SHUTTING THE BARN DOOR BEFORE THE HORSE IS STOLEN: HOW AND WHY STATE PUBLIC UTILITY COMMISSIONS SHOULD REGULATE TRANSACTIONS BETWEEN A PUBLIC UTILITY AND ITS AFFILIATES

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I. INTRODUCTION

State public utility commissions should have the authority to regulate transactions between public utilities and their parent companies, subsidiaries or other affiliated corporations. In the absence of such authority, a public utility can (1) arrange transactions with affiliated entities that result in the utility overpaying for goods or services, thereby increasing rates, or (2) take on financial burdens attributable to affiliated entities, which can threaten its solvency. In its report on Enron's fraudulent financial transactions, the staff of the United States Senate Committee on Government Affairs explained:

[W]henever a company conducts transactions among its own affiliates there are inherent issues about the fairness and motivations of such transactions . . . . One concern is that where one affiliate in a transaction has captive customers, a one-sided deal between affiliates can saddle those customers with additional financial burdens. Another concern is that one affiliate will treat another with favoritism at the expense of other companies or in ways detrimental to the market as a whole.1

The root of the problem, as noted by a former California Supreme Court Justice, is that agreements between a public utility and its affiliates are not "made at arm's length or on an open market. They are between corporations, one of which is controlled by the other. As such they are subject to suspicion and therefore present dangerous potentialities."2

The potential dangers of interaffiliate transactions first became apparent early in the twentieth century following the formation of public utility holding...
At that time, "[h]olding companies were taking advantage of the fact that they owned utilities in multiple states to engage in interstate, intracompany transactions that could not be controlled by state public utility commissions." In response, Congress passed the Public Utility Holding Company Act of 1935, which gave the Securities and Exchange Commission ("SEC") authority to regulate interstate public utility holding companies and the Federal Power Act, which gave the Federal Power Commission the authority to regulate the rates that one utility could charge another. Many states also passed legislation during this time period that authorized their public utility commissions to review certain transactions between utility companies and their affiliates.

Even with these state and federal attempts to oversee transactions between regulated entities and their affiliates over the years, the difficulties in controlling such transactions still persist. A recent online version of the Wall Street Journal noted that energy companies "burned by disastrous forays into commodities trading..." were attempting to recoup some of their losses by passing part of their financial burdens on to their affiliated utility units. As a result, utilities bought assets from affiliates, made loans to their affiliates, or passed...
more money on to their parent companies by reducing capital spending. Recognizing that utilities were subject to manipulation by their parent companies, credit-rating agencies reduced the utilities’ debt ratings, thus raising the costs of borrowing money or refinancing debt for the utilities, with the potential that these higher costs would eventually be passed on to electric consumers.

A. Enron and FERC

The most notorious examples of inappropriate interaffiliate transactions are those Enron arranged shortly before its collapse in 2001. In November 2001, Enron attempted to avoid bankruptcy by securing loans for $1 billion on two pipeline subsidiaries, which were secured by the pipelines’ assets. The proceeds of the loans were subsequently transferred to Enron as unsecured loans from the pipelines. After declaring bankruptcy a few weeks later, Enron made no payments on these loans, leaving the pipelines to pay off the entire amount. As noted in the Senate Government Affairs Committee staff report, “ordinarily such costs would be passed on to shippers who use the pipelines, and ultimately to retail natural gas customers.”

In addition, some Enron subsidiaries also had “cash management agreements” with Enron, whereby, at the end of each day, all remaining cash in the subsidiaries was transferred to Enron, which held and invested it, with no indication that the interest earnings were properly credited back to the subsidiaries. Enron made “more extensive use” of this common industry practice than did other companies, holding an average of $195 million from associated companies compared to non-Enron companies holding an average of $6 million. Furthermore, the average amount transferred into Enron’s accounts receivable from associated companies grew from $44 million in 1997 to approximately $195 million in 2000.

There was also evidence that “Enron may have used its public utility affiliate, Portland General Electric (PGE), to engage in the questionable export and reimportation of electricity from California during the Western energy crisis of 2000-2001 and disguised these prohibited interaffiliate transactions.”

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9 Id.
10 Id.
11 STAFF OF SENATE COMM. ON GOV’T AFFAIRS, supra note 1, at 2 (explaining that on December 2, 2001, Enron, then the nation’s seventh largest company, filed for bankruptcy protection amid allegations of financial and other fraud. Enron’s collapse left thousands unemployed, erased billions of dollars of shareholder value and triggered crises, not only in investor confidence in U.S. financial markets, but in consumer and investor confidence in the energy markets as well).
12 Id. at 3.
13 Id. at 28 n.82 (explaining that the proceeds were exchanged for “promissory notes that stated they were subordinated to prior payment of all senior indebtedness upon the dissolution, liquidation or reorganization of Enron.”).
14 Id. at 28.
15 Id.
16 Id. at 29.
17 Id. at 29 n.89.
18 Id. at 29 n.90.
19 Id. at 3.
cluding there was a “shocking absence of regulatory vigilance” over Enron’s activities, the Senate Government Affairs Committee reported that the Federal Energy Regulatory Commission (“FERC”) was “unprepared and unwilling to act against suspect interaffiliate transactions either because the Commission’s rules were inadequate or because it was not able to effectively monitor whether companies were complying with the rules.”

B. Western Resources Inc. and the Kansas Corporation Commission

The problems encountered in policing affiliate transactions that shift financial burdens to regulated utilities – and thus to consumers – are not confined to companies regulated by FERC. A recent example of a state public utility commission’s attempts to regulate transactions, that would have improperly shifted costs to regulated utilities, is the Kansas Corporation Commission’s ("KCC") investigation into Western Resources, Inc.’s (“WRI”) proposal to separate its non-regulated affiliates from its public utility businesses. WRI is a public utility holding company that operates Kansas Power and Light and Kansas Gas and Electric, electric utilities providing retail service to approximately 636,000 customers in Kansas. WRI also wholly owns Westar Industries, Inc. ("Westar"), a subsidiary that is not regulated by the KCC.

The KCC, citing its “plenary authority” to supervise and control electric utilities doing business in Kansas, opened its investigation into WRI’s pro-
proposals after Westar filed a Registration Statement ("Statement") with the SEC. The Statement indicated that prior to the proposed split off, Westar and WRI intended to distribute the holding company's assets and liabilities among WRI's affiliated entities via an Asset Allocation Agreement ("Agreement") between the two companies. The KCC staff estimated that consummation of the Agreement would result in WRI's December 31, 2000 consolidated balance sheet reflecting 113.02 percent ($2.97 billion) of WRI's long-term debt in its electric utility businesses and negative equity of 13.02 percent (approximately $300 million). Staff estimates further showed that, as of December 31, 2001, WRI's proposals would result in the transfer $1.6 billion of consolidated debt from its nonutility businesses (primarily from Protection One, Inc., Westar's residential and commercial security monitoring subsidiary) to WRI's regulated utility operations. If effectuated, the Agreement would cause WRI's equity to fall from approximately 50 percent of its total capital structure in 1995 ($1.7 billion) to 25 percent of its total capital structure as of December 31, 2001 ($1.8 billion).

WRI's financial condition was further worsened by credit rating downgrades it received in response to an earlier split off proposal, which resulted in its debt issuances falling from investment grade to junk bond status. As a result, WRI was unable to issue unsecured notes to finance its short-term capital needs and was forced to secure short-term cash by mortgaging its property...
at an interest rate of 10.5 percent\textsuperscript{37} — costs which WRI’s electric consumers were at risk of bearing.

There were other questionable interaffiliate transactions as well. For example, prior to proposing the split off, WRI advanced at least $927 million to Westar.\textsuperscript{38} The advance was originally classified as a loan from WRI to Westar.\textsuperscript{39} As noted during the KCC’s hearings, WRI’s management and board of directors made a “pivotal decision” to reclassify the loan to an investment, thus transforming $927 million of debt on Westar’s books to $927 million of common equity.\textsuperscript{40} In addition, WRI transferred stock it owned in ONEOK, a natural gas company, which it valued at $1 billion in its 2000 Annual Report, to Westar in advance of filing the split off proposal with the SEC.\textsuperscript{41}

The KCC concluded that WRI’s split off was designed so that WRI’s electric businesses would hold significant amounts of debt at the time of the split off but no Westar assets, while Westar would own all of WRI’s unregulated assets but would not be responsible for the long-term debt used to acquire them.\textsuperscript{42} As a result, WRI’s asset-poor and debt-laden electric businesses would likely be forced to pay off the debt either through increases in electric rates or other cost-cutting measures which would “impair WRI’s ability to perform routine maintenance, retain qualified employees or make the necessary capital improvements to meet the needs of Kansas electric customers.”\textsuperscript{43} The KCC ordered WRI to stop the transactions necessary to complete the split off and found the Asset Allocation Agreement to be “contrary to the public interest and having no force and effect.”\textsuperscript{44} The KCC directed WRI to prepare a plan to restore WRI’s electric utilities to financial health, achieve a balanced capital structure, and protect ratepayers from the risks of WRI’s non-utility businesses.\textsuperscript{45}

WRI requested reconsideration of the KCC’s order, arguing that the Kansas affiliated interests statutes did not extend to the Asset Allocation Agreement because it had been filed by Westar, and that the commission was “not

\textsuperscript{37} Id. at 4.

\textsuperscript{38} July 20, 2001 Order, supra note 26, at 7 n.2 (explaining this investment was originally classified as an intercompany receivable owed by Westar to WRI, but was later reclassified as an investment in Westar by management).

\textsuperscript{39} Id.

\textsuperscript{40} Id. at 8 (footnote omitted).

\textsuperscript{41} Id. at 2 n.1 (noting WRI originally acquired the stock when it exchanged its natural gas business at a book value of approximately $594 million for 45 percent ownership interest in ONEOK, Inc.).

\textsuperscript{42} Id. at 12.

