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EEI **EDISON ELECTRIC INSTITUTE**

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JUL 30 1999

Missouri Public Service Commission

Via next day delivery

July 29, 1999

Mr. Dale Hardy Roberts
Secretary
Missouri Public Service Commission
Truman State Office Building
301 West High Street, Suite 530
Jefferson City, MO 65101

Re: Case No. EX-99-442

Dear Mr. Roberts:

Enclosed for filing in the case no. referenced above, please find an original and fourteen copies of the Reply Comments of the Edison Electric Institute.

Thank you for your attention in this matter.

Sincerely,

Johannes W. Williams

Johannes W. Williams
Director, Industry Legal Affairs

Enclosures

cc: William Niehoff (w/ encl.)
Patrick J. Joyce (w/ encl.)
William G. Riggins (w/ encl.)
Lera L. Shemwell (w/ encl.)
John B. Coffman (w/ encl.)
Mathew Morey (w/ encl.)
Louis Harris (w/ encl.)

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Missouri Public
Service Commission

BEFORE THE STATE OF MISSOURI
PUBLIC SERVICE COMMISSION

In the Matter of the Commission's Consideration of Proposed Rules for Electric Utility Affiliate Transactions, 4 CSR 240.24.015	:	Case No. EX-99-442

REPLY COMMENTS OF THE EDISON ELECTRIC INSTITUTE

Pursuant to the publication of the proposed rules referenced above in the Missouri Register, the Edison Electric Institute ("EEI") hereby respectfully submits the following comments in reply to the initial comments filed by the Office of the Public Counsel ("OPC") and the Missouri Industrial Energy Users Group ("MIEG").

I. Since Missouri Is Not Implementing Open Access Or Unbundling Its Electricity Industry At This Time, Restrictions And Conduct Prescriptions Are Not Warranted

Missouri is not at this time proposing retail access for electricity, nor is it implementing a broad restructuring of the utilities in the state. If electric utilities contemplate providing new services, in addition to the electricity they provide already, they will be doing so as new entrants into markets where established firms should have ample ability to compete. Hence, there is no need for the sorts of restrictions advocated by the OPC and MIEG.

In addition to there being little need for these restrictions, the Commission could cause real harm to consumers and competition in adopting them. In fact, such restrictions ultimately impede utilities from meeting their utility obligations at the lowest possible cost to consumers. Because the electricity business is cyclic and demand resource usage peaks in predictable ways, utilities can use utility resources for other revenue creating purposes when not in use to provide bundled utility services. By doing so, utilities spread the costs of these resources over the

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expenses of providing both regulated and non-regulated products and services. Since utility ratepayers would ordinarily pay the entire cost of the resources used to supply utility services, the extra revenue enables lower utility rates through the contribution to fixed, (i.e., joint and common costs) made by the unregulated non-utility affiliate. If the affiliate is capable of providing services that others also can provide, yet it can do so at little additional cost to the utility, utility and non-utility customers alike benefit.

These cost savings are known in the economic literature as economies of scope, or, in some instances, economies of vertical integration. In the abstract, all corporations represent a collection of repeated transactions brought together under one corporate family to eliminate the transaction costs that inevitably arise each time one agent within the company needs the services of another. Electric utilities combine a host of personnel and resource interactions or internal functions to deliver a bundled energy product efficiently to end-use consumers. As corporations, utilities exist for the same reason General Motors, General Electric, and Exxon do: there are tremendous cost savings from providing all of these transactions together within one firm, irrespective of whether the firm is producing vehicles, electricity generators or consumer products, petroleum, or electricity. For example, these cost savings arise from a reduction in the transaction and training costs involved in hiring new staff or harnessing new resources each time a routine task is performed, and from other ways of more intensively using utility resources.

Many firms sell more than one product or service because it costs less to provide them through one firm than it does to provide each separately in different firms. These scope economies occur in a variety of ways. Many reflect savings realized when identical inputs needed to produce different products are purchased in bulk; others result from a reduction in managerial overhead;

still others reflect a lower cost of advertising and marketing. The list of possible ways facilities and services can be used more efficiently is only bounded by the imagination and creativity of management. Economists Mark Lowry and Lawrence Kaufmann characterize these economies as more fully utilizing resources within the firm.[1]

Utilities have always been multiproduct firms, providing both regulated and unregulated goods and services. However, even in cases where utilities have provided bundled and regulated generation, transmission and distribution services, they have also provided several distinct regulated products in ways that lower average costs. For example, in addition to retail services regulated by this Commission, utilities also provided requirements services, transmission access, economy power, and emergency energy, each of which are regulated by the Federal Energy Regulatory Commission.

Every utility must maintain offices, computer equipment, billing facilities, and many other resources whose costs are generally referred to as overhead that contributes to common and joint costs. Also, utilities hire meter readers, engineers, energy management experts, environmental experts, lawyers, and a host of other human resources that provide products and services to the entire corporation, rather than to specific divisions. Because of the cyclical nature of the business, during particular periods, some of these resources may not be used as intensively as during "peak" periods. For example, during seasonal periods of low electricity demand, and monthly periods before and after billing cycles, the utility can achieve more intensive use of these resources and lower its operating costs of providing regulated services through sharing with an affiliate or

1 *See* Lowry, Mark and Kaufmann, Lawrence, The Cost Structure of Power Distribution, (Edison Electric Institute, May 1999).

through intracorporate transactions. Many other examples exist of scope opportunities.

The efficiencies of providing multiple services are considerable. For example, a utility can offset the costs of billing by sharing computer hardware, software, and support facilities and personnel with non-utility affiliated businesses. The asset sharing between utility and non-utility affiliates can similarly reduce the cost of common and joint costs for office space, communications equipment, maintenance crews, and management.

In regulating utility businesses in competitive markets, regulators need to ensure that the economies of scope and scale associated with vertical integration are captured and shared with utility customers. This all along has been an objective of traditional utility regulation: to ensure that the economies of the vertically integrated utility, operating as a local monopoly provider of services, were captured and shared with utility ratepayers. If Missouri moves to retail access, regulators still need to ensure that ratepayers are able to benefit from the economies of scope inherent in vertical integration or other intracorporate relationships.

However, given that some utility affiliates may operate in competitive markets, utility customers also should benefit from scope economies resulting from utility and non-utility affiliate transactions. Pricing rules that seek to capture all of the benefits for ratepayers will fail to capture them at all because they will discourage economically efficient transactions between the utility and its affiliates. Fortunately, regulating firms that provide both regulated and unregulated services is nothing new for regulatory agencies, and has only slight differences from ordinary utility regulation. Most of the difference stems from the need for protecting against discrimination toward affiliates with respect to the use of essential facilities or competitively sensitive information.

II. Economies of Scope Provide Real Benefits to Consumers and Are Not Unfair, Anticompetitive, or Harmful to Consumers.

Eliminating any ability of utilities or their affiliates to realize or achieve economies of scope in the codes of conduct proposed by OPC, MIEG and others precludes customers of regulated services from receiving any financial advantage from those economies of scope and forecloses utility efforts to lower utility rates by finding new ways to use resources more intensively. Worse, the proposed amendments of OPC would undermine existing non-regulated activities and cause immediate harm to ratepayers by eliminating the non-regulated affiliate's contribution to the fixed costs of providing regulated services.

Part of the problem with the OPC proposed rules seems to be the erroneous perception that lower costs resulting from economies of scope are somehow anticompetitive, unfair, or otherwise harmful to consumers. Some concerns reflect ignorance about the dynamic processes by which competitive markets deliver better goods at lower costs. For example, OPC doubts that utility affiliates will pass on to consumers "savings resulting from so-called 'scale and scope' economies." OPC at 8-9. According to OPC, allowing utility affiliates to benefit from lower costs acts as a barrier to entry to competitors, which ensures that the lower costs will not be passed onto the affiliate's customers.

OPC appears not to understand how competitive markets work. As new entrants in markets through their non-utility affiliates, utilities will only win market share if they use their scope economies to lower prices and/or provide better products and services. Of course, the non-utility affiliate might eventually establish itself as the benchmark against which other competitors must compare favorably to remain in business. However, the utility and its affiliates do not act alone; their competitors are continuously finding better or lower-cost ways to provide products or services. Moreover, none of the scope advantages about which OPC is concerned are unique to the utility; any multiproduct firm can benefit from similar scope economies. For the utility to remain in business, it must also continuously innovate, holding back no scope economies. Thus, OPC is incorrect to suggest these scope economies will not be shared with the affiliate's customers. Competition will ensure it.

Nor is OPC correct when it contends that the advantages at issue are "unique business advantages possessed by the monopolist who has been given an exclusive franchise that was insulated from any serious competitive pressures." OPC at 9. There is nothing "unique" about economies of scope; a multiproduct firm does not have to be a utility to benefit from joint advertising with affiliates, shared information among affiliates, or brand familiarity. Indeed, being an affiliate of a utility in a non-regulated market imposes costs of its own and utility competitors bring their unique advantages to the market without sharing them.[2]

Frequently, OPC and MIEG couch these recommendations as a desire to "level the playing field." While such an objective and the innuendo of "fairness" it conjures may seem as American as baseball, more careful scrutiny of the concept reveals its shortcomings as a policy objective. The pursuit of the level-playing-field goal could cause real harm to both ratepayers and consumers of the non-utility affiliates.

In competitive markets, the playing field can never be truly level: everyone enters the

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2 Kahn, Alfred E., Letting Go: Deregulating the Process of Deregulation (MSU Public Utilities Papers 1998) at 24 (moreover, "competitive advantages arising out of economies of … scope are precisely the kind of efficiency advantages that we expect and *want* to prevail under competition")(emphasis in original).

market with their own distinctive advantages and disadvantages. These differences extend beyond micro and macro borders -- just as humans with different physical and intellectual endowments can prosper in the working world, and countries in different climates, with different natural resource endowments, and different geographic characteristics can prosper in the world economy, companies with different levels of capital, employees, and experience can prosper in the competitive market place. Indeed, part of the dynamic competitive process is a direct result of these differences in corporate endowments.

Nor does it matter from where these endowments spring. Whether they come from debt financing, intracorporate wealth transfers, or from government subsidies and protections is irrelevant, notwithstanding OPC's frequent concerns that utility affiliates are benefiting from having been part of a regulated monopoly. For example, at some point in the future, oil companies operating gasoline stations in Missouri might want to participate in the generation supply markets. However, they benefit from offshore oil field concessions subsidized by the government. Will they be penalized for using these governmentally subsidized brands?

A. Restrictions Against Information Sharing Are Harmful

Many of OPC's recommended prescriptions would eradicate the very efficiency advantages that Dr. Kahn suggests that regulators would want to encourage.

For example, OPC would preclude the sharing of non-customer specific information with an affiliate unless it is made available to all competitors. Suggesting an "obvious" need for this rule, OPC argues that it is unfair to allow a utility to share with its affiliates vendor lists, utility purchasing discounts, local franchise requirements, new development areas, aggregate consumption information by locale without also sharing the information with all other competitors.

Naturally, these prescriptions extend to acquiring information on behalf of affiliates, sharing market analyses or other proprietary, non-publicly available reports, requesting authorization from utility customers to pass their account information exclusively to affiliates, affiliates appearing to speak on behalf of utilities and vice versa, suggesting that the customer will receive preferential treatment as a consequence of purchasing with the affiliate, giving the appearance that the affiliate speaks on behalf of the utility. OPC argues that if this behavior were allowed, the affiliate would gain an advantage solely due to the use of a government authorized monopoly that would enable the utility to create a preference for its affiliate. According to OPC, affiliates have not "earned" this advantage through excelling in a competitive market with a level playing field.

Besides failing to recognize that the sharing of this information is a real economic benefit to the customers of both the utility and its affiliate(s), OPC's argument is fraught with other flaws. Most of the data under discussion are publicly available from other sources. Moreover, since Missouri is not yet restructuring electric markets, none of the data will involve the utility's essential facilities needed to market power by utility competitors. While the affiliate does benefit from the proximity to the utility, this reflects corporate economies of scope, the sharing of which is neither unfair nor anticompetitive and actually benefits the customers of the regulated utility. The affiliate's rivals will have conducted their own research, possibly borrowing some conducted by an affiliate. No market participant would expect any competitors to share any of their own research or market analyses with it. Indeed, release of any market studies or research might reveal sensitive corporate strategies or marketing techniques. Just as the rivals should not be expected to share their data, utilities and their affiliates should not be compelled to share with all or be restricted from sharing it within the corporate family.

Similarly there is no reason to deny the utility the ability to conduct joint marketing with an affiliate. Data that facilitates market analyses are publicly available from a variety of sources, and the utility has no better ability to improve the accuracy of its forecasts and assessments of consumer behavior and market trends than the rest of the market's participants. Where the affiliate is entering markets never before explored by the utility, the utility and affiliate will be in no stronger position with regard to understanding demand, pricing and consumer behavior than any other competitor. On the contrary, in many markets affiliates may enter, the company will be in a weaker position than other participants who occupy incumbent positions.

EEI has discerned widespread customer opposition to restrictions on utilities providing customers with information on affiliate services. On March 12, 1999, EEI published a summary of public opinion research activities in New Hampshire, Rhode Island, Massachusetts, Vermont, New jersey, Connecticut, California, Illinois, the District of Columbia, Maine and Michigan, which found opposition to this type of restriction in the range of 54-74%.

