Utility Marketing Affiliates: A Survey of Standards on Brand Leveraging and Codes of Conduct

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No clear consensus has emerged. Should regulators hold to a hard line?

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Regulators have wrestled for decades with transactions between vertically integrated monopoly utilities and their corporate affiliates.

Most problems have usually involved a shifting of costs, risk, or profit, as when an electric utility buys coal from a subsidiary. On the telephone side, AT&T’s equipment dealings with Western Electric and Bell Labs were always a worry for regulators. The concern, of course, was whether ratepayers (all were essentially captive then) were paying too much and bearing improper risks, while providing profits actually higher than the allowed rate of return, masked by accounting mischief.

Now comes an old issue in a new guise—whether and how to regulate a new breed of transaction that in the course of industry restructuring may allow incumbent utilities to raise barriers against competition, favoring their affiliates and actively disadvantaging others. Two such concerns are (1) the leveraging of established utility brand names and logos, by extending their use to affiliates, and (2) wider dealings that may deter competitors, such as when the distribution company loans its technical staff and senior management to the affiliate, providing inside information on customers.

To counter these problems, state public utility commis-
sions are embracing "Codes of Conduct," but the questions they face are anything but straightforward. Some "tough calls" are required. This paper considers the efficacy of these efforts, urging strict commission oversight of transactions with affiliates in three sectors—telecommunications, natural gas, and electricity—each now involved in restructuring.

Learning from Telcos
Branding has emerged as a contentious issue in telephone industry restructuring, appearing as a major obstacle in over one-third of the roughly 90 arbitration decisions in the data bank of the National Regulatory Research Institute. Some 24 state PUCs have tackled the issue during their arbitration and mediation activities under the Telecommunications Act of 1996.

The central question in the branding debate is whose company name and logo will appear on resold service—the incumbent carrier that originates the service or the new competitor that resells it? Understandably, the competitor is looking for a toe-hold in the market. It wants to "rebrand" everything to spread its name around, or at worst make the incumbent "unbrand" it. All resellers argue that to do otherwise would allow the incumbent to foreclose viable entry into the new market.

As of last fall, in 73 arbitration decisions in which AT&T was involved, PUCs had allowed Ma Bell to use its brand name in 45. The incumbent local exchange carrier was allowed to use its name in three instances. In 13 cases both carriers were prohibited from doing so.

In telephone cases, the branding issues have been of two types: (1) operator and directory assistance services, and (2) direct customer contact services, like installation and repairs. Vermont and New Hampshire have taken a strict line, requiring NYNEX to unbrand all these services (including its own). New York, however, decided that unbranding all services is not desirable, saying it would lead to confusion. Michigan said unbranding would violate certain rules imposed by the Federal Communications Commission.

On the other hand, Virginia ruled in a GTE case that where the carrier cannot provide branding for others it must unbrand operator services and directory assistance for all carriers' customers, including its own. Kentucky requires Bell South to unbrand or rebrand only those services it brands for itself. Ohio adopted a case-by-case approach with Ameritech, while Wisconsin has required Ameritech to rebrand its operator and directory assistance services. Colorado and Montana do not require branding vehicles or employees (clothing) that go out into the field to serve customers, but employees must tell the customer that they are appearing on behalf of the competitor carrier. Florida requires that unbranded information (e.g., repair slips) be left with customers. Missouri and Texas allow Southwestern Bell employees to identify themselves that way but require that they say for which company's behalf they are there and that they leave generic documentation with space to fill in the competitor's name. In a case involving U S WEST and AT&T, Idaho took a similar position, adding that the local carrier must abstain from making disparaging remarks about AT&T, "selling its own services in the course of a customer premises visit," and must leave behind AT&T-supplied documentation.

Learning from Gas
In the natural gas industry, PUCs have recently faced the issues of branding and the appropriate intracorporate relations
Utility Arguments

Comments presented in the Illinois case, as characterized by the commission.*

ILLINOIS POWER indicates that the exclusive sharing of corporate support information, services, and personnel between a utility and its affiliated interests will not impact the competitive balance.

COMMONWEALTH EDISON asserts that the ban on joint marketing adversely affects legitimate competition and innovation.

MIDAMERICAN ENERGY asserts that denial of the right of utilities and their affiliated interests to share corporate support services makes them less efficient and places them at a competitive disadvantage.

NICOR GAS states that joint marketing and sales activities by utilities and their affiliates utilize economies of scope and scale, result in cost savings to consumers, and reflect [the] customer's desire for one-stop shopping.