\textsuperscript{43} Id. at 12, 13.

\textsuperscript{44} Id. at 41-42.

\textsuperscript{45} Id. In a subsequent order, the commission (1) rejected the financial plan proposed by WRI; (2) directed WRI to reverse certain accounting transactions; (3) directed WRI to transfer its KPL utility division to a utility-only subsidiary of WRI, after review and approval of WRI’s plan to do so by the commission; (4) instituted interim standstill protections to prevent harm to WRI’s utility businesses as a result of their affiliation with WRI’s nonutility businesses pending adoption of final requirements relating to such affiliation; and (5) instituted an investigation into the appropriate type, quantity, structure and regulation of the nonutility businesses with which WRI’s utility businesses may be affiliated. No. 51 Order, supra note 34, at 3-4.
empowered to substitute its judgment for that of the board of directors of the unregulated subsidiary... The KCC denied the petition and WRI subsequently filed for judicial review.

C. State Public Utility Commission Authority and Interaffiliate Contracts

Assertions such as those made by WRI are common battle cries used by a public utility in questioning commission authority over transactions with its affiliates. Such assertions raise the question of how far state regulators can go to stop public utility holding companies, or their unregulated subsidiaries or affiliates, from harming consumers by "milking their utility units" through interaffiliate transactions such as those described above.

This note will examine various court decisions involving public utility commission authority over such transactions, and distill principles from those


47 Initial Brief of Westar Energy, Inc. (WRI), at 4-6 (Aug. 19, 2002) (citing Shawnee Co. Dist. Ct. Mem. Decision and Order, Case No. 01-C-1190, 6-7 (Feb. 5, 2002) wherein the court remanded the petition to the KCC pending the outcome of the KCC's review of WRI's mandated remedial financial plan). In its Initial Brief, WRI reasserted the arguments made in its Aug. 6, 2001 Petition for Reconsideration. Id. at 22.

48 See e.g., Mountain States Tel. & Tel. Co. v. Pub. Serv. Comm'n of Wyo., 745 P.2d 563, 568 (Wyo. 1987) (observing that management decisions are "entirely that of the utility" because permitting civil servants to make those determinations instead of management results in no accountability for those decisions to investors in the business); PNM Elec. Servs. v. N.M. Pub. Util. Comm'n, 961 P.2d 147, 152 (N.M. 1988) (affirming that the commission had the authority to require a public utility to provide optional utility services through an affiliate and that the exercise of such authority was not an invasion of management as argued by the utility company); Midland Cogeneration Venture Ltd. P'ship v. Mich. Pub. Serv. Comm'n, 501 N.W.2d 573, 580-81 n.3 (Mich. Ct. App. 1993) (concluding there was no statutory authority for the Michigan Public Service Commission to regulate an affiliate's accounting and bookkeeping practices, which is a managerial decision); Lone Star Gas Co. v. Corp. Comm'n of Okla., 39 P.2d 547, 553 (Okla. 1934) (holding "[t]he powers of the Commission... do not extend to an invasion of the discretion vested in corporate management. It does not include the power to approve or disapprove contracts about to be entered into, nor to the approval or veto of expenditures proposed.").

49 Smith, supra note 8. See also The Servicing Function, supra note 7, at 981 (explaining how transactions between a public utility and its affiliate may negatively impact consumers. Consumers can be harmed by overpayments for affiliate services made by the utility which result in a "swelling" of the utility's operating expenses, which can (a) prevent a rate reduction when profits are reviewed to determine whether the utility is making more than a reasonable return, or (b) minimize the return so that only small profits are shown, or none at all, which then requires a rate increase. Overcharges for capital expenses, such as construction or engineering services, can broaden the rate base (the value of property used by the utility in providing service) upon which the utility is entitled to earn a return and increase costs of operations by increasing the amount annually charged to the utility's depreciation accounts, thereby increasing the rate required to yield an adequate return.; Pac. Tel. & Tel. Co. v. Pub. Util. Comm'n, 215 P.2d 441, 449 (Cal. 1950) (Carter, J., dissenting) (pointing out that if a "raid on the treasury of the operating utility" results in the utility becoming insolvent, consumers can be harmed because consumers will either have to pay higher financing costs to acquire the capital necessary for the expansion of service demanded from a utility or higher operating expenses for a receiver).
decisions regarding state commission authority to second-guess management decisions over affiliate transactions. Part II of this note examines early twentieth century Supreme Court decisions regarding state public utility commission authority over servicing contracts between public utilities and their parent holding companies. Part III reviews state judicial responses to public utility challenges made since those early Supreme Court decisions. Part IV evaluates the continuing vitality of the "invasion of management" defense, which is frequently asserted by utilities in challenging commission authority over interaffiliate transactions. The conclusion summarizes why commission authority should be construed to encompass direct regulation of interaffiliate transactions between public utilities and their parent, subsidiary, or affiliate companies.

II. EARLY SUPREME COURT DECISIONS REGARDING COMMISSION AUTHORITY TO INDIRECTLY CONTROL INTERAFFILIATE CONTRACTS

In *Munn v. Illinois*, the Supreme Court upheld an Illinois statute, that regulated public warehouses and required the inspection of grain, as a legitimate regulation of private business because that business was "affected with a public interest." The Court explained that property became "clothed with a public interest" when used in a way that affected the community at large. Owners of such property, said the Court, "must submit to be controlled by the public for the common good," to the extent of the interest created.

Utility companies were affected with a public interest and by the 1930's most state governments had created public utility commissions to oversee them. A major goal of public utility commissions is to ensure that the utility rates charged to consumers are "just and reasonable." To accomplish this goal, state legislatures have generally vested commissions with broad authority to supervise and regulate public utilities within their states, and courts are

51 *Id.*
52 *Id.*
53 Fickinger, *supra* note 3, at 90 (citing C. WILCOX & W. SHEPHERD, PUBLIC POLICIES TOWARD BUSINESS 334, 354 (5th ed. 1975)).
54 See e.g., *NEV. REV. STAT.* 704.040(1) (2001) ("Every public utility shall furnish reasonably adequate service and facilities, and the charges made for any service rendered or to be rendered, or for any service in connection therewith or incidental thereto, must be just and reasonable"); *66 PA. CONS. STAT.* § 1301 (2000) ("Every rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be just and reasonable . . .").
55 See e.g., *KAN. STAT. ANN.* § 66-101(2002) which provides "[t]he commission is given full power, authority and jurisdiction to supervise and control the electric public utilities . . . doing business in Kansas, and is empowered to do all things necessary and convenient for the exercise of such power, authority and jurisdiction."); *KAN. STAT. ANN.* § 66-101h (2002), which provides, among other things, that "[t]he commission shall have general supervision of all electric public utilities doing business in this state . . . and shall carefully examine and inspect the condition of each electric public utility . . . the manner of its conduct and its management with reference to the public safety and convenience"); *KAN. STAT. ANN.* § 66-101d (2002) which authorizes the commission to investigate any act or practice of an electric public utility that affects its ability to provide efficient and sufficient service at just and reasonable rates; *66 PA. CONS. STAT.* §§ 501(a), (b) (West 2002 ) ("[T]he commission shall have full power and authority, and it shall be its duty to enforce, execute and carry out, by its
frequently deferential when commissions exercise that authority in regulating public utilities.\textsuperscript{56}

Courts, however, have been more reluctant to affirm commission decisions that attempt to directly regulate transactions between a public utility and its affiliate or parent corporation.\textsuperscript{57} Public utility commissions began grappling with questionable interaffiliate transactions shortly after public utility holding companies emerged, early in the twentieth century.\textsuperscript{58} Public utility holding companies were formed, among other reasons, to “satisfy more economically the needs of small operating companies for highly skilled engineering and management.”\textsuperscript{59} To meet the needs of their operating utilities, holding companies developed servicing contracts, which “refer[red] to the performance for the operating utility by another company of any operations regarded as necessary or desirable for the utility’s functioning and which could be performed by a staff as part of its own organization.”\textsuperscript{60}

The most commonplace servicing contracts were those between local Bell operating companies and their parent, American Telephone and Telegraph (“AT&T”).\textsuperscript{61} AT&T’s servicing contract included a guarantee by AT&T to not only furnish its subsidiary with all the instruments necessary to provide telephone service, but also (1) managerial advice regarding public relations, engi-

\textsuperscript{56} See e.g., Fairview Water Co. v. Pa. Pub. Util. Comm’n, 502 A.2d 162, 166 (Pa. 1985) (finding the Pennsylvania Public Utilities Commission had full power in regulating utility rates and services, excluding the power of eminent domain); PNM Elec. Servs. v. N.M. Pub. Util. Comm’n, 961 P.2d 147, 150 (N.M. 1998) (recognizing that the New Mexico Public Utility Commission possesses expansive regulatory power to broadly and liberally construe the New Mexico Public Utility Act to effect legislative policies); CURB v. State Corp. Comm’n, 28 Kan. App. 2d 313, 324-25 (Kan. Ct. App. 2000) (noting that the vast powers of the commission should not be construed so narrowly as to defeat the commission’s purpose but should be liberally construed to include every power that can be fairly implied from the language of the statute and necessary to enable the commission to exercise its express powers).

\textsuperscript{57} See e.g., Pac. Tel & Tel. Co. v. Pub. Utils. Comm’n, 215 P.2d 441 (Cal. 1950) (finding the California commission did not have statutory authority to prescribe terms of conditions of contracts between the utility and its affiliate and that such authority could not be implied from its general rate-making powers); Mountain States Tel. & Tel. Co. v. Pub. Serv. Comm’n of Wyo., 745 P.2d 563, 568 (Wyo. 1987) (rejecting the commission’s attempt to regulate the publication of an advertising directory by a subsidiary of Mountain Bell because the “PSC is not in a position to take on any aspect of utility management. It must restrict its position to ‘regulation’ with management decisions being entirely that of the utility.”).