Finally, OPC has provided no justification for its stand against the utility sharing benefits of the government authorized monopoly that are nonessential. The benefits of publicizing the affiliate's relationship with the utility were "earned" by the utility's provision of excellent utility services. Moreover, it is puzzling that OPC would attempt to prevent utilities from disseminating information that customers clearly want, as shown in the discussion in the preceding paragraph.

EEI agrees with OPC, however, that the utility should avoid creating an impression that the provision of utility services is in any way unlawfully tied to the purchase of the affiliate's products. Nor should the utility be permitted to deliberately create an impression that there is a tying arrangement. While the utility and its affiliates can ensure that it is not creating a tie, it cannot control the impressions of its customers.

B. Branding Restrictions Prevent Customers from Knowing the Identity of the Parties with Whom They Are Dealing.

In an age when consumer protection starts with truth-in-labeling, OPC's recommended prescriptions against sharing corporate brands and labels is puzzling. One wonders whatever happened to the days when consumer advocates insisted on companies providing more information about their affiliations, not less.

Besides being an odd request from a consumer "advocate," OPC's arguments justifying these prescriptions are flawed. While the utility's level of expenditure does not match that used in the national advertising campaigns by McDonald's, Coca-Cola, automobile manufacturers, and long-distance telephone companies, OPC is incorrect to suggest that utilities have not advertised for name recognition and marketing in conjunction with superior service and low prices. Further, utilities have marketed in other ways, such as to promote conservation, weatherization, emergency preparedness, and utility safety. Contrary to OPC's contention, the fact the Missouri's rates are very low compared to other parts of the country creates "earned" brand loyalty. Moreover, OPC's recollection of the development and implementation of minimum service and safety standards is cloudy: these standards were <u>not</u>, and never have been, mandated by the government. Missouri utilities are part of the North American Electric Reliability Council regions that have <u>voluntarily</u> subjected themselves to reliability and safety standard with great success. Utilities have favorable brand recognition in Missouri because they earned it by providing reliable electricity within the requirements society placed on the utility. Merely being a regulated monopoly is insufficient to guarantee favorable brand loyalty.

OPC's recommendation that any affiliate uses of the utility's brand name should require the payment of royalties is based on an inapt comparison to the McDonald's Corporation and the payments its franchisees pay. As businesses unaffiliated to McDonald's corporate hierarchy, franchisees pay for the right to sell McDonald's products under the McDonald's brand name. They pay for the contractual relationship with McDonald's and benefit from its national advertising campaigns, sponsorships and other public relations activities. Franchisees also benefit from McDonald's product testing and development, as well as market research.

The relationship between a utility and its affiliates is completely different. The affiliate wishing to share the utility's name *is* within the corporate family. The affiliate is selling a *different* product or service from what the utility sells. While the affiliate might benefit from utility's advertising and public relations, much of it will have no beneficial impact on the affiliate's sales. Moreover, as compared to McDonald's, the utility's product testing and development, market research, and corporate sponsorships are puny. In short, OPC would require affiliates to pay for something that is unlikely to yield the same offsetting benefits that one normally considers in royalty type settings. A royalty may constitute an unconstitutional tax on the exercise of fundamental First Amendment rights. See Ogletree, Charles J., et al., Constitutional Grounds to Challenge State Public Utility Commission Restrictions on Affiliate Use of Utility Name and Logo (EEI July 1999 (draft)) at 3, n. 5.

This is not to suggest that the brand has no value to the affiliate and its customers. However, as Dr. Kahn points out, the reverse could be true:

> So far as the economic principle is concerned, such favorable associations as consumers may have with those brands -- e.g., expectations of service quality (and

> certainly not all utility company brands do carry such favorable rather than hostile associations)--are an economy of scope, the benefits of which it would be anti-competitive to both the companies and consumers who value them.[3]

In any event, Kahn further notes that,

> This value is almost certain to increase over time, as residential customers, particularly, have to choose among competing suppliers of gas and electricity, where safety, reliability, and continuity are likely to be aspects of the quality of service upon which they would place a high value but about which it is likely to be very difficult for them to make informed choices. In these circumstances, the several competitors are likely themselves to place heavy emphasis upon their reputations, earned in other markets. The question is not, as some competitors of the utility companies have claimed, whether there may be some confusion in the minds of consumers about whether they are being served by their familiar regulated utility company or by some unregulated affiliate, and whether, therefore, it may be necessary to require the utility company to refrain from using its familiar brand in the competitive market. Instead, the situation is one in which it is likely to be positively *desirable* for customers to know what company is serving them and to be guided in their selection by such favorable *or unfavorable* experiences as they may have had with those companies in the public utility context and/or by the *reputations* of their several suitors based on their performance in other markets or providing other goods and services. Comparable benefits of favorable associations (or handicaps of unfavorable associations) with their names and reputation are of course available to competitors, large and small, local and national.[4]

Brand name sharing (referred to here as "branding") can benefit Missouri consumers in four important ways. First, branding contributes to lower unit costs for services provided by utilities and their affiliates. This facilitates lower prices for regulated and competitive services. Second, branding provides important convenience benefits to consumers, such as lower search costs. Third, branding reinforces a utility company's incentive to provide good value on its full array of regulated and competitive products. Fourth, branding promotes the development of market-responsive product offerings. Each of these benefits is explained further below.

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3 Letting Go, at 27-28.

4 *Id.*

Lower Unit Costs: It is generally easier for companies to diversify when they have a recognized brand name. Diversification allows firms to spread their common costs, which cannot be attributed to specific products, across more output. By spreading common costs, unit costs decline for the firm's entire product line. This can give rise to "economies of scope," which we discussed above at 1-4. Brand names, therefore, facilitate scope economies which, in turn, make lower prices possible. In competitive markets, lower market-clearing prices are realized as lower-cost firms try to attract customers away from higher-cost firms.

Greater Convenience Benefits: Branding creates convenience benefits by reducing the amount of time that customers spend shopping for products and services. All marketplace transactions require that consumers spend time collecting and processing information on alternative product offerings. Reductions in shopping time have real value for today's busy consumers. This is manifest in many modern institutions, from mail order and Internet retailing to home shopping television networks. Search costs are especially large when consumers are not familiar with a market.

In addition, customers who choose to stick with known brand names are not necessarily unsophisticated shoppers who are in need of consumer protection. In fact, consumers who are satisfied with the value of their utility services may correctly conclude that the expected cost savings, if any, from choosing alternative suppliers do not exceed the search costs. Choosing the utility brand for some types of competitive products is a rational decision for these customers. Consumers routinely make such decisions in other markets. For instance, customers in many Midwestern states purchase cellular phone services from Ameritech under the Ameritech label. Therefore, if affiliates of Missouri's utilities are not permitted to use the utilities' brand names, some customers will be forced to bear unwanted and unnecessary search costs.

The Commission must not underestimate the convenience benefits that flow from branding. While one may not easily observe the costs of undertaking marketplace transactions, these costs are a real component that consumers factor into their purchasing decisions. Relying on known brands reduces these costs for some customers and thus adds value equivalent to a price reduction.

Enhanced Incentives to Provide Good Value: Branding also reinforces incentives for utilities and their affiliates to provide regulated and competitive services with desired quality attributes at reasonable prices -- in other words, to deliver good value for customers' money. A brand's worth depends on customers' satisfaction with their purchases of products carrying that name. A diversified utility is, therefore, motivated to offer good value on its full line of products. For example, customers who are dissatisfied with the value of utility services may be less willing to buy competitive products sold under the same name.

More Market-Responsive Product Offerings: Recognized brands may also facilitate product innovation and increase the range of products available to customers. While any company faces uncertainty about the demand for its new product offerings, consumer acceptance of new products tends to be greater when they are associated with a familiar brand. Allowing affiliates to use the utility's brand name may, therefore, lead to competitive markets that are more responsive to evolving consumer demands.

Equally erroneous is OPC's attempt to liken the payment of royalties to the common utility practice of making economy trades. In this context, OPC contends that the free use of the brand by the affiliate somehow means that the utility no longer has to minimize its costs. Of course, there is a world of difference between trading economy energy and conducting third party transactions with other utilities and selling your brand name to your affiliate and receiving a royalty fee. Economy transactions reflects efforts to lower the cost of generation to both parties and allows both to reduce reserve margins. Sharing brand name informs consumers about the identity of the company with which they are dealing and, as we stated above at 13-14, reduces transaction costs for them.

Additionally, brand name restrictions that apply only to select market participants are in violation of the rule announced by the U.S. Supreme Court in Greater New Orleans Broadcasting Association v. United States, 67 U.S.W.L. 4451 (June 15, 1999). See Ogletree, Charles J., et al., "Utility Affiliates: Why Restrict Use of Names and Logos?" Public Utilities Fortnightly, July 15, 1999, attached as Exh. 1.

C. Having Restricted Their Ability to Function in the Utility, Intervenors Would Unemploy Utility Employees

Not satisfied with weaning out every last drop of economies of scope from the utility-affiliate relationship and, in the process, putting a stop to whatever business relationships currently exist between the utility and its affiliates, OPC proposes to impose limitations on the career opportunities of existing utility employees by making it overly expensive for affiliates to hire employees from the utility, especially in situations where the utility may at some future point be required to separate its divisions during a transition to competition in electric supply markets. The OPC proposed requirement of effectively extracting a ransom payment for transferring employees cannot be justified by the familiar regulatory requirement that, if assets are sold at prices above their net book value, ratepayers are entitled to the difference, because the transfer price proves that the depreciation charges they paid up to that point were generous. No such reasoning is applicable to the transfer of employees, on the basis of the analogy that ratepayers have similarly paid for the accumulation of experience that has made them more valuable than they would otherwise be. Purchasers pay the costs of the employees' services they receive when they receive them; they do not, by so doing, acquire an equity stake in the employees themselves — nor could they, under the Thirteenth Amendment's termination and prohibition of slavery.

This serfdom takes the form of a recommendation that any affiliate pay the utility 15% of the salary of any employee transferred to the affiliate, although OPC states a clear preference for a 25% premium. Moreover, OPC would prohibit transferred employees from returning to the utility for two years. As was the case when slavery was legal in this country, the justification was mainly economic: failure to require the affiliate to reimburse the utility for employee training, according to OPC, represents an unfair preference. However, businesses routinely invest in human capital, only to see that capital dissipate when employees move on to new challenges. In free countries, this is a fact of life that no regulatory agency can affect.

MIEG makes similar recommendations, although not to the draconian extent of OPC. MIEG says that management should not have dual roles for the utility and for the affiliate. MIEG defends limiting the time period in which an employee, once transferred to an affiliate, can return to the utility. MIEG also would require a specified compensation whenever the affiliated hired utility personnel.

The Commission should eschew any hindrance to the movement of employees within the corporation. While Missouri is not undertaking restructuring at this time, the restrictions OPC and MIEG propose could have a deleterious impact on the morale and opportunities of Missouri's hard-working utility employees, with no benefit whatsoever.

III. Transfer Pricing Needs to Promote Efficiency

The OPC does not offer any formal guidelines that the Commission can follow in seeking to prevent cross-subsidies and at the same time preserve and promote efficient use of utility resources and facilities through utility and affiliate sharing. However, economists have provided considerable illumination into this problem.

A. The Pricing of Purchases by an Affiliate Should Fall Within a Subsidy-Free Zone of Reasonableness

One general rule developed by economists for pricing of affiliate transactions recommends that the price be set according to the concept of "the range of subsidy-free pricing" or a "zone of reasonableness."[5] The range of subsidy-free prices is between a minimum of incremental cost and a maximum of stand-alone cost. If the price set for a utility/affiliate transaction fell in this range, there would be no cross-subsidy. Incremental cost refers to the extra costs a utility incurs to provide the quantity of the good and service requested by the affiliate. Stand-alone cost in the economics literature refers to the costs an entity would have to incur actually to build "from scratch" the facilities needed to produce the product it seeks to acquire. A cross-subsidy exists at a price above stand-alone cost, and not below, because all of society will be better off if the transaction did not occur at that price, or if the product were provided by the affiliate or by a stand-alone third party at a price based on the stand-alone cost.

The decision process that the Commission needs to consider in constructing its pricing rules is one that emulates the decision process of the utility or of any business. This can be likened to a "buy vs. build" decision. Firms do not always consider acquiring or building their own

5 *See, e.g.*, Kaufmann, Lawrence; Meitzen, Mark; and Lowry, Mark Newton, Controlling for Cross-Subsidization in Electric Utility Regulation (Edison Electric Institute, July 1998), at 5.

"facilities" when examining prices for every product or service they purchase, but the concept is useful because it illustrates the point that the decision to engage in a transaction between the utility and the affiliate will depend on an examination of opportunity costs.

For example, a competitive affiliate of a utility would never pay more for the use of the utility's facilities or services than what it would pay if it could purchase the good or service elsewhere or produce the good itself. If the non-regulated utility affiliate either voluntarily paid, or was forced to pay, more to its utility affiliate than what it would cost to procure the same goods and services from a stand-alone third-party provider, that affiliate would be subsidizing utility ratepayers. Thus, stand-alone cost, or a measure of opportunity cost, is the upper bound of the subsidy-free zone of reasonableness. The same principle applies in the reverse direction: if the utility paid its affiliate more than the stand-alone cost for the good or service, the utility and potentially its ratepayers would be cross-subsidizing the affiliate.