EDISON ELECTRIC INSTITUTE states that requiring utility sharing of non-tariffed services [with unaffiliated entities] attempts to socialize the economies of integration that inherently are a part of any business organization.


between utilities and their affiliates, often on the introduction of pilot retail access programs. The decisions are varied, but brand name usage by the incumbent local distribution company is commonly allowed (there appear to have been only two instances where it was not). Codes or standards of conduct are almost always employed. These sets of rules are often modeled after Federal Energy Regulatory Commission Order 497 but generally are more comprehensive, obligating regulated gas utilities to provide the same services, information, and pricing terms to all marketing entities—theirs and others—as well as restricting personnel deployment, establishing complaint procedures, and allowing for reporting and audit oversight.

Pennsylvania* established an “Interim Code of Conduct” for natural gas competition requiring complete separation, no staff sharing, comparability of treatment, no joint marketing, and no dealing on inside information. Staff members report that, nonetheless, independent marketers “are complaining everywhere.”

Maryland,* on the other hand, established a "generic code of conduct" prohibiting joint management for high level executives but not others. No structural separation was required on the grounds that certain efficiencies would be lost and that in any event the existence of performance-based regulation would control the problem of transfer price inflation. Complaints are to come directly to the PUC, and a pattern of violations could force divestiture of affiliates. A Maryland commissioner reports that gas marketers seem to be satisfied with the arrangements.

Massachusetts* created a code of conduct through a collaborative with interested parties, drawing in part on experience at the Ontario Energy Board. Under its rules, the marketing affiliate of Boston Gas can say, “We're an affiliate of Boston Gas,” but cannot say, “We're Boston Gas doing something for you.” Other marketers reportedly are very suspicious of the workability of the separation.

Ohio has employed a standard of conduct in its pilot program requiring new complaint procedures. Commission staff there say they also would look to the Office of Attorney General to participate in any necessary enforcement through the fair trade and state antitrust laws or private actions thereunder.*

New Jersey* requires only accounting separation of the unregulated affiliates in its two pilot programs. According to staff, there is a widely held perception among state legislators and marketers that the overlap in employees and logos has been injurious to real competition. A new collaborative on the subject may be in the offing.

Legislation signed into law in April 1997 and administered by the Georgia PSC provides fairly strict limitations on relations between distribution companies and their affiliates.* In a July 1998 decision the commission prohibited a prominent LDC under its jurisdiction from allowing a marketing affiliate to use a name “too similar” to its own on grounds that it would be “misleading” and retard the development of competition.

New York faced these issues most recently in a settlement agreement involving a complicated corporate restructuring between Brooklyn Union Gas and Long Island Lighting and their affiliates. Detailed requirements were
set out to “protect customers from harm” and not restrict competition. One of these last is the prohibition on employee “revolving door” transfers—for no longer than 18 months at a time and not again for at least 18 more months. Further, the PSC prescribed a charge (ratemaking credit) of 20 percent of the first year of compensation for each utility employee loaned out. Another wrinkle in the agreement was a royalty feature for gas utility customers to compensate them (in the form of a ratemaking credit) for the affiliate’s use of the name, reputation, and expertise of the company, and “to capture any unquantifiable subsidies or misallocations resulting from affiliate transactions.” Interestingly, the parties also agreed not to challenge the PUC’s authority to levy royalties.

**Learning from Electricity**

A number of commissions are working toward devising codes of conduct for use in electric restructuring. In 1997, the Strategic Issues Committee and Staff Subcommittee on Accounts for the National Association of Regulatory Utility Commissioners prepared and disseminated for comment a draft paper for use by PUCs addressing the relationship between the activities of regulated and nonregulated affiliated companies in a restructured electric industry. In September this document still awaited action at the committee level.

Commissions in New Jersey and Pennsylvania are working on fashioning agreeable codes of conduct using working groups and collaboratives. New York completed a negotiated agreement and settlement on a Consolidated Edison restructuring plan for retail competition. Safeguards were similar to the above-mentioned Brooklyn Gas-LILCO case. However, branding was allowed, and a royalty payback of 2 percent of the capital investment in the affiliate is required for use of the logo. A new complaint system must be set up by the utility with the utility having 20 days to informally resolve complaints on its own, and failing that, to promptly refer the matter to the PSC. The PSC has remedial authority for serious or sustained violations of the standards of competitive conduct, including ordering divestiture. At its call, the PSC can choose an independent auditor to review utility compliance with the terms of the agreement.

In June 1998, the Illinois Commerce Commission approved rules on nondiscrimination in affiliate transactions pursuant to a new (1997) state law. Preferential treatment of their own affiliates over others by tariffs or terms and conditions of sale, saying or implying to customers that dealing with the incumbent distribution company affiliate gives a special benefit over dealing with unaffiliated suppliers, and differentially processing requests for similar services—all are prohibited.