\textsuperscript{58} The Servicing Function, supra note 7, at 957.

\textsuperscript{59} Id. at 958.

\textsuperscript{60} Id. at 959 n.10.

\textsuperscript{61} George W. Simpkins, State Regulation of Contracts with Public Utility Affiliates, 20 St. Louis L. Rev. 1, 19 (1934).
neering, construction, research, accounting or the law; (2) licenses under all patents issued; (3) protection against patent infringement claims; (4) representation of all suits before public utilities commissions, federal commissions or taxing bodies; and (5) financial assistance to any extent necessary. In return, AT&T received four and one half percent of the gross income of the subsidiary. The standard percentage charge was later reduced.

Servicing contracts raised the original question of state commission authority over interaffiliate transactions, primarily when it came to setting rates. The early conclusions reached by commissions were mixed. At least one state high court, while concluding the commission’s exclusion of servicing contract fees from the utility’s operating expenses was not “against the manifest weight of the evidence,” nevertheless warned “the commission is not the financial manager of the corporation, and is not empowered to substitute its judgment for that of the directors of the corporation . . .” The question of whether a commission has authority to value servicing contracts when setting rates was ultimately answered as part of a series of United States Supreme Court decisions.

A. The Competitive Price Test

In 1921, Southwestern Bell sought to enjoin the city of Houston from enforcing an ordinance that, it alleged, resulted in telephone rates that were too low. In deciding that Southwestern Bell could include the cost of its servicing contract with AT&T in rates, the Court noted that Southwestern Bell had shown that the contract fees were reasonable and “less than the same could be obtained for from other sources.” The Court also found that AT&T’s control of both Southwestern Bell and the affiliate which provided Southwestern Bell with its equipment and supplies was “not important beyond requiring close scrutiny of their dealings to prevent imposition upon the community served by the Company . . .” One commentator lauded this decision as recognizing that servicing contracts required close scrutiny and that state commissions had the authority to review the fees charged for such contracts using a competitive price test. Another commentator observed, correctly, that the competitive price test was not a good measure of the reasonableness of such contract charges because there was no competition then existing in the telephone industry by which competitive prices could be measured.

62 Id.
63 Id.
64 Id.
65 Id. at 30.
66 Id.
69 Id.
70 Id.
71 Simpkins, supra note 61, at 31.
72 The Servicing Function, supra note 7, at 984.
B. The Good Faith Test

Two years later, in Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission of Missouri,\(^73\) the Court concluded that the commission had not allowed the utility to earn a fair return on its investment, which was a violation of the Southwestern Bell’s due process rights.\(^74\) The Court receded from its previous position and invalidated the commission’s disallowance of over half of the servicing contract fees paid by Southwestern Bell to AT&T. It declared that the four and one-half percent charge on gross revenues was the customary charge for servicing contracts, and that there was nothing to indicate bad faith in making the contract between AT&T and its subsidiary.\(^75\)

Finding that the utility’s board of directors had exercised “a proper discretion about this matter requiring business judgment,”\(^76\) the Court admonished the Missouri Public Service Commission not to forget that the state “is not the owner of the properties of the public utility companies and is not clothed with the general power of management incident to ownership.”\(^77\) In issuing its warning, the Court relied on the “general rule” expressed by the Illinois Supreme Court that “[t]he commission is not the financial manager of the corporation; nor can it ignore items charged by the utility as operating expenses, unless there is an abuse of discretion in that regard by the corporate officers.”\(^78\) The Supreme Court’s reliance on the Illinois Supreme Court’s earlier warning was ironic, given that the Supreme Court negated commission action similar to that affirmed by the Illinois high court.\(^79\) The adoption of the Court’s newly articulated good faith standard led one commentator to observe:

[I]t would seem not to matter how excessive the prices paid were compared to the competitive cost of the services or supplies, provided only the board of directors were sufficiently stupid or inattentive not to realize that this was a fraud upon their own corporation. It gives incompetence full privilege to mismanage the property as it will and charge the cost of the folly to the consumer.\(^80\)

Many commissions refused to follow the good faith test of Southwestern Bell.\(^81\) They were able to maneuver around the Court’s good faith test by finding that no valuable services had been provided in return for the contract payments. They accomplished this in one of two ways.\(^82\) The commission either concluded that the affiliate did nothing at all to benefit the operating company or that the operating company had enough executives to perform the services covered by the contract instead of relying on the affiliate.\(^83\)

\(^{73}\) 262 U.S. 276, 287 (1923).
\(^{74}\) Id.
\(^{75}\) Id. at 288-89.
\(^{76}\) Id.
\(^{77}\) Id.
\(^{79}\) See Simpkins, supra note 61, at 26.
\(^{80}\) Id. at 35.
\(^{81}\) Id. at 41.
\(^{82}\) Id.
\(^{83}\) Id. at 41 n.118.
\(^{84}\) Id. at 41 n.119.
C. Disallowance of Unreasonable Servicing Contract Fees

The good faith standard put forth in *Southwestern Bell* was short-lived. In *Smith v. Illinois Bell Telephone Co.*, the Illinois Bell Telephone Company appealed an order by the Illinois Commerce Commission, asserting its telephone rates were too low and violated the due process clause of the Fourteenth Amendment. Despite a lower court’s findings that the servicing contract was made in good faith, and the services and supplies were competitively priced, the Court noted Western Electric Company (AT&T’s equipment supply subsidiary) “occupied a special position with particular advantages in relation to the manufacture and sale of equipment to the licensees of the Bell system, including the Illinois Company.” As a result of this special relationship, the Court, while finding AT&T had rendered valuable services, remanded the case for more specific findings regarding the cost of the services provided by Western Electric and the reasonable amount that should be allocated to Illinois Bell’s operating expenses.

Shortly thereafter, in *Dayton Power & Light Co. v. Public Utilities Commission*, the Court settled the question of how a commission was to obtain the information about an affiliated entity’s costs of service. The Court affirmed the Ohio Public Utilities Commission’s valuation of property of affiliated producing and transportation companies, as though they were part of the local public utility, because the affiliated companies were not dealing at arm’s length. The Court concluded that, “in view of the close relation between the affiliated companies,” the burden was upon the utility to sustain the fairness of a management contract between Dayton Power and Columbia Engineering and Management Company, a company affiliated with Dayton Power.

I. Despite Commission Disallowance Authority, the Ambiguous Limitations of Southwestern Bell Remain

By the early 1930s, the Supreme Court’s decisions had thus evolved. The Court recognized the dangers of interaffiliate contracts caused by the absence of arm’s length negotiations between a public utility and its affiliates and concluded that commissions were entitled to closely scrutinize such transactions. Utility companies had the burden of showing that contracts between a public utility and its affiliates were fair, and commissions could determine the proper allocation to the utility of those costs incurred by the providing entity that were deemed to be reasonable. The Court, however, left in place its ill-defined

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86 Id.
87 Id. at 153.
88 Id. at 154, 157.
90 Id. at 295.
91 Id. at 307.
92 This does not apply when an affiliate charges FERC-approved rates for wholesale utility services, such as wholesale electric power, because a state utility commission’s regulation is preempted by FERC in such instances. See Nantahala Power & Light Co. v. Thornburg, 476 U.S. 953, 971 (1986); Miss. Power & Light Co. v. Mississippi, 487 U.S. 354 (1988).
limitation on commission authority over interaffiliate transactions with its warning that a utility commission was not "the financial manager of the corporation."93

2. Disallowance of Unreasonable Servicing Fees is Insufficient to Prevent Payment of Excessive Fees to Affiliates

States began to codify the doctrine of Smith, placing the burden on the operating company to prove the fees entered as operating expenses were reasonable in view of the cost to the service-providing entity, thus assuring that commissions had the authority to disallow those expenses determined to be unreasonable when setting rates.94 Such provisions remain in place today, but provide, at best, indirect control over servicing contract fees, or other inappropriate charges against the operating company, because there is little a commission can do to curtail excessive interaffiliate payments outside the context of a rate hearing.95 That is, disallowance of servicing contract fees can only contribute toward a decrease in rates if a rate case is held. This is unlikely given the time and expense of a rate case and the reality that it is up to the utility company to present a rate case to the commission. For example, in Duke Energy’s recent agreement to refund $25 million to its electric customers to settle allegations that it had transferred expenses of its non-utility affiliates into its regulated utilities, the chairwoman of the South Carolina Public Service Commission reported that neither of Duke’s utilities had been subjected to a rate case in more than a decade.96 She reported that the inappropriate transactions might not have been discovered had it not been for an inside tip, which led to an independent audit that uncovered the shift.97

Even if a commission disallows some portion of the servicing fees or other charges, and subsequently reduces a utility’s rates, the utility can still fully compensate the holding company for the agreed-upon fees by reducing other operating expenditures.98 As observed by one commentator, “such indirect control seems a dubious method of preventing the payment of excessive fees to affiliates,” which is detrimental to consumers and investors alike.99 Nor does such authority prevent a holding company from shifting huge amounts of debt or loan repayment responsibilities to public utilities, such as was attempted by

94 The Servicing Function, supra note 7, at 985 n.122 (the states that codified such provisions by 1936 were New Hampshire, New York, Oregon, Pennsylvania, South Carolina, Virginia, Washington, Wisconsin, and Louisiana).
95 Id. at 986 (explaining that the disallowance of servicing contract fees as a method of stopping excessive payments to affiliates was unlikely to be effective unless exercised in a rate case, which was unlikely to occur solely for the purpose of reducing servicing fees because of the time and expense of litigating a rate case. If servicing fees were disallowed during a rate case, such disallowance could increase the utility’s net operating revenue and improve the utility’s return, thus subjecting the utility to lower rates, which would ultimately decrease income and force a comparable reduction in expenditures).
96 Smith, supra note 8.
97 Id.
98 The Servicing Function, supra note 7, at 986.
99 Id.
To prevent such shifts, commissions need more direct control over the transactions between public utilities and their affiliates.

