrary to VNJ arguments, a requirement of arm's-length dealing need not eliminate vertical economies of scope. Arm's-length dealing requires only that these economies not be hoarded by the incumbent, but instead shared, to the extent feasible, with competitors. Such sharing has two benefits. First, it expands the universe of customers who will benefit from vertical economies. Second, it assures that competition among the competitors, affiliated and unaffiliated, will be determined by the relative merits of the competitors rather than by historic and unearned endowments.

Q. Does this conclude your direct testimony?

A. Yes.

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Scott Hempling provides legal representation and policy advice concerning the regulated industries, with an emphasis on competition, mergers and acquisitions, corporate restructuring, diversification and State-federal jurisdictional issues. He is a frequent witness before Congressional committees and lecturer at industry conferences. Clients include State commissions, independent power producers, municipal power systems, residential consumers and public interest organizations.

EDUCATION

B.A. *cum laude*, Yale University (Economics and Political Science), 1978. Recipient of Continental Grain Fellowship and Patterson Award.

J.D. *magna cum laude*, Georgetown University Law Center, 1984. Recipient of *American Jurisprudence* Award for Constitutional Law; editor of *Law and Policy in International Business*.

PRESENT AND RECENT CLIENTS

State Governmental Bodies

Arkansas Public Service Commission: General advice on federal electricity policy, including mergers, federal-state relations and transmission access.

Arizona Corporation Commission: General advice on federal electric policy. Advice on electric utility holding company diversification under the Public Utility Holding Company Act (PUHCA).

Connecticut Department of Public Utility Control: Advice on electric industry restructuring.

Connecticut Office of Consumer Counsel: Representation in merger proceeding involving Northeast Utilities and Public Service of New Hampshire, focusing on merger's effects on utility finance costs.

Kansas Corporation Commission: General advice on federal electricity policy and representation before FERC; representation of staff in merger proposals involving Kansas utilities.

Massachusetts Department of Public Utilities: Advice on FERC filings related to the New England Power Pool.

Michigan Public Service Commission: Technical advice on proposed amendments to PUHCA.

Missouri Public Service Commission: General advice on federal electricity policy and representation before FERC.

National Association of Regulatory Utility Commissioners: Co-contractor on study of shareholder recovery of historic costs (1994).

Nevada Consumer Advocate: Advice on proposed merger between Sierra Pacific Power and Washington Water Power.

Nevada Public Service Commission: Advice on electric industry restructuring.

New Hampshire Public Utilities Commission: Legal advice on implementation of retail competition.

New Jersey Division of Ratepayer Advocate: Advice on electric restructuring.

North Carolina Utilities Commission: Advice to Public Staff on merger between Duke and PanEnergy.

Oklahoma Corporation Commission: Appellate counsel in state Supreme Court case concerning "interim rates"; counsel to Staff in Oklahoma Gas & Electric rate case.

Pennsylvania Office of Consumer Advocate: Advice on proposed acquisition by NUI Corp. of Pennsylvania Gas & Water.

Texas Office of Public Utility Counsel: Advice on electric industry restructuring; witness in utility rate case on accelerated depreciation of “stranded costs.”

Vermont Department of Public Service: Expert witness on the appropriate treatment of utility diversification and interaffiliate transactions.

Vermont Legislature: Advice on electric industry restructuring.

Virginia State Corporation Commission: Advice on electric utility diversification and electric industry restructuring.

Municipal Power Systems

Connecticut Municipal Electric Energy Cooperative: Counsel before FERC and the SEC in proceedings concerning Northeast Utilities' proposed acquisition of Public Service Company of New Hampshire (1990-91); general electric advice.

Iowa Association of Municipal Utilities: Advice on electric industry restructuring.

Public Interest Organizations

American Association Retired Persons: Representation in case before the California Public Utilities Commission in "performance-based" rate case.

American Public Power Association, Consumer Federation of America: Preparation of *amicus* brief to the U.S. Supreme Court in *Arcadia, et al. vs. Ohio Power Company*, involving interpretations of PUHCA.

Energy Foundation: Draft study on implementation of integrated resource planning concepts by FERC.

Environmental Action Foundation: General advice on electricity policy; representation before FERC, the SEC and the U.S. Courts of Appeals.

Independent Power Producers

National Independent Power Producers: Advice and representation in Wisconsin proceedings involving relations between utilities and independent power producers; authorship of study of defects in wholesale generation markets (1994).

EnerTran Technology Company: Advice and representation in Wisconsin proceedings.

Trigon Engineering: Advice on gaining transmission paths for independent generation project.