With respect to the lower end of the range, in sharing facilities and services with an affiliate, so long as the utility's revenue exceeds the additional, or "incremental," costs of using the resources, these additional activities spread the fixed costs of overhead and use personnel more intensely than otherwise be the case. Utility customers benefit by bearing a lower share of overhead costs and sharing the direct salaries and indirect benefits of personnel across other uses with affiliates. Thus, incremental cost is the lower bound of "the range of subsidy free prices." Any price the utility receives for affiliated transactions in excess of incremental costs is a gain for utility ratepayers because it reduces the joint and common cost ratepayers must bear through

Commission-approved rates.[6]

The point selected within the range of subsidy-free prices is arbitrary, depending on a regulatory or political decision of how to divide the economies of scope between utility ratepayers and the customers of the competitive affiliate. However, since ratepayers benefit from rate reductions whenever the utility can get even a small amount over incremental costs for overhead and labor, regulators should provide maximum incentives for affiliate transactions and flexibility of price. If the Commission insists on too high a price within the subsidy free range, the competitive affiliate might find a better deal elsewhere, and the ratepayers will continue to bear the full costs of the resources that could have been shared.

B. Affiliates Should Pay Tariffed Rates for Utility Services

For access to and use of tariffed utility services, the non-utility affiliates should pay the same regulated rates as their competitors. Allowing an unregulated business within the utility to purchase utility services at lower rates that are not available to other competitors would be an unfair preference and would be harmful to competition.

In establishing transfer prices of goods and services between a utility and its competitive affiliate, the Commission needs to distinguish between regulated utility services and non-regulated, primarily because the latter are not, and should not be treated as, essential facilities, which would be how the OPC would have them treated.

C. Pricing the Purchases of a Utility From Its Affiliate Should Reflect the Complexities of the Purchase Decision.

Regulatory rules on pricing need to mirror the decision-making process a utility undergoes

[6] *See, e.g.*, Gordon, Kenneth, and Augustine, Charles, Fostering Efficient Competition in the Retail Electric Industry (Edison Electric Institute, August 1998), at 25-26 for a discussion of this issue.

in deciding whether to buy input or produce it itself. They also need to recognize that utilities may treat one-time transactions differently from longer-term arrangements. The utility compares the market price of the good or service with its own incremental cost in providing it to itself. The utility would never pay more than its own incremental costs in providing the good or service, and would never find a competitive seller to provide it for less than the market price. Thus, the appropriate rule for one-time utility purchases from affiliates or non-affiliates is the lesser of a prevailing market price or the utility's own incremental costs.

For pricing ongoing transactions the rule is somewhat different. This is an instance where OPC and the Commission's proposed pricing policies face considerable risk of jeopardizing economies of scope. Traditionally, utilities brought within one company a host of personnel and resource interactions or internal functions to deliver a bundled energy product efficiently to end-use consumers. The interactions and the exercise of internal functions, as directed by management, led to the discovery of efficient transactions that marshaled the utility's resources toward the common aim of providing reliable, bundled, delivered electricity. Utilities brought these discreet transactions within one corporate umbrella for the same reason that all multiproduct firms do: there are tremendous cost savings to providing all of these functions together within one firm as opposed to providing them separately.

Changes in the electric industry at the wholesale and retail levels, even when Missouri has not initiated restructuring of its own retail markets, leads even Missouri's utilities to consider separating many personnel and resources into different reporting and business arrangements -- including into whole new corporate affiliates – even though many of the same interactions among the same people marshaling the same resources are still needed to provide utility services. It was considered unwise for regulators to place rigid oversight of every interaction between personnel and utility resources in the previous environment; it remains so in today's changing markets. The Commission should not establish rigid, bright-line pricing and other rules whenever the utility shares resources with an affiliate in the provision of utility services today. Establishing such rules would effectively resurrect the transaction costs and undo resource usage efficiencies that the corporate structure provides.

Also, many utility purchase agreements from an affiliate are of an on-going nature. A bright-line rule appropriate for one-time transactions makes little sense for long-term, repeated transactions because many of the benefits of the utility/affiliate arrangement are realized over the long term and are not reflected in short-term market prices. The classic example is where a utility buys a coal mine to lower its fuel costs and, for regulatory or legal reasons, does so through an affiliate. By purchasing a mine, the utility can guarantee for the life of the mine a secure source of a certain grade of coal at a predetermined, fixed price. Purchasing the mine only makes sense if the utility uses the coal in its own plants. Accordingly, the utility would enter a long-term contract with its affiliate. During the contract period, market prices for coal might be lower or higher than the contract purchase price; purchasing the mine hedges this volatility. Clearly, applying a bright-line rule in this circumstance would not permit a longer view warranted by the transactional economies and risk reduction of this arrangement.

IV. Conclusion

Consistent with the initial comments that EEI filed on June 29, 1999, the Commission should establish affiliate pricing policy in this proceeding that recognizes that the incremental cost is the floor for the use of utility property for a non-utility business, there is a range between the incremental cost and the market price for the purchase of non-utility goods by the utility and regulated rates may be based on fully distributed costs for access to and use of essential utility goods and, therefore, for all of the reasons offered in these reply comments, EEI urges the Commission to reject the proposed amendments sought by the OPC and the MIEG.

Date: July 29, 1999

Respectfully submitted,

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Utility Affiliates: Why Restrict Use of Names and Logos?

By Charles J. Ogletree Jr., Karen J. Miller and Ronald C. Jessamy

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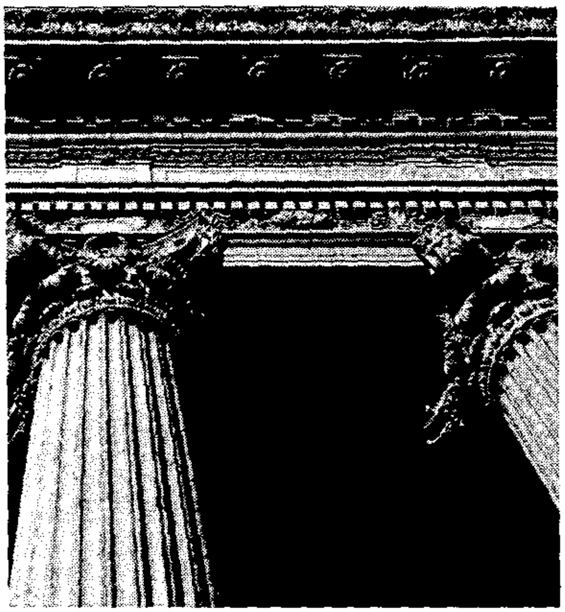

The constitutional case against codes of conduct. By Charles J. Ogletree Jr., Karen J. Miller and Ronald C. Jessamy

BY THE END OF MAY, WHETHER BY LEGISLATION OR BY rule, 20 states had told electric utilities to unbundle their integrated services so as to grant direct access to delivery services to allow competitors to offer generation supply directly to consumers.

Yet even as states open the way for competitors, certain vocal constituencies would handicap utilities and their affiliates, denying them equal footing. New entrants seek to eliminate or constrain competitive advantages they would ascribe to utility affiliates.

In fact, some state public utility commissions (PUCs) have embraced this idea of competitive handicapping. They have adopted codes of conduct that purport to level the field by restricting affiliates in their marketing practices. These rules proscribe certain relationships between the regulated utility (often recast as provider only of distribution service) and its unregulated affiliate (a provider of the electricity product in the competitive retail market). Such rules typically impose restrictions that would bar affiliates from using the utility's name or logo, gaining too much market share or engaging with the utility in joint advertising or marketing activities. Such rules might also prohibit the utility from referring customers to affiliates.

Here we are concerned with the first category on the list—restrictions on the use of name and logo. Examples range from outright prohibitions against use by affiliates, to less restrictive alternatives, such as forcing affiliates to pay royalties[1] to utilities or publish disclaimers to disavow any connection with the utility's name.[2]

What does the law say about name and logo restrictions?

As shown on page 35, such limitations violate First Amendment rights of free speech. In short, those advocating this sort of competitive handicapping seek to achieve through PUC rules what the U.S. Supreme Court consistently has declined to permit under the antitrust law: protecting *competitors* rather than protecting *competition*.[3]

At least one state PUC, the Illinois Commerce Commission, has recognized how affiliate restrictions can burden competition. In a recent order, the ICC noted that attempts to level the field can impose costs on the incumbent that would not be borne by new entrants." It found "no plausible reason" for disparate treatment.[4]

Last month the U.S. Supreme Court affirmed this idea when it ruled that a ban against private casino ads that did not apply to publicly owned casinos violated the First Amendment. *(Greater New Orleans Broadcasting Assoc. Inc.,*

The Illinois Commerce Commission found "no plausible reason" for disparate treatment.

Rights for Commercial Speech? Courts Leaning Toward Greater Protection.

The First Amendment, as applied to the states through the Fourteenth Amendment, protects commercial speech from unwarranted governmental regulation.[1] Commercial speech is accorded constitutional protection because it advances society's interest in the free flow of information.[2]

The *Central Hudson* Test

In 1980, in the *Central Hudson* case,[3] the U.S. Supreme Court set a four-part test that must be met for commercial speech to enjoy protection under the First Amendment:

1. The speech must concern lawful activity and not be misleading. (Unlawful or misleading speech deserves no protection). If this first test is met, then the government must prove that . . .
2. The restriction is warranted by a substantial government interest,
3. The restriction directly advances the asserted governmental interest, and
4. The restriction is no more extensive than necessary to serve that interest.

If the government fails to prove any of the last three steps, the restriction is unconstitutional.

An Evolving Doctrine

To the extent that the commercial speech doctrine may be evolving, it appears to be moving in the direction of providing *greater*—rather than less—protection for commercial speech.

In 1996, in the case of *Liquormart v. Rhode Island*,[4] Supreme Court Justice John Paul Stevens (writing for a plurality) concluded that Rhode Island's ban on advertisements for retail liquor prices at any place except the point of sale was an unconstitutional abridgment of the freedom of speech.

In a concurring opinion, arguing for more extensive protection for commercial speech, Justice Clarence Thomas remarked: "I do not see a philosophical or historical basis for asserting that 'commercial' speech is of 'lower value' than 'non-commercial' speech. Indeed, some historical materials suggest to the contrary."

An Historic Shift?

Several commentators have suggested that a shift is impending on how the law applies the First Amendment to commercial speech.[5] However, courts continue to apply the *Central Hudson* test in evaluating regulations of commercial speech,[6] and the academic literature agrees that *Central Hudson* is still the law.[7]

1. See *Virginia State Bd. v. Virginia Citizens Consumer Council Inc.*, 425 U.S. 748, 761-62 (1976).
2. See *Central Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n of New York*, 447 U.S. 557, 563 (1980); *Va. State Bd. v. Va. Citizens Consumer Council, Inc.*, *supra* note 1.
3. *Supra*, note 2.
4. 517 U.S. 484 (1996).
5. See Stewart, David O., "Change Brewing in Commercial Speech," *ABA Journal*, July 1996, p. 44. Stewart notes that "the tide is running in favor of a fundamental re-evaluation of how the First Amendment applies to commercial speech."

   See also, *United Reporting Publ'g Corp. v. California Highway Patrol*, 146 F.3d 1133, 1136 (9th Cir. 1998). ("The current debate centers not on whether commercial speech is a form of expression entitled to constitutional protection, but on the validity of the distinction between commercial and non-commercial speech.")

   See also, Kozinski, Alex and Banner, Stuart, "Who's Afraid of Commercial Speech?" 76 *Virginia Law Review* 627, 650-53 (1990), arguing for full protection of commercial speech and an abandonment of the commercial/non-commercial distinction.
6. See, e.g., *Pearson v. Shalala*, 1999 WL 12782 (D.C.Cir. Jan. 15, 1999); *Bad Frog Brewery Inc. v. New York State Liquor Auth.*, 134 F.3d 87, 96 (2d Cir. 1998); *Washington Legal Foundation v. Friedman*, 13 F.Supp. 2d 51, 71-74 (D.D.C.1998).
7. See, e.g., Langvardt, Arlen W. and Richards, Eric L., "The Death of Posadas and the Birth of Change in Commercial Speech Doctrine: Implications of *Liquormart*," 34 *American Business Law Journal* 483, 542-43 (1997). The authors assert that the four-part *Central Hudson* test "survived" the 1996 *Liquormart* decision, but that "close examination of the principal and concurring opinions reveals that an altered or reduced role for the test is a strong probability."

et al v. U.S., 67 U.S.L.W. 4451, June 14, 1999.) The court ruled that "[d]ecisions that select among speakers conveying virtually identical messages are in serious tension with the principles undergirding the First Amendment" (slip op. at 36). Further, "the speaker and the audience, not the Government, should be left to assess the value of accurate and nonmisleading information about lawful conduct" (*Id.* at 39).

As Dr. Kenneth Gordon noted, testifying on behalf of the Edison Electric Institute (EEI) before the ICC in the affiliate rules case, an advantage possessed by one competitor, but not by others, is not anticompetitive. "On the contrary, it is what competitive markets are all about."

Consumer Confusion? The Supreme Court Doesn't See It That Way

Proponents of name and logo restrictions claim that affiliate use will confuse consumers, who may assume erroneously that the affiliate is the same as the parent company, that being the regulated utility. That issue, however, is not the relevant legal question.