The nine-month California rulemaking to develop standards of conduct for relationships between energy utilities and their affiliates is perhaps a classic case containing sharply delineated positions of the various parties, contrary arguments as to the need and effectiveness of possible safeguard provisions, and divergent philosophies of social intervention and the sanctity of property rights. The 1997 order can be described as fairly strict in the detailed provision of the standards of conduct and as taking a middle position on the branding question between banning their use outright and allowing their use unfettered. The tone of the order conveyed the seriousness with which the commission saw the matter, underscored by the writings of three of the commissioners in the course of deliberations and adoption.

As of July 1998, the Texas PUC was considering the approach of structural separation in which intracorporate transactions would be limited and as transparent and objective as possible, e.g., using bidding procedures for contracting purchases in which a third party evaluates the bids. A disclaimer would be required when an affiliate uses the parent utility’s name or logo.

**Reflections on the Survey**

From this sketch of state actions around the country several conclusions can be drawn. Policymakers (whether commissioners or legislators) do not yet appear fully persuaded in either direction about the seriousness or nonseriousness of the dangers to competition presented by utility incumbent/affiliate transactions. Accordingly, the policy response so far has been uneven, with varying degrees of constraints imposed on the jurisdictional company.
Clearly, more must be done to constrain the incumbents if we are to rely on markets to produce a public interest outcome.

Moving from fact to judgement, mine is that commissions at this time should err on the strict side, with very immature markets for competitive utility service now being the rule. By that I mean they should employ the full range of prohibitions and constraints available and devote sufficient resources to enforce compliance.

**BRAND NAMES.** Brand-name and logo sharing with affiliates should be prohibited for, say, five years, as should any strategic transfers of utility personnel.

**COST SHIFTING.** Regulators should remain alert to cost and risk shifting, the prudence and purpose of utility advertising, and the price paid to or collected from affiliates for corporate services. After all, abuses can still occur because the business units still would not be fully independent of each other. Commission audits and cost allocation reviews should be regularly conducted. The bilateral transfer of insider information, like utility customer consumption patterns, should be prohibited along with any other dealings that convey an undue preference and advantage. Where personnel transfers are allowed they should be of limited duration, one-time events, and should be fully compensated to the jurisdictional utility and flowed through to ratepayer accounts.

**COMPETITOR COMPLAINTS.** Prompt and effective complaint procedures should be established with early involvement of the PUC and informational involvement of the office of attorney general. To discourage frivolous complaints by competitors, a fee system should be imposed for use of commission time and investigatory resources. Noncompliance with the letter or the intent of the standards of conduct would not be tolerated, and both monetary and divestment penalties should be available. A repeat transgression should result in a steeply progressive, harsher penalty. Wide publicity for actual misconduct—regulation by invidious comparisons—also should be employed.

**FAIRNESS AND EQUITY.** The idea that this problem will solve itself over time without intervention is not persuasive, I also question the idea that benefits from efficiencies in vertical integration, innovation, and variety in choice will outweigh these market imperfections. I find more compelling the perspective that aims its focus first on economic power, concluding that any possible anticompetitive behavior will in fact occur unless government intervenes. Fairness and equity cannot be left to themselves. I see branding and associated dealings as significant impediments to market entry by others, perpetuating meritless dominance by the incumbent. That is particularly unfair for an undifferentiated product or service like energy or telecommunications.

**LEARNING FROM EXPERIENCE.** Regulators and utilities alike should recall the mixed results that came from the diversification of the 1980s and early 1990s. PUCs grudgingly acquiesced; holding companies were elaborated; conglomerates were formed. While the worst fears of regulators did not come true, the glowing expectations of utility companies didn’t either. The result often was the pulling back into the core business and the selling off of subsidiaries, much the way that nonutility companies have done over time (e.g., Sears disposing of Caldwell Banker, Dean Witter, and Allstate; Eastman Kodak selling off Bayer Aspirin; and Pepsi Cola divesting itself of Pizza Hut, Taco Bell, and KFC).

My opting for the strict approach is influenced also by two external considerations. One is our experience to date in trying to bring workable competition to local telephone
(and, to some extent our experience with natural gas) service. Here public policy wildly underestimated the power (and will) of the incumbent utility to resist and frustrate change to its own advantage. Despite the rhetoric, it has gone rather badly and so far, at least, has mostly fizzled in the case of local service and residential and small business customers. Clearly, more must be done to constrain the incumbents if we are to rely on markets to produce a public interest outcome.

References*


*Assembled with grateful assistance from Jaison R. Abel, NRRI staff.

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