III. STATE LAW AUTHORIZES COMMISSIONS TO DIRECTLY CONTROL SOME INTERAFFILIATE CONTRACTS

A. State "Affiliated Interests" Statutes

In response to reports by the Federal Trade Commission and investigatory bodies in New York and Massachusetts that holding companies were realizing huge profits from fees on servicing contracts, many states granted commissions direct statutory authority over interaffiliate transactions through "affiliated interests statutes." "Affiliated interests statutes extend public service commission jurisdiction by giving commissions authority to monitor transactions between utilities and corporations or persons who have limited authority over the utility. 'Authority' is statutorily defined; it generally means control through stock ownership." These statutes varied in the degree of control over affiliate transactions provided to each state commission. Some statutes required affirmative approval prior to the contract becoming effective, while others gave commissions the power to restrain payments for unapproved contracts per court order. Other statutes declared unapproved contracts void and some empowered the commission to inspect the affiliate's books and records. Oregon enacted a statute that gave its commission the strongest possible authority, in that it considered the affiliate providing the service as a public utility for purposes of regulation.

Many state commissions still rely on these affiliated interests statutes as the primary tool to regulate interaffiliate transactions. This is despite a resurgence of utility diversification activities in the 1980s that posed additional challenges to commissions in controlling inappropriate interaffiliate transactions.

100 Id. (referring to FEDERAL TRADE COMM'N, UTILITY CORPORATIONS, S. DOC. NO. 92, 70th CONG., 1ST SESS. (1928-36); REPORT OF N.Y. COMM'N ON REVISION OF PUBLIC SERVICE COMM'N LAW (1930); REPORT OF MASS. SPECIAL COMM'N ON CONTROL AND CONDUCT OF PUBLIC UTILITIES (1930)).
102 Fickinger, supra note 3, at 93.
103 Id.
105 Id. at 987 n.131 (noting statutes in New Hampshire and Wisconsin).
106 Id. at 987 n.132 (referring to statutes in Illinois, Massachusetts and West Virginia).
107 Id. at 988 n.134 (referring to statutes in Alabama, Arkansas, Illinois, Indiana, New Jersey, New York and Oregon).
108 Id. at 988.
109 Fickinger, supra note 3, at 92-95 n.41 (listing possible dangers of public utility holding company diversification, such as managerial dilution as more talented managers are transferred to the more competitive non-utility operations, or profit-skimming from the utility to the holding company; wrongful charges for non-utility goods or services and risks or losses being absorbed by the utility while profits are diverted elsewhere; and diversion of retained
One commentator observed that, as of 1982, few states had amended their public utility statutes beyond the affiliated interests statutes to assure that their commissions were able to deal adequately with the consequences of diversification.\textsuperscript{110}

New York’s affiliated interests statute is representative of many state affiliated interests statutes. It provides

\[\text{n}o\] management, construction, engineering or similar contract, hereafter made, with any affiliated interest . . . shall be effective unless it shall first have been filed with the commission, and no charge for any such management, construction, engineering or similar service, whether made pursuant to contract or otherwise, shall exceed the reasonable cost of performing such service . . . If it be found that any such contract is not in the public interest, the commission, after investigation and a hearing, is hereby authorized to disapprove such contract.\textsuperscript{111}

Some commentators criticized statutes, such as New York’s, for not requiring commissions to scrutinize every interaffiliate contract.\textsuperscript{112} More expansive delegations of authority, however, have not always survived judicial scrutiny. For example, Pennsylvania’s original affiliated interests statute prohibited a public utility from making or modifying any contract without getting prior commission approval.\textsuperscript{113} The Pennsylvania Supreme Court found the statute to be an unconstitutional delegation of legislative authority, primarily due to the lack of specific statutory guidelines required for approval of an interaffiliate transaction, other than a tenuous link to the commission’s authority to withdraw previously approved contracts if such withdrawal were in the public interest.\textsuperscript{114} Even if that standard were applicable, the court concluded, “[t]he phrase ‘public interest’ as used in this connection is ‘a concept without ascertainable criterion’” and, as such, was “too vague and elastic to furnish a standard.”\textsuperscript{115}

Despite this initial setback, Pennsylvania’s statute was later amended to require the prior written commission approval of an interaffiliate contract “only earnings from the utility to more profitable ventures or the unequal division of assets attributable to the utility in favor of the non-regulated entity).

\textsuperscript{110} \textit{Id.} at 94-95 nn.39, 40 (noting that only Connecticut and Maine had enacted statutes to address diversification activity adequately. The note examined commission orders in four states dealing with proposed utility diversification activity. The Illinois Commerce Commission concluded “it lacked jurisdiction over a utility holding company’s maneuver calculated to avoid the language of the Illinois regulatory statute.” The Connecticut Public Service Commission, which the author believed set an example for dealing equitably with diversification \textit{ex post}, was unable to involve itself until the diversification was complete and rate-payers had been forced to absorb the costs of the diversification efforts. The New York Public Service Commission avoided the jurisdictional question by “flatly . . . refusing to allow diversification through the holding company arrangement” while the Michigan Public Service Commission was “unable to exercise jurisdiction over a utility’s pre-divestiture conduct which resulted in the displacement of valuable utility assets.”).

\textsuperscript{111} N.Y. PUB. SERV. Law § 110(3) (McKinney 2002).

\textsuperscript{112} \textit{The Servicing Function, supra} note 7, at 987 n.129 (referencing \textit{Legislation: Legislation Extending Control Over Public Utility-Affiliates Contracts, 45 Harv. L. Rev. 729, 733-34 (1932))}.


\textsuperscript{114} Bell Tel. Co. of Pa. v. Driscoll, 21 A.2d 912, 916 (Pa. 1941).

\textsuperscript{115} \textit{Id.} at 915.
if it shall clearly appear and be established upon investigation that [the contract] is reasonable and consistent with the public interest." The statute also applied to a broad assortment of interaffiliate contracts for "management, supervisory, construction, engineering, accounting, legal, financial, or similar services," as well as contracts for "the purchase, sale, lease or exchange of any property, right, or thing or for the furnishing of any service, property, right or thing." Notably, perhaps because of the Pennsylvania statute's specificity, little other case law regarding the commission's authority over such transactions has developed.

**B. Some Courts Narrowly Construe Commission Authority Over Interaffiliate Transactions**

1. **General Telephone Company of Upstate New York v. Lundy**

Case law regarding commission authority over interaffiliate transactions, however, has developed in other jurisdictions with less encompassing affiliated interests statutes than Pennsylvania's. In *General Telephone Co. of Upstate New York v. Lundy*, the New York Court of Appeals concluded that the commission was "powerless" to impair the obligation or otherwise invalidate contracts between a public utility and its affiliated suppliers aside from those types of contracts specifically delineated in New York's affiliated interests statute. However, the court upheld the commission's power to investigate prices charged by all affiliated suppliers, saying such power could be "fairly implied" from the commission's rate making powers, despite the absence of an express grant of legislative authority to conduct such inquiries. The court explained that for such interaffiliate contracts, "the commission does not require the authority to invalidate contracts. All that is required -- and, indeed, all that is given -- is the authority to disregard unwarranted payments to affiliates when calculating the 'just and reasonable' rates which the telephone company will be permitted to charge its subscribers." Observing that the commission's rate-making power was not "subservient to the discretion of (a utility)," the court concluded that when dealing with transactions between affiliates, the commission not only had the right, but "the duty to scrutinize (such) transactions closely" to ascertain whether the prices charged by the affiliates were excessive.

2. **Pacific Telephone & Telegraph Company v. Public Utilities Commission of California**

The *Lundy* court's decision relied, in some measure, on an earlier decision of the California Supreme Court in *Pacific Telephone & Telegraph Co. v. Pub-

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119 Id. at 278. See also N.Y. Pub. Serv. Law § 110(3) (McKinney 2002).
120 Id. at 278.
121 Id. (footnote omitted).
122 Id.
123 Id.
The issue in Pacific Telephone was whether the Public Utilities Commission of California had the authority to prescribe the terms upon which Pacific Telephone could contract with its parent, AT&T. Acknowledging that transactions among affiliated entities had created "problems in regulation," the court noted that California, unlike other states, had no affiliated interests statute. Consequently, the court held that the commission could treat interaffiliate contracts differently than contracts between non-affiliated entities "only to the extent the Legislature so provides or to the extent that they are used as a device to defeat the exercise of powers the commission has been granted."

In so deciding, the court rejected the commission's arguments that the commission's authority over interaffiliate contracts could be fairly implied from the powers the commission had been granted. The court observed that, in the absence of express statutory authority, a commission's control over contracts between affiliated corporations was generally limited to disallowing excessive payments for the purpose of fixing rates, a proposition which Pacific Telephone did not contest.

The court considered the commission's limit on how much Pacific Telephone could pay AT&T as an attempt by the commission to substitute its judgment for that of management as to the reasonable amount to be paid for the contract and how it was to be computed. "Thus the commission [was] seeking to disregard the separate corporate entities, not to exercise more effectively its existing jurisdiction, but to extend its jurisdiction." Decisions, such as Pacific Telephone, that limit commission authority to disallowing excessive fees for rate setting purposes only, are, however, ineffective in preventing excessive payments to affiliates for the same reasons discussed in Part II(C)(2). Notably, the California Supreme Court revisited the conclusions it reached in Pacific Telephone and found that later cases "cast serious doubt on the continuing vitality of much of the reasoning in Pac. Tel."