Instead, the issue is whether any claimed mistaken association would be deemed "misleading" under any of the existing constitutional tests. And to that question, the answer, undeniably, is "no."

Under precedents set out by the U.S. Supreme Court, publication of utility names and logos clearly constitutes commercial speech, and thus deserves constitutional protection under the First Amendment, provided that such speech concerns lawful activity and is not misleading. Even the most basic invitation to engage in a commercial transaction represented by a trade name is sufficient to trigger First Amendment protection from regulation.[5]

Of course, commercial speech may be restricted in some cases, but only if substantial interests are at stake—and then only if such restriction directly advances that substantial state interest. On this point, the Supreme Court has rejected as insufficient an asserted state interest in shielding individuals from material they are likely to find offensive. By analogy, it is also insufficient to assert a state interest in shielding individuals from material they are likely to find confusing.

Do names and logos qualify as commercial speech?

The answer is yes. The Supreme Court defined commercial speech in the famous 1980 *Central Hudson* case (involving utility billing inserts) as "expression related solely to the economic interests of the speaker and its audience."[6] As it said then, "[c]ommercial expression not only serves the economic interest of the speaker, but also assists

What Do Consumers Say? Utilities and Affiliates Should Compete, Say Surveys.

Surveys conducted by the Edison Electric Institute in New Hampshire, Rhode Island, Massachusetts, Vermont, New Jersey, Connecticut, California, Illinois, the District of Columbia, Maine and Michigan confirm that 62 to 82 percent of consumers in those states favor competition in the delivery of retail electric service. What did consumers in those states say about choosing service from the incumbent utility or its affiliated companies?

Buy From Utility or Affiliate?

By a range of 65 to 87 percent, consumers in those states supported the continued sale of electricity by existing utilities and/or their affiliates.

Affiliates Use Utility Name?

Approximately 72 to 81 percent felt that it was important for them to know the owner of their electric provider. Opposition to regulatory limits on affiliate use of utility name ranged from 40 to 79 percent. Similarly, opposition to restrictions on company names ranged from 76 to 92 percent. Opposition to restrictions on providing information concerning affiliate services ranged from 54 to 75 percent.

The Same Around the Country?

Surveys conducted nationally revealed similar results. Eighty-seven percent of consumers favored rules that would would permit electric companies to provide information concerning their affiliates. Similarly, 56 percent of consumers surveyed supported the use of utility names and logos by affiliates.

consumers and furthers the societal interest in the fullest possible dissemination of information."

Justice Harry Blackmun identified the importance of commercial speech and its protection in his concurring opinion in *Central Hudson*. According to Blackmun, the restriction on commercial speech in that case struck at the heart of the First Amendment. He described it as "a covert attempt by the State to manipulate the choices of its citizens, not by persuasion or direct regulation, but by depriving the public of the information needed to make a free choice."

Under the Supreme Court's definition, utility names and logos clearly constitute commercial speech.[7] Even the most basic invitation to engage in a commercial transaction represented by a trade name is sufficient to trigger First Amendment protection from regulation. Utility names and logos are forms of expression through which utility companies communicate relevant and truthful commercial information to consumers; they function as a vehicle for communication of important information concerning the commercial transaction and the utility's corporate affiliations.[8]

In Nevada, in fact, the state public utility commission decided not to deny affiliates the right to state their affiliation with a parent utility company, finding such a rule unconstitutional because it would bar the publication of a true statement.[9]

Proponents offer several reasons for proposing code of conduct regulations that proscribe affiliate use of utility names and logos, none of which meet the constitutional test. In particular, they claim that affiliates who use utility names and logos will confuse consumers, who may assume erroneously that the affiliate is the same as the regulated electric utility parent. The question, however, is whether this association would be deemed "misleading" under any of the existing constitutional tests. Here again, in *Central Hudson*, the Supreme Court put this complaint to rest, noting that "[e]ven in monopoly markets, the suppression of advertising reduces the information available for consumer decisions and thereby defeats the purpose of the First Amendment."

As the court explained, "A consumer may need information to aid his decision whether or not to use the monopoly services at all, or how much of the service he should purchase." Thus, it concluded: "Even when advertising communicates only an incomplete version of the relevant facts, the First Amendment presumes that some accurate information is better than no information at all."

Utility names and logos provide consumers with valuable information concerning the utility's corporate affiliations. This information is valuable irrespective of whether ... view such affiliations positively or negatively, because it helps them make informed market decisions. Unregulated commercial expression does not confuse, but rather informs; it advances the free flow of commercial information.

Protecting Competition? Recent Cases Find Restrictions Overbroad

The Supreme Court in the *Central Hudson* case also requires a "fit between the restriction and the government interest that is not necessarily perfect, but reasonable."[10] In other words, although the regulation is not required to be the least restrictive alternative available, it "must be in proportion to the interest asserted."[11]

In this case, there is simply no "reasonable fit" between name and logo restrictions and the asserted goals of fostering competition, preventing cross-subsidization and avoiding consumer confusion. There are, in fact, other means of furthering the state's purported interests that do not burden free speech.

For example, disclaimers can be employed in the unlikely event that an affiliate might create confusion in using the utility's name or logo.

Those advocating codes of conduct assert an interest in promoting competition in the retail market for the sale of electric generation. The California Public Utilities Commission asserted just such an interest in proposing code of conduct rules for utility affiliates: "We do not want the utility to use its market power to impede competition by giving its affiliate a clear cost advantage not available to competitors." However, in the same case it acknowledged that "some near-term scope and scale economies may be forgone to achieve [an efficient market]."[12]

In practice, the Supreme Court has not been hesitant to strike down commercial speech rules where the rule does not fit the interest at stake. In fact, with the court's 1996 ruling in *44 Liquormart, Inc. v. Rhode Island*,[13] this test has been tightened further still. In *Liquormart*, state regulations failed this "reasonable fit" requirement for ignoring preferable and equally effective means of achieving the same state interest.[14] According to the Fifth Circuit,[15] the *Liquormart* case has now tightened this "reasonable fit" standard. *Liquormart* indicates that the court is now "willing to scrutinize more carefully" any rules that restrict commercial speech more than is necessary, as is shown by an excerpt from the court's plurality opinion:

> Bans that target truthful, nonmisleading commercial messages rarely protect consumers from [commercial] harms.... [T]hese commercial speech bans not only hinder consumer choice, but also impede debate over central issues of public policy.

Proponents of name-and-logo restrictions cannot sustain the burden of proving that such rules fit reasonably the aims of deregulation. Clearly, the ends sought are not advanced by the speech restrictions.

Restrictions on affiliate use of utility names and logos neither promote competition nor prevent cross-subsidization of affiliates. In fact, the restrictions likely will *impede* competition. The practices contained in many of the code of conduct proposals (including restrictions on use of utility names and logos) actually *subvert* competition by subjecting existing utilities to rules that discriminatorily handicap them and simultaneously deprive consumers of the benefits of genuine market competition. Moreover, although cross-subsidization can be a legitimate concern, the restrictions will not materially eliminate the problem unless cross-subsidization in other areas is addressed simultaneously.

Rules limiting use of names and logos represent content-based restrictions on speech; therein lies the heart of the problem.

The Supreme Court has developed a jurisprudence that treats content-based restrictions of speech with much more skepticism than content-neutral restrictions. As the court stated recently, "[c]ontent-neutral regulations do not pose the same inherent dangers to free expression that content-

States That Have Proposed or Adopted Name and Logo Restrictions

State	Name and logo restrictions
Arizona	An affiliate may not use a utility's name or logo unless it discloses that: 1) it is not the same company as the utility; and 2) consumers do not have to buy the affiliate's product in order to continue receiving quality regulated services from the utility.
California	The enforcement rules for violation of the Affiliates' Code of Conduct Rules authorize the commission to prohibit an affiliate's use of a utility's name and logo, either temporarily or permanently, for such violation.
Connecticut	The use of name and logo is permitted if it is accompanied by a disclaimer that the affiliate is not the same company as the distribution company, the affiliate is not regulated by the DPUC, and it is not necessary to buy the affiliate's product to receive quality regulated service.
Iowa	Under a proposed rule, a utility must, no later than May 1, 2002, use a name that is determined by the Iowa Utilities Board to be distinct from the name of an affiliated electric supplier. An affiliated electric company may use any name and logo of its choosing, including that of the incumbent provider or parent company. Utilities may not advertise their affiliation with a competitive provider through a tag line or other means, except that a common logo may be used.
Maine	Prohibited joint marketing or advertising includes a prohibition against use by an affiliate of a name or logo that would be sufficiently similar to the distribution utility's name or logo to trigger royalty payments for goodwill.
Missouri	Under a proposed rule, a regulated utility may not use or allow any affiliated entity or utility to use the name of the regulated electric utility to engage in HVAC services, unless a disclaimer is provided stating that the service provided by the affiliated entity is not regulated by the PSC.
Nevada	The PUC adopted rules prohibiting affiliates from using a name or logo that is deceptively similar to that of the distribution company unless the affiliate is the provider of last resort, but allowing the affiliate to identify itself as such providing a disclaimer follows. Proposed legislation, if passed, will invalidate these rules.
Pennsylvania	Proposed legislation, if passed, will prohibit an affiliate from using a name, logo or other identification similar to that of its parent.

based regulations do, and thus are subject to a less rigorous analysis, which affords the government latitude in designing a regulatory solution."[16]

By contrast, a content-based restriction on speech is subject to strict scrutiny. A content-based government regulation will be struck down unless it is the least restrictive means of advancing a compelling state interest.[17]

The restriction or prohibition of an affiliate's use of its regulated utility's name and logo is a content-based restriction of speech that merits full First Amendment protection. Such regulations, to the extent that they proscribe all communications with the public concerning the relationship between the utility and its non-regulated affiliates, irrespective of the content of those communications, are content-based. Even if the proffered state interest for restricting affiliate use of utility names and logos is found to be compelling, the proposed regulation still would fail the strict scrutiny test. As the Supreme Court has stated, "[t]o survive strict scrutiny ... a state must do more than assert a compelling state interest—it must demonstrate that its law is necessary to serve the asserted interest."[18] Here the restriction, though perhaps motivated by a compelling state interest in consumer protection, is not necessary to advance that interest.

An affiliate takes its roots from the regulated utility. That fact may convey important information to customers, suggesting a long history of service in the electric industry or a strong sense of localism, as Ken Gordon explained in his testimony before the Illinois Commission.

Any proscription on the affiliate's use of the utility's corporate identity deprives consumers of information on "who they are dealing with," noted Gordon. This interference imposes a real cost on consumers. Gordon adds that "a clear brand identity provides accountability, and therefore an incentive for firms to maintain quality levels and thereby better serve customers."

Dr. Alfred Kahn echoed these concerns in comments that EEI submitted in the California PUC's affiliate rules case.

"Such favorable associations as consumers may have with brands—e.g., expectations of service quality and reliability—are an economy of scope," said Kahn, adding that a denial of such benefits, either to consumers or to companies, "would be anti-competitive."

Clearly, more information inherently is pro-consumer in that it permits customers to make informed market choices. Conversely, restrictions on such information by their very nature are anti-consumer.

Overall, proponents of the code of conduct proposals have ignored non-speech restrictive tools that are more effective to achieve fair competition. State prohibitions of affiliate use of utility names and logos place existing utilities at a competitive disadvantage vis-à-vis their non-regulated competitors, who remain free to inform consumers of their own affiliations with reputable, established parent companies.[19] Instead of placing handicaps on incumbent utilities, thus increasing their costs and weakening their ability to compete, state commissions and legislatures can promote competition by adopting competition-enhancing transition rules that are opportunity-based, impartial and forward-looking.

This article is condensed from a work written by the authors on commission for the Edison Electric Institute, titled "Constitutional Grounds to Challenge State Public Utility Commission Restrictions on Affiliate Use of Utility Name and Logo." Charles J. Ogletree Jr. is the Jesse Climenko Professor of Law at the Harvard University Law School. He has gained fame by serving as moderator for more than a dozen topical programs and series broadcast by national television networks. Such programs include "Ethics In America" (PBS, 1989), "Popular Culture: Rage, Rights and Responsibilities" (PBS, 1992), "Political Correctness and The Media" (C-Span, 1994) and "Profits and Promises: New Markets, New Challenges" (PBS, 1995). He wrote "Johnnie Cochran and Marcia Clark: Role Models?" published in "Postmortem: The O. J. Simpson Case" (Jeffrey Abramson, ed., 1996), and "The Tireless Warrior for Racial Justice" in "Reason & Passion: Justice Brennan's Enduring Influence" (W. W. Norton & Co., 1997). Karen J. Miller is an associate and Ronald C. Jessamy is a partner of the Washington, D.C., law firm of Jordan Keys Jessamy & Botts, LLP.

1 Where proponents advocate that affiliates pay royalties to the utilities for use of their name and logo, affiliates may be able to challenge the royalty as an unconstitutional tax on the exercise of the affiliates' fundamental First Amendment rights. See *Murdoch v. Pennsylvania*, 319 U.S. 105 (1943), where an ordinance that required persons canvassing for orders for merchandise to apply for and purchase a license was deemed an unconstitutional tax on the exercise of free speech. But cf., *Rochester Tel. Corp. v. Pub. Serv. Comm'n of N.Y.*, 660 N.E.2d 1112 (N.Y. 1995), holding that the PSC did not violate the Commerce Clause by imputing revenues to a telephone utility for ratemaking purposes, as an implied royalty payment, where its affiliate had used the utility's name and reputation.