LEGISLATIVE TESTIMONY

United States Senate

Committee on Energy and Natural Resources, May 1993 (analyzing bill to transfer PUHCA functions from SEC to FERC).

Committee on Banking and Urban Affairs, U.S. Senate, Sept. 1991 (analyzing proposed amendment to PUHCA).

Committee on Energy and Natural Resources, U.S. Senate, March 1991 (analyzing proposed amendment to PUHCA).

Committee on Energy and Natural Resources, U.S. Senate, Nov. 1989 (analyzing proposed amendment to PUHCA).

United State House of Representatives

Subcommittees on Energy and Power and Telecommunications and Finance, Commerce Committee, U.S. House of Representatives, Oct. 1995 (regulation of public utility holding companies)

Subcommittee on Energy and Power, Energy and Commerce Committee, U.S. House of Representatives, July 1994 (analyzing future of the electric industry).

Subcommittee on Energy and Power, Energy and Commerce Committee, U.S. House of Representatives, May 1991 (analyzing proposed amendment to PUHCA).

Subcommittee on Environment, Energy and Natural Resources, Government Operations Committee, U.S. House of Representatives, Oct. 1990 (assessing electric utility policies of FERC).

Appropriations Subcommittee on Commerce, Justice, State and the Judiciary, U.S. House of Representatives, Apr. 1989 (discussing proposals to increase staff administering PUHCA).

Subcommittee on Energy and Power, U.S. House of Representatives, Sept. 1988 (discussing "independent power producers" and PUHCA).

State Legislatures

Committee on Energy and Public Utilities, California Senate (December 1989) (discussing relationships between electric utilities and their non-regulated affiliates).

Interim Committee on Electric Restructuring, Nevada Legislature (1995-97) (discussing options for structuring the electric industry).

Committees on General Affairs, Finance, Vermont Senate (February-March 1997) (discussing options for structuring the electric industry).

Task Force to Study Retail Electric Competition, Maryland General Assembly (October 1997).

PUBLICATIONS

Is Competition Here? An Evaluation of Defects in the Market for Generation (National Independent Energy Producers, Jan. 1995) (co-author).

The Regulatory Treatment of Embedded Costs Exceeding Market Prices: Transition to a Competitive Electric Generation Market (Nov. 1994) (with Kenneth Rose and Robert E. Burns).

"Depolarizing the Debate: Can Retail Wheeling Coexist with Integrated Resource Planning?" *The Electricity Journal (Apr. 1994*).

Reducing Ratepayer Risk: State Regulation of Electric Utility Expansion (American Association of Retired Persons 1993).

"'Incentives' for Purchased Power: Compensation for Risk or Reward for Inefficiency?" *The Electricity Journal* (Sept. 1993).

"Making Competition Work," *The Electricity Journal* (June 1993).

"Confusing 'Competitors' With 'Competition,'" *Public Utilities Fortnightly* (March 15, 1991).

"The Retail Ratepayer's Stake in Wholesale Transmission Access," *Public Utilities Fortnightly* (July 19, 1990).

"Preserving Fair Competition: The Case for the Public Utility Holding Company Act," *The Electricity Journal* (Jan./Feb. 1990).

"Opportunity Cost Pricing," *Wheeling and Transmission Monthly* (Oct. 1989).

"Corporate Restructuring and Consumer Risk: Is the SEC Enforcing the Public Utility Holding Company Act?" *The Electricity Journal* (July 1988).

"The Legal Standard of 'Prudent Utility Practices' in the Context of Joint Construction Projects," *NRECA/APPA Newsletter Legal Reporting Service* (Dec. 1984/Jan. 1985) (co-author).

OTHER ACTIVITIES

Lecturer

Regulatory Studies Program, National Association of Regulatory Utility Commissioners.

Member

Research Advisory Committee, National Regulatory Research Institute (1994-present).
Roster of Experts, U.S. Dept. of Energy National Electricity Forum (1994).
Editorial Advisory Board, *The Electricity Journal*.

Conference Speaker

American Bar Association
American Power Conference
American Public Power Association
American Wind Energy Association
Electric Power Research Institute
Electric Utility Week
Electricity Consumers Resource Council
Energy Daily
Executive Enterprises
Exnet
Federal Energy Bar Association
Infocast
Management Exchange
National Association of Regulatory Attorneys
Midamerica Association of Regulatory Commissioners
National Association of Regulatory Utility Commissioners
National Association of State Utility Consumer Advocates
National Independent Energy Producers
New England Conference of Public Utility Commissioners
New England Public Power Association
Southeastern Association of Regulatory Utility Commissioners
U.S. Department of Energy Forum on Electricity Issues