C. Other Courts Rely on the Doctrine of Implied Powers to Construe Commission Authority to Regulate Interaffiliate Transactions

As demonstrated by Pacific Telephone and Lundy, courts are sometimes reluctant to find that there is commission jurisdiction over interaffiliate contracts absent specific legislative authority for the commission to police such transactions in some manner. Such conclusions, however, seem to ignore

124 215 P.2d 441 (Cal. 1950).
125 Id. at 443.
126 Id. at 444.
127 Id. at 447.
128 Id. at 445.
129 Id. at 446.
130 Id. at 443.
131 Id. at 446.
132 Id.
the doctrine of implied powers, which has been relied upon by many other
courts to broadly construe commission authority over interaffiliate transactions.
As explained by one commentator, the doctrine of implied powers means that
an administrative agency must have the power to put into effect the measures
necessary to achieve the desired end, regardless of whether the agency is
expressly delegated such power. As was explained, "[t]he larger the powers
conferred with regard to the ends, the larger the powers regularly to be implied
as to means." Since state public utility commissions have been granted
sweeping powers to regulate public utility companies, direct control of interaf-
filiate transactions can be seen as a necessary means of accomplishing the com-
missions' ultimate goal of protecting consumers from the ill effects of harmful
transactions. In applying the doctrine of implied powers to administrative
agencies, the United States Supreme Court also recognized that "[w]ithout a
doubt the [administrative agency] may not go beyond the words of the statute
properly construed, but they must be read in the light of its general purpose and
applied with a view to effectuate such purpose."

I. International Railway v. Public Service Commission

Using the doctrine of implied powers, the New York Supreme Court
broadly construed the New York commission's authority to control contracts
between a public utility and its affiliates, and affirmed the commission's deci-
sion to order the cancellation of a management contract between International
Railway and Mitten Management, Inc. Mitten controlled International Rail-
way's system and properties. The contract in question provided that Mitten
would have "complete charge and supervision of the business, system and
properties" of International Railway, subject only to the supervision of the
board of directors of International Railway, which Mitten also dominated.

The commission concluded that the contract was unnecessary for the proper
management of the corporation and was an unneeded expense that was not in
the public interest, and ordered it to be cancelled.

The court found that the commission had not unlawfully invaded manage-
ment's prerogatives or overruled management decision's regarding the com-
pany's affairs in ordering cancellation of the contract. The court held that
the commission had the implied authority under its public interest standard to
cancel the contract, as a "necessary concomitant" of the power to disapprove,
which was expressly stated in the statute. The court pointed out that mere
disapproval of the contract was not supported by a realistic view of the purpose
of the statute, which, per the legislative history, was "to restrain contracts

135 Hans J. Morgenthau, Implied Regulatory Powers in Administrative Law, 28 Iowa L.
Rev. 575, 601-02 (footnote omitted).
136 Id.
139 Id.
140 Id. at 128-29.
141 Id. at 135.
142 Id.
143 Id. at 132. See also N.Y. Pub. Serv. Law. § 110(3) (McKinney 2002).
between public utilities and affiliates when such contracts were found to be contrary to the public interest."\textsuperscript{144}


In New York Telephone Co. v. Public Service Commission of New York,\textsuperscript{145} the New York Court of Appeals also took an expansive view of the commission’s authority over management contracts between a public utility and its affiliate. The court rejected New York Telephone’s argument that the term “management contract” within New York’s public service law\textsuperscript{146} meant only “the all-encompassing power to run the local operating company’s business lock-stock-and-barrel.”\textsuperscript{147} The court held that a directory publishing agreement (“DPA”) between the telephone company and its affiliate was subject to the commission’s approval as a management contract\textsuperscript{148} because the affiliate had been given total control and responsibility for managing New York Telephone’s directory business.\textsuperscript{149}

The court found nothing in the statute or the legislative history that supported New York Telephone’s narrow construction, nor did the statute include a precise definition for the term management.\textsuperscript{150} The court explained that while the impetus for passing the legislation in the first place had been public utility holding company abuses of servicing contracts, the primary purpose of the legislation was to “prevent the utilities from insulating themselves from regulatory control through these contractual devices so that they could charge large fees ‘at the expense of the operating company and ultimately the consumer.’”\textsuperscript{151} The legislature’s concern, the court concluded, was with enriching utility owners at the expense of ratepayers through all types of management contracts, not just the lock-stock-and-barrel type.\textsuperscript{152} The interpretation advocated by New York Telephone, the court said, would “frustrate the very ameliorative purpose of the legislation and should be avoided.”\textsuperscript{153}


In BellSouth Advertising & Publishing Corp. v. Tennessee Regulatory Authority, a case with issues similar to those in New York Telephone, the Tennessee Supreme Court went even further and concluded the Tennessee Regulatory Authority (“TRA”) had direct jurisdiction over an advertising company that had been assigned the responsibility for BellSouth’s directory services.\textsuperscript{154}

\begin{thebibliography}{99}
\bibitem{id} Id.
\bibitem{146} \textit{See} N.Y. PUB. SERV. LAW § 110(3) (McKinney 2002).
\bibitem{147} \textit{N.Y. Tel.}, 530 N.E.2d at 847.
\bibitem{148} Id. at 845.
\bibitem{149} Id. at 848.
\bibitem{150} Id.
\bibitem{151} Id. at 847 (quoting \textit{REPORT OF N. Y. COMM’N ON REVISION OF PUBLIC SERVICE COMM’N LAW}, 1930 N.Y. LEGIS. DOC. No. 75, at 63 (Feb. 23, 1930)).
\bibitem{152} Id.
\bibitem{153} Id. at 848.
\bibitem{154} BellSouth Adver. & Pub’g Corp. v. Tenn. Regulatory Auth., 79 S.W.3d 506, 516 (Tenn. 2002).
\end{thebibliography}
The case began when the TRA ordered the advertising company, an affiliate of the regulated BellSouth Telephone Company, to provide competing telephone companies the opportunity to contract for their names and logos to appear on the telephone directory under the same terms and conditions that the advertising company had provided to BellSouth.\textsuperscript{155}

In reaching its decision, the Tennessee Supreme Court concluded that a regulatory body, such as the Public Service Commission, was "not bound in all instances to observe corporate charters and the form of corporate structure or stock ownership in regulating a public utility" and, to obtain accurate information as to revenues and expenses for the purposes of determining rates, the commission could "consider entire operating systems of utility companies."\textsuperscript{156} To do otherwise would allow the regulated utility, "through the device of holding companies, spin-offs, or other corporate arrangements to place the cream of a utility market in the hands of a parent or an affiliate, and to strip the marketing area of a regulated subsidiary of its most profitable customers."\textsuperscript{157}

Applying this reasoning, the court concluded that TRA had jurisdiction over the advertising affiliate.\textsuperscript{158} The court so concluded because BellSouth delegated its responsibility over the white pages directories to its advertising affiliate, and because the advertising affiliate had exclusive control over the directories.\textsuperscript{159} To find otherwise would allow BellSouth to escape "the legal responsibilities [to provide the names and logos of competing local exchange telephone companies on the cover of the white page directories] thrust upon it."\textsuperscript{160}


In his dissent in \textit{Pacific Telephone}, a former California Supreme Court Justice also offered persuasive arguments for applying the doctrine of implied powers to broadly interpret commission authority over interaffiliate transactions.\textsuperscript{161} Justice Carter correctly placed greater emphasis on the implied powers of the commission under California's Public Utilities Act for finding that the commission did have the authority necessary to regulate interaffiliate contracts, even in the absence of express statutory authority to do so.\textsuperscript{162} The commission’s power extended over interaffiliate contracts, he argued, because the commission was vested with the statutory authority to "supervise and regulate every public utility in the state and to do all things, whether herein specifically designated or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction."\textsuperscript{163}

\textsuperscript{155} Id. at 508.
\textsuperscript{156} Id. at 516 (quoting Tenn. Pub. Serv. Comm’n v. Nashville Gas Co., 551 S.W.2d 315, 319-20 (Tenn. 1977)).
\textsuperscript{157} Id. (quoting Tenn. Pub. Serv. Comm’n, 551 S.W.2d at 321).
\textsuperscript{158} Id. at 516.
\textsuperscript{159} Id.
\textsuperscript{160} Id.
\textsuperscript{162} Id. at 450 (Carter. J., dissenting).
\textsuperscript{163} Id. (citing 1915 CAL. PUB. UTIL. ACT § 31; 2 DEERING’S CAL. GEN. LAWS, ACT 6386).
Justice Carter argued that if a commission is authorized to take indirect action through its subsequent disallowance of costs (i.e., disallow payment of some or all of an interaffiliate contract’s fees during a rate case as the majority had concluded), the commission could surely take precautionary measures to stop the contract in advance of it incurring the fees. He pointed out that a commission must have the authority to stop “a ‘raid on the treasury of the operating utility’” before it happened because customers would be negatively affected if the utility became insolvent, explaining:

an insolvent utility has no credit with which to obtain the capital necessary for the continuous expansion for service demanded from a utility under modern conditions and that operation of a utility by receivers seems usually to be thought to result in higher operating expenses than would ordinarily be incurred.

He urged that the commission be allowed to “of necessity . . . lock the door before the horse is stolen.” Such preventive action was justified with interaffiliate contracts because the contracts were not made at arm’s length or in an open market. Instead, “[t]hey are between corporations, one of which is controlled by the other. As such they are subject to suspicion and therefore present dangerous potentialities.”

5. Arizona Corporation Commission v. State ex rel. Woods

Other courts have been in agreement with Justice Carter’s reasoning on the question of a public utility commission’s implied authority to regulate interaffiliate contracts. The Supreme Court of Arizona found the constitutionally established Arizona Corporation Commission had the authority to promulgate regulations that required public service corporations to report information about, and obtain permission for, transactions with other affiliated organizations under its general ratemaking authority. The court explained:

The Proposed Rules arguably prevent utilities from endangering their assets through transactions with their affiliates. If such transactions damage a utility company’s assets or net worth, the company will have to seek higher rates for survival. Thus, transactions with affiliated corporations could have a direct and devastating impact on rates . . . . we believe the Commission’s regulatory power permits it to require information regarding and approval of, all transactions between a public service corporation and its affiliates that may significantly affect economic stability and thus impact the rates charged by a public service corporation.