2 Some federal restructuring legislative proposals have even included this type of restriction. See H.R. 4798, introduced by Rep. Dennis Kucinich in the 105th Congress.

3 See, e.g., *Spectrum Sports v. McQuillan,* 506 U.S. 447, 458 (1993); *Atlantic Richfield Co. v. USA Petroleum Co.,* 495 U.S. 328, 338 (1990); *Cargill Inc. v. Monfort of Colorado Inc.,* 479 U.S. 104, 109-10 (1986); *Brunswick Corp. v. Pueblo Bowl-O-Mat Inc.,* 429 U.S. 477, 488 (1977).

4 Consolidated Docket Nos. 98-0013 and 98-0035, June 12, 1998, at 25, 186 PUR4th 508 (Ill.C.C.).

5 See *Friedman v. Rogers,* 440 U.S. 1, 11 (1979). ("Once a trade name has been in use for some time ... [it] is used as part of a proposal of a commercial transaction.")

6 *Central Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n of New York,* 447 U.S. 557, 561 (1980).

7 See, e.g., *Adolph Coors Co. v. Brady,* 944 F.2d 1543, 1546 (10th Cir. 1991), noting that "[p]roduct labels, which are part of a firm's marketing plan to provide certain information to the consumer, also constitute commercial speech."

8 Utility "brand" names may convey other important information to consumers as well. "For example, recognized brands may convey the utility company's expertise and history of reliable service." Such commercial information assists consumers in making informed market decisions. See Christensen Associates, *Branding Electric Utility Products: Analysis and Experience in Related Industries* 1, 1997 (Edison Elec. Inst.).

9 See "PUC's Rules Require Affiliates to 'Disclaim' Use of Name or Logo," *Retail Wheeling and Restructuring Report,* December 1998, p. 80 (Edison Elec. Inst.).

10 See *United States v. Edge Broadcasting Co.,* 509 U.S. 418, 429 (1993).

11 Hornell Brewing, 819 F. Supp. at 1238.

12 D.97-12-088, I. 97-04-012, Dec. 16, 1997, at 54, 183 PUR4th 503 at 539. Note also that in a recent case involving Southern California Edison Co., the PUC waived its disclaimer rule (requiring affiliates to publish a disclaimer before using the utility's name or logo) for certain situations—namely, building signage, company vehicles, employee uniforms and installed equipment on customer premises. D.99-04-069, Apr. 23, 1999, p. 13-15.)

13 517 U.S. 484, 507 (1996) (plurality opinion).

14 Finding a lack of reasonable fit because "alternative forms of regulation that would not involve any restriction on speech would be more likely to achieve the state's goal of promoting temperance."

15 See *Greater New Orleans Broadcasting Ass'n v. United States,* 149 F.3d 334, 338 (5th Cir. 1998).

16 *Turner Broad. System Inc. v. FCC,* 520 U.S. 180, 212 (1997); see also *Ward v. Rock Against Racism,* 491 U.S. 781, 798 n.6 (1989).

17 *Perry Educ. Ass'n v. Perry Local Educators' Ass'n,* 460 U.S. 37, 45 (1983).

18 *Burson v. Freeman,* 504 U.S. 191, 199 (1992).

19 The nature of many electric utility rivals weakens arguments that the utility brand is an unfair advantage. Many rival companies have substantial financial resources, related skills and experience, and established brands in other industries. These assets can compensate for a lack of immediate name recognition in the electric industry and enable these firms to be effective competitors in retail electric markets. See, "Branding Electric Utility Products," *supra,* note 7, at 12-13.

Cost Allocation and Affiliate Transactions

A Survey and Analysis of State Cost Allocation Issues and Transfer Pricing Policies

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GLOSSARY

1. **Affiliates** - companies that are related to each other due to common ownership or control.

2. **Asymmetric Pricing** - refers to the use of differing pricing methods depending on the direction of the transfer. Specifically, this refers to higher of cost or market being charged for transfers from the regulated utility to the non-regulated affiliate and lower of cost or market being charged for transfers from the non-regulated affiliate to the regulated utility.

3. **Cost Allocation Manual** - an indexed compilation and documentation of a company's cost allocation policies and related procedures.

4. **Cost Allocators** - the methods or ratios used to apportion costs. A cost allocator can be based on the origin of costs, as in the case of cost drivers; cost-causative linkage of an indirect nature; or one or more overall factors (also known as general allocators).

5. **Common Costs** - costs associated with services or products that are of joint benefit between two business units.

6. **Cost Driver** - a measurable event or quantity which influences the level of costs incurred and which can be directly traced to the origin of the costs themselves.

7. **Cross Subsidization** - occurs when a firm, producing more than one product, uses the revenues from the sale of one product to cover the costs of producing another product.

8. **Direct Costs** - costs which can be directly identified with a particular service or product.

9. **Fully Allocated Cost** - fully allocated cost equals the sum of the direct costs plus an appropriate share of indirect costs.

10. **Incremental Pricing** - pricing services or products on a basis of only the incremental costs of their production while one or more pre-existing services or products support the fixed costs.

11. **Indirect Costs** - costs that cannot be identified with a particular service or product. This includes, but is not limited to, overhead costs, administrative and general costs, and taxes.

12. **Negotiated Pricing** - refers to a method or methods of pricing services or products for which the terms have been discussed and agreed upon by the parties involved in the agreement.

13. **Non-Regulated** - refers to services or products that are not subject to price regulation by regulatory authorities.

14. **Prevailing Market Price** - a generally accepted market value that can be substantiated by clearly comparable transactions, auction prices or appraisal values.

15. **Regulated** - refers to services or products that are subject to regulation by governmental authorities.

16. **Stand-alone Cost** - the cost that an entity would incur in providing a particular service or product itself (*i.e.*, build from the ground up), rather than receiving the service or product from a shared service provider.

17. **Tariff Based Price** - refers to prices that are pre-approved by the regulatory commission and are on file with the commission.

18. **Transfer Pricing** - refers to the pricing of services and products that one segment of an organization or an affiliate supplies to another segment of an organization or an affiliate.

INTRODUCTION

Restructuring of the electric industry is having profound effects on company structures through reorganizations, mergers and acquisitions and new methods of business operation. As competition develops in wholesale and retail markets, an increasing number of utilities are rapidly moving into non-regulated business operations which will have far-reaching accounting and economic implications for regulated utilities and their non-regulated affiliates. Administrative rules governing the allocation of costs for services and products transferred between regulated utility operations and non-regulated affiliate operations are currently being considered, debated and implemented in state proceedings. In national regulatory arenas, policy guidelines addressing these critical issues are being developed for consideration by state regulatory commissions and their staff. Because of concerns that regulated utilities will cross subsidize affiliate business operations at the expense of consumers of regulated services or harm competition, regulators and competitors seek to impose strict accounting procedures on utilities to ensure that only justified costs are attributed to regulated activities.

Cost Allocation and Transfer Pricing

Historically, cost allocation within a regulated utility was directly related to the regulatory ratemaking process. Typically, costs were allocated to generation, transmission and distribution functions as well as customer classes at highly aggregated levels. In the competitive market, however, more utilities are offering a wider range of services and products, which involve non-regulated affiliates. As a result, costs related to affiliate transactions must be allocated properly between the regulated portion of the business and the non-regulated affiliate without cross subsidizing other business operations. The basic goals of cost allocation methods should be to ensure proper distribution of costs between the regulated utility and their affiliates and to minimize the time and expense necessary to record and audit transactions.

Cost allocation is the process of assigning a single cost to more than one cost object. A cost object can be any physical item, activity, function, process or organizational unit in which a separate measurement of cost is desired. When used in the context of a regulatory proceeding determining revenue requirements for a regulated utility (*i.e.*, a pipes or wires company), the issue of cost allocation refers to a set of accounting practices that correctly assign costs and can be used to prevent cross subsidization between the regulated utility and its non-regulated affiliates.

In theory, if services and products were purchased individually and were used by only one business unit, tracing the flow of costs would be simple. In reality, however, firms rarely operate in this manner for both efficiency purposes and good business practice. Three basic questions are typically answered when making determinations about cost allocations; 1) What basis should be used for cost allocation? 2) Which costs will (or should) be allocated? 3) What procedure will be used to allocate common costs?

In the utility industry, a variety of methods are used to capture and allocate costs between regulated and non-regulated operations and a variety of methods are also used to price services and products.

The pricing of services and products between one segment of an organization for a service or product that it supplies to another segment of an organization or to an affiliate is referred to as "transfer pricing." Transfer pricing is largely dependent on the types of transactions involved and should be performed on a transactional basis. Transactions may include transfers of services and products for sale, transfers of services and products not for sale, and the transfer of capital assets. When a regulated utility provides services and products to a non-regulated affiliate (and vice-versa), or transfers capital assets to its non-regulated affiliate (or vice-versa), regulator concerns, largely centering on the issue of cross subsidization of affiliate business operations, exist.

A transfer pricing policy which forces transactions between a regulated utility and a non-regulated affiliate at a price which is uneconomic discourages efficient activities that could potentially lower rates for regulated customers. Conversely, a transfer pricing policy that permits a regulated utility to engage in cross subsidization of a non-regulated affiliate harms ratepayers and may harm competition. State or federal law may also restrict the transfer pricing rules that a regulatory agency can implement. For example, pursuant to the Public Utility Holding Company Act of 1935 ("PUHCA"), registered holding companies must comply with rules implemented by the Securities and Exchange Commission ("SEC") which generally require affiliate transactions to be conducted at cost. The various transfer pricing methods in use to price affiliate transactions will be discussed and defined later in this paper.

Codes of Conduct and Standards

In part, to address these cost allocation and transfer pricing issues, an increasing number of states undergoing restructuring have developed "Codes of Conduct" or "Standards" through regulatory proceedings to govern relationships between regulated utilities and their non-regulated affiliates. Codes of Conduct define permissible relationships between a utility and other market participants, in particular the utility's non-regulated affiliates. Issues that are often covered in Codes of Conduct include: 1) corporate governance, structural separation and affiliate relations; 2) discrimination, subsidization and cost allocation; 3) marketing restrictions; 4) resource restrictions and 5) regulatory oversight. Many of the issues appearing in Codes of Conduct surrounding cost allocation and transfer pricing of affiliate transactions are also being addressed in draft guidelines being put forth by The National Association of Regulatory Utility Commissioners ("NARUC").

Guidelines for Cost Allocation & Affiliate Transactions

The NARUC, in conjunction with the electric and natural gas industries and other stakeholder groups, is drafting "Guidelines for Cost Allocation & Affiliate Transactions" ("Guidelines"). The draft Guidelines should be viewed in light of accepted accounting policies and procedures for allocating costs and recording transfers of services and products between the utility and its affiliates as well as economic principles for pricing those transfers.

The Guidelines are needed in part to increase the likelihood that state regulatory commissions will adopt effective and adequate safeguards regarding potential cross subsidization between the regulated and non-regulated businesses of electric and gas utilities while avoiding regulatory policy choices that have tended to reduce economic efficiency or harm consumers of regulated services in the long run. The electric and natural gas industries have united views on needed changes to the draft Guidelines. In particular, these changes would focus on areas specific to technical definitions, cost allocation principles, documentation and content of a Cost Allocation Manual ("CAM"), affiliate transaction pricing methods, and audit requirements which include access to affiliate books and records. The research in the following paper will, in part, concentrate on those areas significant, not only to the NARUC project, but also to recent state regulatory proceedings.

Survey of Current State Commission Rules

In order to properly gauge the current status of affiliate rules as well as understand methods already in place at state commissions, a nationwide survey was undertaken by Deloitte & Touche on behalf of the Edison Electric Institute. The survey consisted of a questionnaire put before each of the 51 state commissions (including the District of Columbia). A copy of the questionnaire used is included in *Appendix A*. The questions were designed to obtain feedback on the main issues to be addressed in this paper.

In total, 33 commissions responded directly with either complete or partial answers to the survey questions. Where necessary, follow up calls were made to several of the states responding in order to clarify and deepen the understanding of certain responses. For states not responding, publicly available information, such as state laws, Codes of Conduct or commission orders were reviewed to determine how the commission would have likely responded. For 7 additional states, this resulted in sufficient information to allow the majority of the survey to be completed, for a total of 40 states represented. Remaining states were not included in the formation of the results. A complete matrix indicating the state-by-state responses can be seen at *Appendix B*.

Purpose Of Paper

This paper discusses the basic accounting and economic issues surrounding cost allocation policies and procedures, transfer pricing methods and the relative merits of each. In addition, this paper will provide a resource for discussing other issues which are currently under debate in both state and national forums, specifically confidentiality, reporting requirements, and audit requirements which include access to affiliate books and records. Lastly, this paper summarizes the results of the survey performed by Deloitte & Touche on behalf of the Edison Electric Institute ("EEI"), gauging the status of present-day regulatory rules and practices on cost allocations and affiliate transfer pricing policies.