The court found that the commission must be given the authority to prevent a utility from engaging in activities that “so adversely affect its financial position that the ratepayers will have to make good the losses,” and concluded that giving the commission the authority to approve or disapprove of such transactions in advance was the only “common-sense” way to do that. The

164 Id. at 449.
165 Id. (citing Simpkins, supra note 61, at 58).
166 Id.
167 Id.
168 Id.
170 Id. at 816.
171 Id. at 818.
Court put it simply, saying: “the Commission was given the power to lock the barn door before the horse escapes.”

D. The Arguments for Implying Commission Authority to Effectuate Measures Necessary to Protect Consumers

The willingness of many courts to broadly construe a commission’s authority over interaffiliate contracts correctly recognizes such agreements are “potent with possibilities adverse to the interests of the consumers” caused by the absence of arm’s length dealings between the parties on either side. The almost boundless statutory power granting commissions broad authority to supervise and regulate every public utility under their jurisdiction should also be read as giving commissions the implied powers to directly regulate the potentially dangerous transactions between a public utility and its affiliates. This is especially true since many transactions, like those engaged in by Enron and WRI, can impair a utility’s financial stability or adversely affect consumers’ rates. Broadly construing a commission’s authority to encompass such transactions addresses the “realities of administrative problems” inherent in modern interaffiliate transactions and is consistent with the principle that “[t]he larger the powers conferred with regard to the ends, the larger the powers regularly to be implied as to means.” In so doing, courts can acknowledge the realities of modern holding company transactions and allow commissions to effectuate those measures necessary to achieve the desired legislative end of protecting consumers from the negative effects of self-serving deals which otherwise would evade regulatory detection.

Given the realities of infrequent and utility-driven rate cases in the regulatory process, the only common sense way by which a utility commission can prevent a public utility from engaging in transactions that will adversely affect its financial position is through the authority to approve or disapprove such

172 Id.
174 See e.g., N.Y. PUB. SERV. LAW § 66(1) (McKinney 2002) (“The commission shall: [h]ave general supervision of all gas corporations and electric corporations under any general or special law . . .”); N.Y. PUB. SERV. LAW § 66(2) (McKinney 2002) (“The commission shall: . . . investigate and examine the methods employed . . . in manufacturing, distributing and supplying electricity . . . and have the power to order such reasonable improvements as will best promote the public interest, preserve the public health and protect those using such gas or electricity . . .”); N.Y. PUB. SERV. LAW § 66(5) (McKinney 2002) (“The commission shall: [e]xamine all persons, corporations and municipalities under its supervision and keep informed as to the methods, practices, regulations and property employed by them in the transaction of their business. Whenever the commission shall be of opinion . . . that the rates, charges or classifications or the acts or regulations of any such person, corporation or municipality are unjust, unreasonable, unjustly discriminatory or unduly preferential . . . the commission shall determine and prescribe the just and reasonable rates, charges and classifications thereafter to be in force for the service . . . and the just and reasonable acts and regulations to be done and observed . . .”).
175 Morgenthau, supra note 135, at 575.
176 Id. at 601-02 (footnote omitted).
transactions in advance. As Justice Carter correctly reasoned, commissions unquestionably have the authority to deal with interaffiliate transactions indirectly, (i.e., disallow costs or disapprove them for rate making purposes after-the-fact). By construing commission authority to encompass approval or disapproval of interaffiliate transactions in advance, courts are simply allowing commissions to lock the door before the horse is stolen.

IV. THE INVASION OF MANAGEMENT DEFENSE SHOULD NOT APPLY TO PUBLIC UTILITIES

A second difficulty with commission authority over interaffiliate transactions is that the commission, in taking action on such transactions, has invaded the prerogatives of management. As explained in one law review article on the subject, the term "invasion of management" generally means "the order is illegal because it usurps the rights of ownership" or "regulation has exceeded its proper limits." The underlying question posed by such an assertion is: to what extent did the legislature intend the management of public utilities to remain with the owners of the property at issue?

Unfortunately, there is little guidance to be gained from the Supreme Court cases on this question. On the one hand, *Munn v. Illinois* seems to suggest that since the owner of utility property has submitted his property to the control of the public for the common good, the legislature intended the owner of the utility property to have very little management control over it (aside from certain constitutional assurances regarding recovery of costs). A commission, therefore, should be allowed to directly control those contracts between a public utility and its affiliate that it finds to be contrary to the public interest. At the other end of the spectrum lies the Supreme Court's ill-defined Lochner-era admonition that, while a commission may regulate with a view to enforcing reasonable rates, it is not the owner of the public utility's property nor "clothed with the general power of management incident to ownership." Under this view, the commission's authority would seem to be limited to assuring that retail utility rates are reasonable.

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178 *Pac. Tel. & Tel. Co.*, 215 P.2d at 449 (Carter, J., dissenting).
179 Id.
180 Management Invaded – A Real or False Defense?, 5 STAN. L. REV. 110, 111 (1952) [hereinafter Management Invaded].
181 Id. at 110, 117.
182 Id. at 117.
184 See Moeller, *supra* note 5, at 358-59 nn.132, 135 (citing *Lochner v. N. Y.*, 198 U.S. 45, 61 (1905)) (finding a New York labor statute to be unconstitutional under the Fourteenth Amendment because it was "an illegal interference with the rights of individuals ... to make contracts regarding labor upon such terms as they think best ... "). *Lochner* "ushered in the so-called Lochner era of economic substantive due process, which, in retrospect, appeared to be hostile to state economic and social regulation." Id.
186 Management Invaded, *supra* note 180, at 117.
One law review article suggested that generally worded grants of power to commissions clearly refer only to those services and facilities in the area of direct utility-consumer contact and observed that "commission orders are uniformly upheld when the managerial decision 'invaded'" is within areas of utility-consumer contact. However, the article, which relied largely on the California Supreme Court's reasoning in *Pacific Telephone*, said a commission's power to regulate is properly limited by invasion of management arguments when "a regulatory body has attempted to order 'how' a service or facility is to be provided" as opposed to what kind of service is to be provided. Further, it also suggested that courts limit a commission's power to regulate what services are provided when "no public necessity can be shown [for the service] and the service is losing money."  

A. The Invasion of Management Rationale Has Succumbed to Regulatory Realism

I. General Telephone v. Public Utilities Commission

Since *Pacific Telephone*, however, cases not only in California but in other jurisdictions as well, have "cast serious doubt[s] on the continuing vitality" of the "'invasion of management' rationale" and, consequently, some of the propositions put forth in the law review article discussed above. As explained by the California Supreme Court in *General Telephone v. Public Utilities Commission*, thirty years after its decision in *Pacific Telephone*, "the Pac. Tel. court's observations regarding the commission's power to control the relationship between utilities and their parents or affiliates have succumbed to regulatory realism." Regulatory realism means that courts approve of commission practices which refuse to recognize the distinction between public utilities and their affiliates or parents for regulatory purposes.

*General Telephone* involved a challenge to a commission order that directed the telephone company to solicit competitive bids for new switching equipment in lieu of its usual practice of buying switching equipment from an affiliate. In so ordering, the commission tied its directive to a finding that General's telephone service was unsatisfactory and that the commission's order was necessary to prevent General "from favoring GTE's manufacturing subsidiary to the detriment of the service General provides." General Telephone Company, relying on *Pacific Telephone*, argued that the legislature had not granted the commission the power to regulate the company's contracts; the commission could not imply such powers under the commission's rate-making authority because "[almost] every contract a utility makes is bound to affect its rates and services"; and that "[the] determination of what is reasonable in con-

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187 Id. at 118-119.
188 Id. at 122.
189 Id. at 123.
191 Id. at 355.
192 Id.
193 Id. at 351.
194 Id. at 350 n.3.
ducting the business of the utility is primarily the responsibility of management.”

The court disagreed, noting that the invasion of management rationale “now appears to be disfavored” and explained “[w]e have been unable to locate a single case since Pac. Tel. in which this court has annulled a commission order based on this rationale.” To the contrary, the court recounted its affirmation of a commission order requiring Southern Pacific Railroad to furnish a particular type of passenger service, “even specifying the particular equipment to be used, despite Southern Pacific’s claim that the order was an invasion of management.” The court also noted “the most conspicuous example of an asserted but rejected claim of ‘invasion of management . . . ’ – the commission’s order requiring construction of a passenger station and terminal in Los Angeles . . . in Atchison, etc., Ry. Co. v. Railroad Com . . . In that case, the commission not only ordered the construction and specified the amount to be spent, but provided plans for the station.”

“[A]s the ‘invasion of management rationale’ has waned, [the California Supreme Court] has been more willing to permit regulatory bodies to exercise powers not expressly stated in their mandate.” Under its regulatory realism paradigm, the court concluded that, although the commission could not treat interaffiliate contracts differently than other contracts entered into by the utility for conducting its business, it could refuse to recognize the distinction between public utilities and their affiliates. As an example, the court pointed to its previous affirmation of commission orders wherein the commission looked directly to the profits of the parent from sales to affiliates in calculating rate

197 Id.
198 Id. at 353-54 (citing S. Pac. Co. v. Pub. Utilities Comm’n, 260 P.2d 70, 79 (Cal. 1953)) (finding the Commission had express legislative authority to order changes in service and the type of passenger cars to be used in providing such service, observing:

In exercising the powers . . . granted it may not be disputed that the commission to some extent invades the functions of management. But they are not necessarily unlawfully invaded. They are subjected to the exercise of the police power of the state in the regulation of the public utility. It is undoubtedly true that for the most part all lawful regulations of a public utility in the exercise of the police power are to some degree an invasion of the managerial functions of the utility. In the absence of such regulations the utility would be free to exercise all powers of management otherwise within the law.