COST ACCUMULATION AND ALLOCATION

Overview of Shared Services

Most companies currently provide both regulated and non-regulated services and products. Unregulated activities can be performed either as part of a utility company (below-the-line income and expense) or through subsidiaries or other affiliated companies. The majority of companies today are organized as holding companies having subsidiaries that are both regulated and non-regulated affiliates. Some holding companies are Registered Holding Companies ("RHC")[1] because they are "registered" or authorized to conduct business in accordance with the PUHCA as administered by the SEC. Other holding companies are Exempt Holding Companies ("EHC")[2] because they are "exempt" from the provisions of PUHCA with the exception of those sections of PUHCA related to the acquisition of securities of public utility companies and the acquisition of foreign (non-US) utility companies. Depending on the type of organization, for accounting, reporting and ratemaking purposes, regulated affiliates fall under the jurisdiction of the Federal Energy Regulatory Commission ("FERC"), state public utility commissions and/or the SEC.

The term "regulated affiliate" usually means the regulated operating utility company(ies) or subsidiary(ies). Sometimes the term "regulated affiliate(s)" is also used to refer to fuel subsidiaries, mining subsidiaries, or other operations that supply services or products exclusively to a regulated utility or another regulated affiliate. The cost of such services and products are passed through (*i.e.*, allowed to be recovered in the utility's(ies') cost of service and rates) after review by the regulator to the utility's(ies') customers, thus the term "regulated affiliate." With industry restructuring and unbundling, the generation function may be deregulated and provided through a non-regulated entity while the transmission and distribution functions may continue to be provided through regulated entities.

Service companies of RHC's are regulated by the SEC as to accounting, reporting, cost allocation and pricing. Service Companies of EHC's are not regulated by the SEC. Service companies of RHC's or EHC's are not directly regulated by the FERC or state public utility commissions. The cost of services and products provided by the service companies of both the RHC and EHC are, however, subject to the same regulatory scrutiny as any other regulated utility costs before such costs are allowed to be included in the utility's cost of service for ratemaking purposes.

The term "non-regulated affiliate" refers to an affiliated entity or subsidiary that is not regulated by a utility regulator (*i.e.*, the regulator does not have jurisdiction over a non-regulated affiliate). For purposes of the following section, the term "affiliate" will refer to both regulated and non-regulated affiliates unless otherwise stipulated.

Services and products can be delivered to affiliated entities in several ways. One method is to have the parent and/or the utility provide the service or product to or among the affiliated entities. Another method of providing services and products is through the use of a separate service company. For years, RHCs have used service companies authorized by, and under the oversight of the SEC to provide services to affiliates. Industry restructuring, domestic and foreign mergers and acquisitions, and the transition to competition are resulting in the formation of additional holding companies with service companies. Centralization of activities through the creation of service companies results in economies of scale, which cannot be achieved by an affiliate on a stand-alone basis. The provision of shared services to achieve benefits of consolidation and economies of scale, means that the majority of the shared service costs are incurred to provide common services to multiple affiliates which, by definition, requires an allocation of such costs.

The provision of shared service within an affiliated group can take many forms. Services can be provided to domestic utility companies and regulated affiliates including other regulated service companies, to non-regulated affiliates including non-regulated service companies, and to a combination of both regulated and non-regulated affiliates. In addition, there can be provision of services and products between member affiliates. Examples would be the provision of services by one utility operating affiliate to another affiliated operating utility to repair storm damage or for a loan of stores material. Such services are charged or billed directly from one entity to another and are not the focus of this paper.

The provision of services and products is typically covered by service agreements between the service provider and the receiver(s) of the service. The service agreement sets forth the types of shared services to be provided which usually include general and administrative services such as general executive, advisory, administrative, accounting, legal, regulatory, engineering, human resources, and purchasing. The service agreement also sets forth the cost or price to be charged for the service provided as well as how such costs are to be allocated or billed to the receiving entity. The costs of providing such services are accumulated and billed to affiliates using cost–causative principles. Services provided to affiliates by service companies of RHCs are provided to the affiliates at fully allocated cost (break even) as required by the SEC. Also, services provided to affiliates by service companies of exempt holding companies or by a parent or utility affiliate are usually provided at cost, although not required by the SEC. In addition to requiring "at cost" pricing to affiliates, the SEC has responsibility for approving the cost allocation formula or methodologies for the RHCs.

Cost Accumulation

Affiliate transaction information including the costs of providing both regulated and non-regulated services are captured in accounting systems for accumulation and allocation to the appropriate affiliates. Typically, the primary information systems used for accumulating affiliate costs are: Payroll (time reporting); Accounts Payable (expense accounts and vendor invoices); and General Ledger Journal Entries. Information systems are linked to the General Ledger for recording the accounting information on the books of the affiliate for which the costs were incurred. Implementation of activity-based costing or activity-based management systems have provided utilities with better cost accounting tools for accumulating and assigning costs. These cost accounting systems allow for the accumulation of costs at a fairly low level and, therefore, provide more detailed information for analyzing and assigning costs to the appropriate affiliated company(ies) based on the activities performed.

Cost Allocation Principles

The application of cost allocation principles can result in more accurate product or service costs and information that can be used to manage operations as well as provide more accurate information to regulators. These transaction principles are applied when resources are shared between business units within a company or on an intercompany basis as when capital assets or services and products are utilized between regulated operations and non-regulated affiliate operations.

For allocation purposes, the costs associated with services and products provided to affiliates can be classified as direct, indirect or common costs. Affiliate costs can be either expensed (*i.e.*, income statement item) or capitalized (*i.e.*, balance sheet item) on the receiving company's books.

Direct costs can be identified with a particular service or product and can be incurred on behalf of one or more affiliates. For example, direct costs such as for engineering services incurred for the benefit of only one affiliate can be directly assigned (billed 100%) to that affiliate. Direct costs that benefit more than one affiliate, such as employee benefit administration, must be charged or allocated to the affiliates receiving the service on some cost causative basis such as the number or ratio of employees to total employees. To the maximum extent practicable, in consideration of cost benefit standards, costs should be collected and classified on a direct basis for each service or product provided.

Indirect costs cannot be identified with a particular service or product. Indirect costs include but are not limited to overhead costs (*e.g.*, corporate, departmental, business unit), administrative and general costs, and taxes. Indirect costs are charged to the appropriate product or service to which they relate using relevant cost allocators. An underlying cost accounting principle, and the general method in use, is the fully distributed cost alignment method (fully allocated costs). The fully allocated costing philosophy is based on the premise that both direct and indirect costs are identified for services and products and that services and products should bear the sum of the direct costs plus a proportional share of indirect costs. In other words, the costs of services and products should include all costs that would be incurred on a stand-alone basis (*i.e.*, all costs if the affiliate produced the service or products itself), thereby removing any cross subsidization between business profitability (*e.g.*, regulated vs. non-regulated).

Common costs, as distinct from indirect costs, are usually defined as costs associated with services or products that are of joint benefit between regulated and non-regulated business units. The primary cost driver of common costs, or a relevant proxy in the absence of a primary cost driver, should be identified and used to allocate the cost between regulated and non-regulated services or products. An example of a common cost is a corporate headquarters building which houses both regulated and non-regulated business operations. Common building space costs can be allocated to business units based on the amount of square feet occupied by the various business units multiplied by the cost per square foot of the space occupied.

Companies use various methods to identify and record direct costs to regulated and non-regulated affiliates for services and products. One method is to assign costs directly to an account number using the FERC Uniform System of Accounts ("FERC USOA") or the SEC Uniform System of Accounts for Mutual Service Companies and Subsidiary Service Companies ("SEC USOA") of RHCs. A charge (or entry) to the account on the provider's books would also appear in the same account on the receiving entity's books. Another method is to charge direct costs to a product code, project code, work order or service number. Other methods of assigning direct costs are to identify and charge the costs based on an activity number or a company number. In some cases, deferral accounts and job numbers are used to capture costs. These systems for capturing and recording costs incurred in providing services to affiliates are also used to allocate or bill the costs of the services to the appropriate affiliates. These systems can also contain information for mapping or translating the costs charged to the affiliates to the appropriate account number. For example, a project code may capture the cost of administering the employee benefits program for all the affiliates of an affiliated group. The costs identified by the project code are then allocated to the affiliates receiving the service using the same allocation factor such as the number of employees. In this way each affiliate is charged a proportionate share of the costs associated with administration of the employee benefits program based on the ratio of each affiliate's number of employees to the total number of employees in the affiliated group.

As previously mentioned, indirect costs include costs such as administrative and general costs, sometimes referred to as indirect overhead costs, and cannot be identified with a particular service or product. These indirect or "residual" costs which cannot be specifically attributed to a product, service or affiliate and for which there are no cost causative relationships, are typically accumulated or "pooled" and then allocated in the same ratio as all other costs are assigned or allocated (using a general allocator based on total company expenses). One method for allocating indirect costs would be to spread such costs using a general allocator based on how all operation and maintenance ("O&M") costs are assigned or allocated. Allocation of indirect costs, which have no readily identifiable cost causative relationships, on the basis of how all other costs have been allocated on a cost causative basis is a proxy or surrogate for allocating indirect costs on a cost causative basis. Some companies allocate indirect costs using multi-factor allocation formulas based on factors such as labor costs, plant investment or revenues.

Appendix C includes 5 detailed examples of how companies currently assign costs to both regulated and non-regulated affiliates. The examples also reflect how the services are provided (*i.e.*, by the parent and/or utility or through a service company) and how the costs of such services are assigned or allocated.

Cost Allocation Manuals ("CAM's")

CAM's, or comparable written documentation, are used by many investor-owned electric utilities to accurately explain and reflect policies and procedures for allocating costs for services and products between regulated and non-regulated operations. Some regulatory jurisdictions require companies to maintain a CAM for regulatory proceedings. Common contents of a CAM include a listing and description of services and products provided between the regulated utility and non-regulated affiliate, a description of the cost allocators and allocation methods or transfer pricing methods and procedures used, and an organization chart of the holding company depicting all affiliates and regulated entities. NARUC's current Guidelines define a CAM as an indexed compilation of a company's cost allocation policies and related procedures.[3]

In 1986 and in 1996, the Federal Communications Commission ("FCC") issued orders[4] which, in part, mandated the filing and approval of CAM's for all local telephone carriers and dominant inter-exchange carriers with more than $100 million in operating revenue. The action was directed at precluding carriers from imposing costs and risks of non-regulated services and products onto captive ratepayers. Although a CAM is one method for accomplishing this goal, there are alternative reporting requirements, as will be discussed later, which may prove less burdensome and just as effective.

TRANSFER PRICING METHODS

Transfer prices are not a concern in most industries since private firms are generally free to allow one segment of the firm to subsidize another, if they so choose. However, in regulated markets, such as electric power and natural gas, regulators have an interest in establishing policies that protect customers of the regulated portion of a firm from subsidizing non-regulated activities. Regulators want to prevent a utility from exploiting its position as a provider of essential monopoly services to provide a non-regulated affiliate with an unfair competitive advantage. An unfair competitive advantage could be provided through preferential treatment, sharing of customer and retailer information, or other commercially sensitive information.

As restructuring progresses in the electric power and natural gas industries, and previously regulated segments of the industry become competitive, transfer pricing methods are increasingly gaining the attention of regulators. Specifically, as many utilities transfer generation assets to an unregulated affiliate, either voluntarily or as part of a restructuring proceeding, state regulatory commissions have focussed attention on the price at which such assets are transferred.

Regulators are generally concerned with protecting customers from cross subsidies that could potentially result from affiliate transactions in two directions:

- For the sale of services or products or for the transfer of capital assets from a regulated utility to a non-regulated affiliate, regulators want to ensure that the non-regulated affiliate does not pay less than a price that would be considered fair to ratepayers for the services or products or for the capital asset.

- For the sale of services or products or for the transfer of capital assets from a non-regulated affiliate to a regulated utility, regulators want to ensure that the regulated utility does not pay more than a price that would be considered fair to ratepayers for the services or products or for the capital asset.

Various methods exist for the pricing of a transfer of services and products and capital assets between the regulated utility and its non-regulated affiliates. State regulatory commissions have adopted several of these methods. The methods addressed in this report are:

- Fully allocated cost
- Incremental cost
- Prevailing market price
- Tariff based prices
- Negotiated prices
- Higher of cost or prevailing market
- Lower of cost or prevailing market

The following section will describe the basis and identify the pros and cons for each transfer pricing method identified above.

Methods

Fully Allocated Cost

Historically, fully allocated cost has often been used by regulators to set transfer prices for services and products. Fully allocated cost methods provide that revenues collected from the sale of services and products, or capital assets equals the sum of the direct costs plus an appropriate share of indirect costs. Fully allocated cost pricing results in adequate revenues that cover total cost for each service and product. For the transfer of capital assets, fully allocated cost reflects the net book value of the capital asset.

Fully allocated cost pricing results in the regulated utility and non-regulated affiliates paying the same price for shared services or products. Many regulators are comfortable with the fully allocated cost methods and generally believe that it results in a fair outcome for utility customers.

From an economic perspective, fully allocated cost pricing eliminates any cross subsidization since the non-regulated affiliate bears all of the incremental costs plus a proportional share of the fixed costs. The method results in prices that are attributable to identifiable and verifiable costs.

However, some economists believe that incremental cost is the most preferable method for setting transfer prices. Fully allocated cost based transfer prices could prevent or discourage economic transactions if the market price is above incremental cost but below fully allocated cost. Customers of the regulated utility would suffer since they would not realize the benefits of a transaction that is otherwise economically justified.