199 Id. See also Atchison Ry. Co. v. R.R. Comm’n, 209 Cal. 460 (Cal. 1931) aff’d sub. nom Atchison, T & S.F. Ry. Co. v. R.R. Comm’n of Cal., 283 U.S. 380 (1931) (ordering the construction of, and specifying the amount to be spent for, a railroad station).
200 Id. at 354 (referring to Ralph’s Grocery Co. v. Reimel, 69 Cal. 2d 172, 176 (Cal. 1968) (concluding that the sole function of a court in determining whether an administrative rule falls within the coverage of the delegated power is whether the agency “reasonably interpreted the legislative mandate”); Gay Law Students Ass’n v. Pac. Tel & Tel. Co., 24 Cal. 3d 458, 469-70 (Cal. 1979) (holding plaintiffs’ allegations of arbitrary employment discrimination against homosexuals as a cause of action against the utility under the Public Utilities Code; noting the state generally expects a public utility to conduct its affairs more like a governmental entity than a private corporation; and concluding “[u]nder these circumstances, we believe the state cannot avoid responsibility for a utility’s systematic business practices and that a public utility may not properly claim prerogatives of ‘private autonomy’ that may possibly attach to a purely private business enterprise”).
201 Id. at 355.
base\textsuperscript{202} and affirmed an earlier conclusion that the "utility enterprise must be viewed as a whole without regard to the separate corporate entities . . . ."\textsuperscript{203} The court also referenced a commission finding that two wholly owned subsidiaries of GT&E, "are, in effect, different departments of one business enterprise, so there exists no incentive to real bargaining . . . ."\textsuperscript{204}

The court stopped short of expressly overturning \textit{Pacific Telephone}. Instead, the court distinguished \textit{Pacific Telephone} and affirmed the commission's order because it involved direct utility-consumer contact -- that is, telephone service to consumers could only be improved if General Telephone could "be pried away from its dependence on the antiquated equipment being manufactured by [its affiliate]."\textsuperscript{205} Despite the court's failure in \textit{General Telephone} to specifically decide whether the invasion of management rationale survived,\textsuperscript{206} there can be little doubt that if the rationale exists at all, it is applicable only when the commission's action has "nothing to do with the 'relationship of the utility to the customer'" or does not "affect 'the manner in which the utility provide[d] the affected services.'"\textsuperscript{207} Consistent with the law review article's observations noted above, the "management invaded" pejorative has little application in the area of 'direct consumer-utility contact.'\textsuperscript{208}

2. PNM Electric Services v. New Mexico Public Utility Commission

The California Supreme Court's view is consistent with the opinions of other state courts. For example, the New Mexico Supreme Court, in upholding a commission order denying Public Service of New Mexico's applications to provide optional electric and gas services, concluded that such denial did not constitute an impermissible intrusion upon a management prerogative.\textsuperscript{209} Explaining that the commission's order was based upon the commission's statutory obligation to ensure that the utility did not engage in activities that could harm its ability to provide service at just and reasonable rates, the court found that the commission was well within its authority to require that the optional services be carried out through unregulated subsidiaries.\textsuperscript{210} Although recognizing there were limits to a commission's ability to inject itself into the internal management of a utility, the court rejected that argument as a basis for reversal and found the invasion of management prohibition had "waned."\textsuperscript{211} The court

\textsuperscript{202} \textit{Id.} See \textit{Pac. Tel. & Tel Co. v. Pub. Utils. Comm'n}, 401 P.2d 353, 370 (Cal. 1965) (affirming the determination by the commission that Western Electric was not entitled to a return on its sales that was any higher than the return Pacific was entitled to earn on its regulated operations).


\textsuperscript{204} \textit{Id.} (citing Decision No. 75873, 69 Cal. P.U.C. 601, 634-639 (1969)).

\textsuperscript{205} \textit{Id.} at 355.

\textsuperscript{206} \textit{Id.}

\textsuperscript{207} \textit{Id.} at 356.

\textsuperscript{208} \textit{Id.} See also \textit{Barnett Stepak v. Am. Tel. & Tel. Co.}, 186 Cal. App. 3d 633, 646 (Cal. Ct. App. 1986) (noting that the invasion of management rationale, while "near terminal" in the area of direct consumer-utility contact, has life in other areas, such as in fairness to disappearing minority interests when they would have no effect on rates or services) (internal citations omitted).


\textsuperscript{210} \textit{Id.} at 151.

\textsuperscript{211} \textit{Id.} at 152.
noted that commissions have "substantial latitude in protecting the public" and that "commissions are generally empowered to act in areas seemingly reserved to management prerogative where the regulated action is 'impressed with a public interest.'"\textsuperscript{212}

3. Arizona Corporation Commission v. State ex rel. Woods

In \textit{Arizona Corporation Commission v. State ex rel. Woods}, the Arizona Supreme Court concluded that the Arizona commission had the authority to adopt rules governing interaffiliate transactions even in the absence of regulatory authority separate from its rate-making powers.\textsuperscript{213} The court also rejected an argument that the commission had "no authority to become involved in management issues indirectly related to rates [such as proposing rules governing interaffiliate transactions] because such involvement is not necessary in setting rates."\textsuperscript{214} The court concluded what was necessary in setting rates must be interpreted in light of the commission's "range of legislative discretion"\textsuperscript{215} and in accord with "the framers' intent of the Commission's function: to protect consumers from abuse and overreaching by public service corporations."\textsuperscript{216} The court was persuaded by the California Supreme Court's pronouncements that "the utility enterprise must be viewed as a whole without regard to the separate corporate entities . . ." and "[t]he invasion of management arguments fail to recognize the special relationship between affiliated companies and the strong potential that transactions between affiliates will affect rates."\textsuperscript{217} The court continued that the intent of the framers was to "protect our citizens from the results of speculation, mismanagement, and abuse of power" and that limiting the Commission's ratemaking power so that it could "do no more than raise utility rates to cure the damage from [unwise] inter-company transactions" would subvert that intent.\textsuperscript{218} The court concluded that the proposed rules did

\begin{itemize}
\item \textsuperscript{212} \textit{Id.} (citing Pub. Serv. Co. v. State \textit{ex rel.} Corp. Comm'n, 918 P.2d 733, 739 (Okla. 1996) (quoting Mo. Pac. R.R. Co. v. Corp. Comm'n, 672 P.2d 44, 44 (Okla. 1983)). It should be noted that in \textit{Pub. Serv. Co.}, the Oklahoma Supreme Court struck down a commission regulation which required an acquiring electric supplier to pass the costs of changing suppliers onto the customer rather than allowing the company to make the decision whether to pass the cost on or to absorb the cost. The court said the regulation in question was an improper invasion of management because "how and who" should absorb the cost of a change in electric suppliers was not within the realm of the Commission's authority, absent some overall public effect. \textit{Id.} at 740. In coming to its decision, the Court relied upon its 1934 decision in \textit{Lone Star Gas Co. v. Corp. Commission}, wherein the Court held "[t]he powers of the commission are to regulate, supervise and control the public service companies in their services and rates, but these powers do not extend to an invasion of the discretion vested in corporate management. It does not include the power to approve or disapprove contracts about to be entered into, nor to the approval or veto of expenditures proposed." \textit{Lone Star Gas Co. v. Corp. Comm'n}, 39 P.2d 547, 553 (Okla. 1934).
\item \textsuperscript{214} \textit{Id.} at 816.
\item \textsuperscript{215} \textit{Id.} (quoting Simms v. Round Valley Light & Power Co., 294 P.2d 378, 384 (Ariz. 1956)) (explaining "[t]he commission in exercising its rate-making power of necessity has a range of legislative discretion . . .") (internal cross-reference omitted).
\item \textsuperscript{216} \textit{Id.}
\item \textsuperscript{217} \textit{Id.} at 817 (citing Gen. Tel. Co. v. Pub. Utils. Comm'n, 670 P.2d 349, 355 (Cal. 1983)).
\item \textsuperscript{218} \textit{Id.}
\end{itemize}
not "constitute an attempt to control the corporation rather than an attempt to control rates." \(^{219}\)

4. BellSouth Advertising & Publishing Corporation v. Tennessee Regulatory Authority

Other state courts have also endorsed the regulatory realism paradigm put forth in *General Telephone*. For example, in *BellSouth Advertising & Publishing Corp. v. Tennessee Regulatory Authority*, \(^{220}\) the court concluded "the Public Service Commission is not bound in all instances to observe corporate charters and the form of corporate structure or stock ownership in regulating a public utility, and in fixing fair and reasonable rates for its operations." \(^{221}\)


Courts have also affirmed commission decisions, which ignored the distinction between public utilities and their affiliates when imputing benefits from an affiliate's business operations to the utility, when such benefits can be linked to contributions made by ratepayers toward that affiliate's profits. For instance, the New York Court of Appeals affirmed an order by the New York commission to impute a two percent royalty, as revenue to Rochester Telephone Corporation from unregulated affiliates, to compensate ratepayers for "improper cost-shifting" and the uncompensated use of the telephone company's name and reputation. \(^{222}\) In addition, the New York Court of Appeals recently reversed the Appellate Division's annulment of a New York Commission order, which required New York Telephone Company to distribute the intrastate portion of the proceeds of the sale of its communications research facility to the telephone company's ratepayers as a credit to its customers' bills. \(^{223}\)

B. An Abuse of Discretion Standard is an Ineffective Second Choice


Not all courts, however, have been willing to eviscerate the invasion of management rationale as a defense to commission orders that are alleged to have improperly intermeddled in management prerogatives. For example, in *Duquesne Light Co. & Pennsylvania Power Co. v. Pennsylvania Public Utility Commission*, the Commonwealth Court of Pennsylvania affirmed two commission orders that established a market price-capping mechanism for the cost of

\(^{219}\) *Id.* at 818.

\(^{220}\) *BellSouth Adver. & Publ’g Corp. v. Tenn. Regulatory Auth.*, 79 S.W.3d 506 (Tenn. 2002).

\(^{221}\) *Id.* at 516 (citations omitted).


coal purchased from certain mines.\textsuperscript{224} The companies argued that the commission's denial of the right to recover the cost of coal purchased from certain mines interfered with the utilities' lawful management decisions in initiating and continuing a mining project that was not found to be imprudent.\textsuperscript{225} Acknowledging that there were limitations to the commission's authority to "inject itself in the management of a public utility," the court nevertheless concluded that a commission may regulate utilities "where their actions affect the public they serve. Of course, rates affect that public. Indeed, the Commission has an ongoing duty to protect the public from unreasonable rates."\textsuperscript{226}


The Pennsylvania Supreme Court, however, later tempered this opinion in \textit{Pennsylvania Public Utility Commission v. Philadelphia Electric Co.}.\textsuperscript{227} In \textit{Philadelphia Electric}, the commission and consumer advocate challenged an order of the Commonwealth Court, which reversed a commission order denying a $57 million rate increase requested by the utility.\textsuperscript{228} In affirming the lower court's ruling in part, and reversing it in part, the court explained that an obvious corollary to the proposition that it is not within a public utility commission's province to interfere with the management of a utility unless an abuse of discretion can be shown, is that "if there has been an abuse of managerial discretion, and the public interest has been adversely affected thereby, then the Commission is empowered to intervene."\textsuperscript{229}

Despite the Pennsylvania courts' view that the invasion of management rationale is still viable in a regulatory setting, the judicial approach to its use is worthy of consideration for those who reject the conclusions in \textit{General Telephone}. It is arguable that the Pennsylvania approach is more closely aligned with the Supreme Court's utterance on the subject in \textit{Southwestern Bell}, and represents a more restrained approach to regulatory activism. It is unclear, however, who would bear the burden of showing that the utility's action was an abuse of discretion, or arbitrary, or how such an approach would protect rate-payers before the damage was done. As such, the Pennsylvania approach may be no better than the well-settled principle that commissions may disallow inappropriate operating expenses generated by interaffiliate contracts, which will only result in a rate reduction if implemented as part of a rate case.

C. The Arguments for Discarding the Invasion of Management Rationale

On the other hand, \textit{General Telephone} and the decisions that are supportive of it, offer numerous valid reasons for courts to disregard the antiquated invasion of management rationale when dealing with transactions between a public utility and its affiliates. As observed in \textit{General Telephone}, the invasion

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\textsuperscript{225} \textit{id.} at 1278.
\textsuperscript{226} \textit{id.} (citations omitted).
\textsuperscript{227} 561 A.2d 1224, 1228 (Pa. 1989).
\textsuperscript{228} \textit{id.} at 1225.
\textsuperscript{229} \textit{id.} at 1226-27 (internal citations omitted).
of management rationale is no longer viable in a jurisdiction where courts have routinely affirmed commission orders that have directed utilities to take actions normally reserved for management. Such is the situation in California where, for example, in *Southern Pacific*, the California Supreme Court affirmed a commission order to provide rail service to consumers by the use of a certain kind of rail car.\(^{230}\) In *Atchison Railway Company*, the California Supreme Court also affirmed a commission order to construct a new rail station, complete with plans for the station supplied by the commission.\(^{231}\) Thus, in jurisdictions where the invasion of management rationale has not, in the past, limited a commission’s exercise of powers normally reserved for management in deciding “how” a service is to be provided, the rationale cannot be a viable defense in the future.

Further, the regulatory realism paradigm, embraced by a number of state courts, allows a commission to disregard the distinction between a public utility and its affiliates when looking at interaffiliate transactions, because there is no “incentive to real bargaining” in such instances.\(^{232}\) As a result, courts have rejected the invasion of management defense when commissions have (1) looked at the profits of the parent or the affiliate in calculating rate base, (2) construed affiliates as being subject to direct commission regulation when they are performing obligations of the regulated entity, or (3) extended their authority over interaffiliate transactions in the absence of specific legislative authority to do so.

As pointed out in *General Telephone*, almost all regulations put forth by a public utilities commission can be said, in some way, to invade the prerogatives of management.\(^{233}\) However, such invasions are not necessarily unlawful so long as the commission is exercising the police powers of the state in protecting the public from mismanagement and the abuse of power that could result from interaffiliate transactions negotiated in the absence of arm’s length bargaining. As correctly referenced in *General Telephone*, the state generally expects a public utility to conduct its affairs more like a governmental entity than a private corporation.\(^{234}\) “Under these circumstances . . . a public utility may not properly claim prerogatives of ‘private autonomy’ that may possibly attach to a purely private business enterprise.”\(^{235}\)

This concept is consistent with the proposition put forth in *Munn v. Illinois*, which provided that when a person commits property to a use in which the public has an interest, that person has granted the public an interest in that use, and must submit to be controlled by the public for the common good.\(^{236}\) Legislatures have granted commissions broad supervisory powers to protect consumers from abuse and overreaching by utilities. For example, the California commission is vested with vast regulatory powers to supervise and regulate

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\(^{234}\) Gay Law Students Ass’n v. Pac. Tel & Tel. Co., 595 P.2d 592, 599 (Cal. 1979).

\(^{235}\) Id.

\(^{236}\) Munn v. Illinois, 94 U.S. 113, 126 (1876).
its jurisdictional utilities and “to do all things, whether herein specifically designated or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction.”\textsuperscript{237} By implication, therefore, any action that impacts a utility’s ability to provide reliable service to its customers at reasonable rates is properly within the commission’s jurisdiction. This is particularly true of transactions between a public utility and its affiliates, because such arrangements lack arm’s length negotiations and are thus “subject to suspicion and . . . present dangerous potentialities.”\textsuperscript{238}

Lastly, as observed in General Telephone, invasion of management can only apply to commission decisions that do not involve direct utility-customer contact or affect the utility’s ability to serve the public efficiently at reasonable rates.\textsuperscript{239} As noted by the California Supreme Court in Pacific Telephone, however, “[a]lmost every contract a utility makes is bound to affect its rates and services.”\textsuperscript{240} Likewise, almost every interaffiliate transaction is bound to affect a utility’s rates or services. In view of broad commission authority to regulate the rates and services of public utilities, and the growing acceptance of the principle that the invasion of management rationale has little application in the area of direct consumer-utility contact, there can be very few legitimate assertions that commissions invade the prerogatives of management when directly regulating transactions between public utilities and their affiliates.

V. CONCLUSION

The standard established by the Supreme Court in Smith, which allows commissions to investigate the cost incurred by an affiliate in providing a service to a public utility and disallow any portion of it deemed to be unreasonable, provides public utility commissions indirect authority over interaffiliate transactions, but is “a dubious method of preventing the payment of excessive fees to affiliates.”\textsuperscript{241} Moreover, modern interaffiliate transactions have gone far beyond the simple act of overcharging a public utility and thus inflating its operating costs. As demonstrated by the actions of Enron and WRI, “intercorporate dealings . . . of public utilities can have disastrous consequences for the economic viability of the entire enterprise, and . . . such misfortunes are visited not only on the stockholders of the company but the ratepayers of the state.”\textsuperscript{242} As noted by one commentator, “absent regulatory oversight, it is not clear how ratepayers can be protected from holding company accounting abuses such as unrecorded cross-subsidization among subsidiaries.”\textsuperscript{243}

The challenge today is for legislatures and courts to recognize that public utility commissions must have the authority to not only disallow excessive operating expenditures caused by improper interaffiliate transactions, but to guard against other financial pressures being placed upon utilities. The call for

\textsuperscript{238} Id.
\textsuperscript{240} Pac. Tel. & Tel. Co., 215 P.2d at 445.
\textsuperscript{241} The Servicing Function, supra note 7, at 986.
\textsuperscript{243} Id. (citing Fickinger, supra note 3, at 96).
"[I]legislators [to] . . . recognize that public service commission jurisdiction should extend comprehensively over public utility holding companies and their non-utility subsidiaries"\(^\text{244}\) is as urgent today as it has been in the past.

Even in the absence of a specific statutory provision clarifying a commission’s authority over interaffiliate transactions, however, the general statutes authorizing commissions to regulate the activities of public utilities can, and should, be construed to provide commissions with the necessary authority to achieve the desired legislative end of protecting ratepayers from abusive interaffiliate transactions. Such transactions have a great potential to harm ratepayers because they are formed absent arm’s length negotiations and are between corporations that control one another. Public utility commissions, through the doctrine of implied powers, should be able to control interaffiliate transactions to achieve the desired legislative end of protecting consumers from the negative side effects of self-serving deals that might otherwise evade regulatory detection. As argued by Justice Carter in \textit{Pacific Telephone}, if a commission can indirectly disapprove an interaffiliate transaction by disallowing it in rates, it should also be able to "lock the door before the horse is stolen."\(^\text{245}\)

Courts should disregard the invasion of management rationale for nullifying a commission’s order, which was first introduced during a bygone era in which the Supreme Court was hostile to state economic regulation.\(^\text{246}\) In its place stands the regulatory realism paradigm articulated by the California Supreme Court, which allows commissions to ignore the distinctions between public utilities and their affiliates or parents when evaluating interaffiliate transactions.\(^\text{247}\) Further, regulated utilities must be viewed much more like government entities than private entities and, as such, are not entitled to claim the prerogatives of a privately held business. They have submitted to be controlled for the public good. The commission is the body designated by the legislature to exercise the state’s police power in this area and decide what is in the public interest, not utility management. The invasion of management rationale is simply inapplicable to the vast majority of decisions made by public utility commissions, because such decisions affect direct utility-consumer contact or a utility’s ability to provide effective service at reasonable rates.\(^\text{248}\) The invasion of management rationale, like a rusty old battle-axe that has seen better days, has no legitimate role to play in the judicial review of today’s public utility cases.

\(^{244}\) Fickinger, \textit{supra} note 3, at 116.


\(^{248}\) \textit{Id.} at 355-56.