Incremental Cost

As noted above, some economists believe that incremental cost is the preferable method for pricing affiliate transactions and should be used as the benchmark for identification of cross subsidies.[5] This is because any affiliate transfers at incremental cost do not adversely affect the utility customers and incremental cost based transfer prices will maximize economic efficiency.

Economists Michael A. Crew and Paul R. Kleindorfer have stated: "...the use of consumers' and producers' surplus is now broadly accepted as appropriate for welfare analysis in public utility economics. Maximizing net benefit as measured by this traditional welfare function leads to the efficient outcome that price should equal to marginal costs."[6] Likewise, economist Alfred E. Kahn states that "...society's interest is in having transportation, energy or communications provided at the lowest possible cost...And economic efficiency requires, additionally, that no business be turned away that covers the cost to society of providing that service. These basic goals are served by permitting rates to be set at long-run marginal costs."[7] While both economists were discussing the appropriate method for setting prices for regulated utility rates, the concepts are equally applicable to transfer prices.

Transfer prices based on incremental cost, unlike transfer prices based on fully allocated costs, will not prevent or discourage economically justified transactions. Any transaction at a price that exceeds incremental cost will result in lower costs to all customers as compared to the transaction not occurring. Of course, if the utility has an opportunity to sell a service or product to a non-affiliate at a higher price, it should. However, if the price paid by the affiliate is lower than the price paid by regulated utility customers, the transaction may be perceived by regulators as unfair. This is so, even though it would result in lower prices to the regulated utility customers as compared to if the transaction did not take place.

Traditional regulatory ratemaking bases rates on average embedded cost. In an embedded cost study the joint and common costs are allocated to customer classes either on the basis of the overall ratios of costs directly assigned, or by a series of allocators that best reflect the cost causation principles.[8] An additional concern with basing transfer prices on incremental cost is that the prices will deviate from those set under traditional ratemaking for utility services.

Prevailing Market Prices

Prevailing market price, when a market price exists for the service or product, is the preferable method for setting transfer prices while maintaining the "arms length" nature of the transactions, since it reflects the value that the market sets for services or products based on actual supply and demand conditions. Market prices promote economic efficiency (in an effective competitive market) since they take into account both the suppliers' cost of production and the buyers' measure of value.[9] Market based transfer prices should be perceived by regulators as fair since the price for a utility/affiliate transaction would be the same as the price for a non-affiliate transaction.

Unfortunately, market prices that are reflective of the value of intra-firm transactions often do not exist. Also, since some of the services now provided by utilities in a competitive market were formerly provided in a regulated market, workable competition for many of these services may not yet exist.

In the absence of actual market price information, state regulatory commissions may consider administratively determined market prices. For example, concerning the transfer of generation assets, commissions could consider forecasts of the future price of electricity, and determine a transfer price based on those forecasts. Or, commissions could look to recent sales of generation assets by other utilities and develop market price forecasts based on a comparison of those sales to the asset being transferred. However, the use of price forecasts or comparable sales as the basis for setting transfer prices is inferior to the use of actual market price.

Tariff Based Pricing

Tariff based pricing refers to prices that are pre-approved by the regulatory commission and are on file with the commission. Tariff based transfer prices allow for regulatory commissions to review the transfer prices for services and products or capital assets prior to transactions taking place. This could involve either a review of the actual costs that prices are based on, or a review of a method that will set prices based on future costs. Tariff based transfer prices allow for the up front resolution of issues concerning the methods or costs.

Tariff based prices are nondiscriminatory since all customers typically pay the same price for any service or product provided under the tariff. However, tariff based transfer prices can be burdensome if they do not allow for prices to be quickly modified to reflect changed circumstances.

Furthermore, tariffs are set for regulated products and services where regulation is critical to ensure non-discrimination in the provision of essential monopoly services. Tariffs for non-essential services extends regulation into markets that are competitive and do not require regulation. Therefore, tariff based prices treat all products and services as though they were essential monopoly services, which distorts the markets for these products, particularly for non-regulated suppliers.

Negotiated Pricing

Negotiated pricing refers to prices that are based on arms length negotiations between the utility and its affiliates. Negotiated prices allow for real time prices that are reflective of changing market conditions. Negotiated prices avoid distortions created by pre-established transfer prices that are not reflective of current market conditions.

Negotiated prices can lead to different prices for customers that purchase services and products at different points in time. This could be perceived as unfair from a regulatory perspective if an affiliate receives a lower price, even though it may be reflective of lower costs at the time of the purchase.

Asymmetric Pricing - Lower of Cost or Market/Higher of Cost or Market

The lower of cost or market is utilized for transfers from an affiliate to a regulated utility to ensure that the utility is not paying a price more than the regulator would consider fair to ratepayers for the services or products or for the capital asset. By definition, the utility will not pay more than market price and could pay less than market price if the cost is below market.

The higher of cost or market is utilized for transfers from a regulated utility to an affiliate to ensure that the affiliate is not paying a price less than the regulator would consider fair to ratepayers for the services or products or for the asset. For sales from the utility to an affiliate, the utility will be paid at least its costs and could receive payments in excess of its costs if the market price exceeds its costs.

These methods ensure that regulated services are not subsidizing non-regulated services. However, these methods share many of the problems associated with transfer prices based on fully allocated costs. Specifically, while considered fair by regulators since they prevent cross subsidies, these methods may discourage otherwise economic transactions that could lower prices for all customers.

Appendix D contains a chart summarizing the pros and cons associated with the various transfer pricing methodologies.

Which Method is Best?

Determining the correct method for setting transfer prices requires regulators to balance the dual objective of ensuring that customers of the regulated utility are not subsidizing non-regulated activities and promoting economic efficiency that results in the lowest prices. Some of the methods described above tilt in favor of perceived fairness and ensuring no cross subsidies at the expense of economic efficiency, while some do the opposite and promote economic efficiency while giving less weight to perceived fairness, or the cross subsidy issue. The optimal approach is one that gives regulators the flexibility to match the method for setting transfer prices to the specific set of circumstances presented in each case.

Fully allocated cost does not maximize economic efficiency since it can prevent or discourage otherwise economic transactions. However, fully allocated cost is considered by some as the best method since it fairly allocates costs that are common to the provision of both regulated and non-regulated services and results in both regulated utility and non-regulated affiliates paying the same price for regulated or non-tarriffed services or products that are based on the same concept, (*i.e.* fully allocated cost).

On the opposite end of the range of transfer pricing methodologies is incremental cost. While incremental cost is considered the most economically efficient method for setting transfer prices, it is often perceived as unfair since it could result in an affiliate paying a lower price than a regulated utility for the same services or products, because the affiliate would not be making a contribution towards the regulated utility's fixed costs.

The key for regulators is to find the methodology that minimizes compromises to economic efficiency in the name of fairness. For example, assume that the market price for a service provided by a utility to an affiliate is $10. The incremental cost to the utility to provide the service is $8 and the fully allocated cost is $12. The higher of cost or market method would require the utility to charge its affiliate $12 for the service. However, given that the market price for the service is $10, the transaction would not take place since the affiliate could purchase the service elsewhere at the lower market price.[10]

In this example, basing the transfer price on the market price would have allowed the transaction to take place and would have prevented any subsidies from occurring. Further, customers of the utility would have benefited since the transaction would have resulted in a profit of $2 from the sale of the service that could have been used to offset some of the fixed costs or otherwise reduce the costs of the service. The "higher of" method in this example prevented a transaction from occurring without any sound basis in either economic efficiency or fairness. This conclusion is supported by Kenneth W. Costello in his recent article on pricing utility transactions wherein he stated: "The popular "higher of" and "lower of" (or what is often referred to as "asymmetric pricing") provision contained in some states' rules pertaining to the pricing of affiliate transactions seems unnecessary or counterproductive and fundamentally devoid of any sound economic principle."

Basing transfer prices on market prices in this example would represent one reasonable approach to balancing economic efficiency and fairness. While any price above incremental cost would be economically justified, basing transfer prices on market values in this example would have protected customers from subsidizing the affiliate, would be perceived as fair, and would have allowed a beneficial transaction to occur that otherwise would not have occurred if a "higher of" policy was in place.

The same result occurs for transactions from an affiliate to a utility. For example, if an affiliate's fully allocated cost to provide a service is $8 and the market price is $10, the lower of cost or market method would require the affiliate to provide the service for $8. However, the transaction would not take place since the affiliate could sell the service to a non-affiliate for $10. If the utility was able to negotiate a price below the prevailing market price, $9 for example, the "lower of" method would prevent the transaction from taking place and the utility customers would be forced to pay a higher price for the service.

Conclusion

For tariffed services, commissions should provide for maximum transfer pricing flexibility. Commissions will have an opportunity to review tariffs and resolve issues prior to the tariffs becoming effective.

For registered holding companies (pursuant to the Public Utility Holding Company Act of 1935), the SEC has implemented rules that require affiliate transactions to generally be conducted at cost (equivalent to fully allocated cost). Ideally, state commission rules should be consistent with the SEC rules.

For non-tariffed services, regulatory policy concerning transfer prices should balance the dual objectives of economic efficiency and fairness. Rigid "higher of" and "lower of" policies do not meet this objective and may prevent transactions from occurring that could be beneficial to ratepayers.

Market prices should be the benchmark for transfer prices whenever they are readily determinable and reflective of a competitive market. Market prices reflect the value the market places on services, products and capital assets and take into account demand and cost aspects of services, products and assets. Market prices meet the fairness test since all similarly situated affiliated and non-affiliated market participants would pay the same prices for the same services.

However, since market prices are not readily available for many affiliate transactions, a cost based approach must be utilized in many cases. The best policy is one that allows a regulatory commission to determine transfer prices based on a combination of market prices, cost and other information specific to the transaction.

As a general guideline, however, for services and products provided from a regulated utility to a non-regulated affiliate, incremental cost should be considered the floor price. Incremental cost based transfer prices ensure that ratepayers are not harmed by the transaction but suffer from criticisms concerning fairness. Regulatory policy should allow transfer prices to be set below fully allocated cost (and above incremental cost) based on consideration of market prices, cost and other information, whenever the resultant transfer price provides benefits to ratepayers and meets the fairness standard. Likewise, for services and products provided from a non-regulated affiliate to a regulated utility, regulatory policy should allow transfer prices to vary from fully allocated cost based on consideration of market prices, cost and other information.

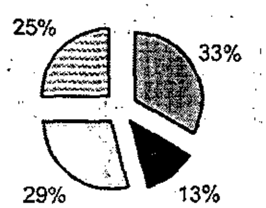
These concepts are similar in nature to those that led regulatory commissions to allow utilities to use flexible pricing to retain customers with competitive options such as self-generation. This practice became prevalent in the 1980's when customers began exploring the installation of cogeneration facilities in response to the Public Utility Regulatory Policy Act ("PURPA"). Commissions recognized that retaining a customer at a rate less than the full tariff rate (presumably based on fully allocated embedded costs), but above incremental cost, could benefit all customers when compared to having the customer leave the utility system. The benefit to other customer's results from the fact that the customer would continue to make a contribution to fixed costs, whereas if the customer left the system, it would make no contribution to fixed costs. Under traditional ratemaking, allowing a customer to leave the utility system could lead to higher costs for all remaining customers since in the next base rate case, remaining costs could be spread over a smaller sales base. Commissions established policies that allowed them to determine prices, sometimes on a case-by-case basis, based on the specific circumstances of situations where other customers would benefit from such discounts and allowed the transactions to occur.

In conclusion, regulatory policies concerning transfer prices should be flexible enough to allow commissions to balance the often-competing objectives of economic efficiency and fairness to ratepayers and competitors of the utility. This requires regulators to make difficult decisions for which no clear answers exist. However, such policies are preferable to policies such as the "higher of" or "lower of" which, while simple and perceived as fair, are not based upon sound economic principles and could prevent otherwise beneficial transactions from occurring.

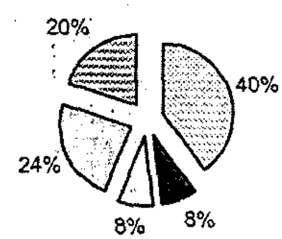
Current Transfer Pricing Rules - Survey Results

The determination of which transfer pricing method is used by regulated utilities and their non-regulated affiliates is clearly a significant issue with state commissions. Nearly all available documentation governing affiliate transactions discusses cost allocation and transfer pricing issues. However, not all commissions responding mandate a specific pricing method. Many commissions simply stated that no cross subsidies were to exist. The survey differentiated cost allocations between capital asset transfers and service and product transfers. The direction of the transaction was also a differentiating factor (*i.e.*, from the regulated utility to the non-regulated affiliate or vice versa). The survey indicated that 60% of the commissions ordered a specific method for pricing of services and products from the non-regulated affiliate to the regulated utility. Similarly, 45% of commissions responding specified a method for the transfers of assets to the regulated utility. For transfers from the regulated utility to the non-regulated affiliates 63% of the responding commissions ordered specific methods of pricing services and product transfers and 55% did the same for capital asset transfers. The following charts indicate the distribution of methods required.

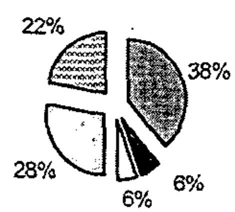
Pricing of Services and Products from the Affiliate to the Utility
(24 of 40 Commissions mandated methods)



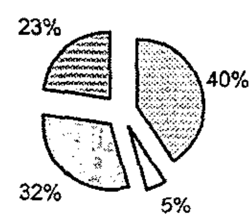
Pricing of Services and Products from the Utility to the Affiliate
(25 of 40 Commissions mandated methods)



Pricing of Asset Transfers from the Affiliate to the Utility
(18 of 40 Commissions mandated methods)



Pricing of Asset Transfers from the Utility to the Affiliate
(22 of 40 Commissions mandated methods)



Higher of Cost or Market
Lower of Cost or Market
Market
Cost
Case by Case
Multiple Methods/Other

For purposes of the preceding charts, similar methods such as lower of fully allocated cost plus 5% or market and lower of fully allocated cost or market were counted as lower of cost or market since they are both variations on the same principle. When referring to cost for capital asset transfers, the commissions generally specified net book cost. Also, where "multiple methods/other" is listed, the commission has a requirement that different methods be used depending on the specific nature of the transfer, or there is a tiered requirement (e.g., fair market value should be used unless market value cannot be established, in which case fully allocated cost should be used), or the specific method was not clear.

Transfer pricing methods and their economic benefits have been clearly described in the previous sections of this document. Of the commissions responding that they have some form of mandate in place, 57% require some form of asymmetric pricing. Many states also mandate specific methods on a case-by-case basis, which indicates that a generic rule is not in place and methods are mandated on a utility-by-utility basis. Case-by-case practices are in use by between 24% and 32% of the commissions depending on the direction and type of transfer. As the charts indicate, the use of cost (representing fully allocated cost for services and products and net book value for capital asset transfers) and fair market value were also common means of pricing transfers between the regulated utility and its non-regulated affiliates.

Given the wide range of methods in use and the complexities of the economic characteristics of these methods, caution should be taken before mandating a specific method. Options exist that may be preferable to asymmetric pricing which will satisfy the overriding requirements that cross subsidies be minimized and economic efficiencies be encouraged.

Market and Regulatory Solutions

Despite regulator concerns, protections against cost subsidization and cost shifting activities between regulated utilities and their non-regulated affiliates have been and continue to be in place through checks and balances. One argument which might be used by regulators as a rationale for imposing asymmetric pricing on regulated utilities and their non-regulated affiliates is the presumption that regulated utilities are naturally disposed to shift costs from non-regulated affiliate operations to captive ratepayers. When this presumption is made, it is important to recognize that safeguards are in place to guard against cost shifting, such as existing regulatory accounting, transfer pricing rules, audits and access to books and records of the regulated utility. Non-regulated business operations are not new to the electric utility industry. Regulatory oversight has controlled cross subsidization in the past. State regulators possess significant authority to protect ratepayer interests in activities, which affect the regulated operating utility company and have ratemaking authority over regulated services, which they can, and do, exercise to protect ratepayers from unreasonable costs.

REPORTING REQUIREMENTS

Given the high level of concern by regulators that affiliate transactions are conducted and regulated adequately, many states have implemented procedures to assist with the monitoring of these transactions. One method for accomplishing this is to establish reporting requirements whereby transactions between the regulated utility and its non-regulated affiliates are reported to the appropriate state commission. Many states have also enacted audit requirements, which will be discussed later, to assist in their monitoring of affiliate transaction activity.

The results of the study indicate the majority, 76% of the states included in the survey responses, have reporting requirements in place. Some additional states (not included in the 76%) that responded they do *not* have requirements in place indicated the ability to request information regarding transactions between the regulated utility and its non-regulated affiliates through rate cases and other means.

Once a commission has determined that a reporting requirement is appropriate, there are several other issues, which will impact both the burden to the utility for reporting and the burden to the commission in their oversight. These issues include: 1) the form of reporting required, 2) the frequency of reporting, and 3) any materiality threshold for amounts to be reported. Despite the general consensus among the commissions responding that some form of reporting is beneficial, no consensus appears to exist regarding the specifics of these reporting requirements.

Form of Reporting

States requiring reporting of the transfer of services and products and/or capital assets mandate several different methods of reporting. Generally, these requirements could be divided into two classes, the first being a historical filing and the second being a prospective filing. Historical filings require the utility to inform the commission after the transfer has occurred, while prospective filings require the utility to inform the commission prior to completing a transfer.

In all but a couple of the states responding, historical reporting was required. An example of this requirement is a state such as Massachusetts, which requires the regulated utility to maintain and file with the commission an annual log of transactions with non-regulated affiliates. This type of reporting allows the commission time to review the submitted transactions without adversely affecting or delaying the transaction. In most states the commission would have ample authority to require an appropriate remedy for any transactions that are considered inappropriate. However, the requirement places a burden on the utility to prepare the information in the required format, and burdens the commissions reviewing the information submitted. Adjusting the mandates relating to the remaining issues of frequency and threshold could further reduce this burden.

States requiring a prospective filing mandate that the regulated utility inform the commission of the transfer prior to its commencement. Where used, this method generally relates to the transfer of capital assets. This can be a broad requirement whereby the utility files, with the commission, a plan for the year with generic details of expected transactions between the utility and its affiliate. As long as transactions are consistent with this pre-filed plan, there are no additional requirements. Further approval is only necessary when the transfer of services and products or capital assets is outside the scope of the plan. Conversely, at least one state requires specific approval of individual transfers as much as thirty days prior to the transaction. The benefit of prospective reporting is that it gives the commissions greater control and reduces the risk of having to go back and "unwind" or otherwise remedy an unacceptable transaction. A downside of this method is the clear potential to interrupt and interfere with the business of the utility. Delays in the approval process or unforeseen transactions could both serve to interrupt business. Additionally, these methods would place a further burden on the commission to act quickly and be responsive to avoid delays.

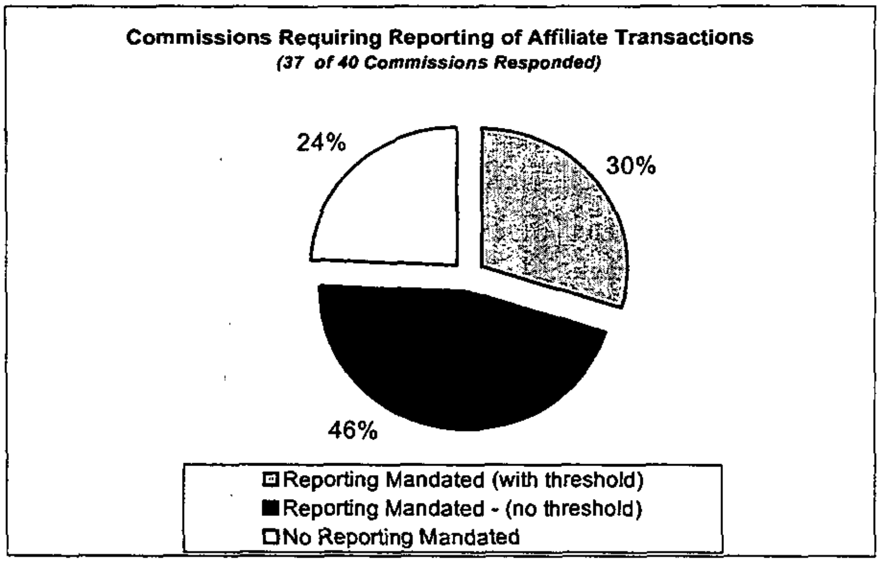
Frequency of Reporting

Commissions requiring reporting of services and products and/or capital asset transfers used two different frequencies, the most prevalent being annual reporting. Other states require transactional reporting, either before or after the transfer of services and products or capital assets that exceed some threshold amount. To some degree, this decision is influenced by the form of reporting opted by the commission. States requiring historical reporting, generally required the transactions to be reported annually, while states that require prospective reports generally require utilities to report potential transactions each time a new transaction is considered.

Pros and cons exist regarding the frequency of reporting. Reporting on an annual basis is likely a lesser burden to both the utility and the commission than transactional reporting. A drawback to annual reporting from the commission's standpoint could be a perceived loss of control and knowledge of the day-to-day affiliate dealings. Transactional reporting provides more timely knowledge of the affiliate transactions at a cost of increased workload, both in oversight and preparation.

Reporting Threshold

Another issue related to the reporting of services and products or capital asset transfers between the utility and its affiliates is the issue of a reporting threshold. Based on the responses, it would appear that only 30% of the states responding have applied a threshold, below which reporting is not required. Regardless of the form and frequency of reporting, there are substantial time and resource commitments required of both the utility and the commissions enacting and overseeing the requirement. Establishing a reasonable threshold is an appropriate means to greatly reduce this commitment while ensuring that material transfers between the utility and its affiliates are reported and being performed in compliance with the rules in place.



A variety of methods are used in establishing thresholds, some as direct dollar amounts, others as a quantifying ratio. Half the states have also allowed for flexibility in the threshold depending on the nature of the transfer and the size of the entities involved. The variability is largely a reflection of the commissions' desired level of involvement and oversight.

Conclusion

Given the majority of commissions that require some level of reporting of service and product and/or capital asset transfers, it appears that commissions perceive such reporting as a valuable means of ensuring compliance with established affiliate rules. Depending on the level of involvement desired by the commissions, many different methods for implementing this requirement exist. It appears reasonable to implement some materiality threshold on reporting requirements, should a commission determine a need exists. However, a commission should carefully evaluate the efficiency and potential effectiveness of establishing such a requirement considering factors such as resources available for compliance and oversight purposes. This is especially true for states requiring prospective filings where the ability to predict minor transfers in the future may be difficult and processing these transfers may cause unnecessary and potentially costly delays for utility business operations. Historical reporting is preferable to prospective reporting unless the prospective reporting requirement is broad enough to cover the nature of acceptable transfers rather than the specifics of individual transfers. Finally, an annual requirement seems to best satisfy the needs for oversight without creating an undue burden on the utility or commission.

OTHER MATTERS

Confidentiality - Survey Results

In a competitive marketplace, utilities could potentially be placed at a competitive disadvantage, especially as it pertains to their non-regulated affiliates, if sensitive information is not kept confidential by commissions requesting or mandating disclosure.

Results of the survey indicate that 91% of commissions responding recognize utility concerns regarding confidentiality. The majority of this 91% indicate they have established procedures that allow a utility to file certain information as confidential in order to meet this concern. At least 33% of the states responding also indicate that although confidential status may be requested by utilities, the commission has the power to override and deny the request.

Some commissions may perceive that they should *not* be held responsible for maintaining the confidentiality of information submitted by regulated utilities. It would be unreasonable for a commission to expect a utility to be held responsible for maintaining the confidentiality of this information, once the information has been submitted and is out of their control.

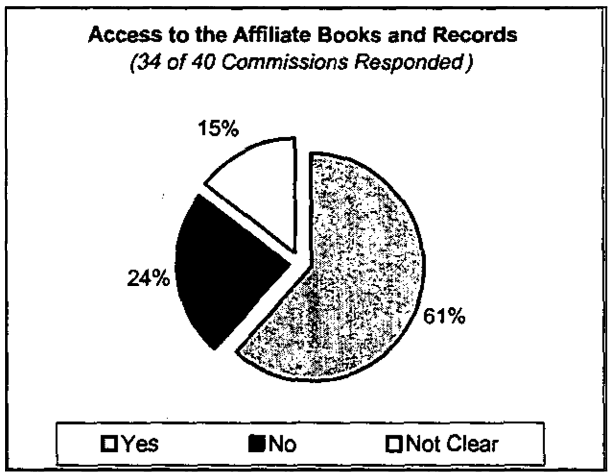
Confidentiality is certainly an issue that needs to be addressed in order to assure regulated utilities and their non-regulated affiliates that sensitive information provided to the commissions will remain confidential and not made public, potentially putting the filing entity at a competitive disadvantage.

Audit Requirements

Access to Affiliate Books and Records - Survey Results

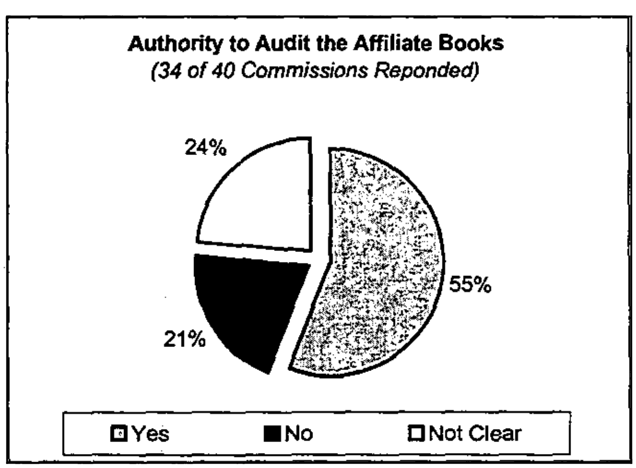
Commission access to the books and records of non-regulated affiliates as they pertain to affiliate transactions often appear in Code of Conduct proceedings. The *level* of access to non-regulated affiliate books and records is a key issue. From a regulator's standpoint, access to transactions between the regulated utility and non-regulated affiliates will ensure oversight authority and help detect possible cross subsidization. For utilities operating in a competitive market, the level of commission access to non-regulated affiliate books and records is particularly sensitive. Non-regulated competitors are not subject to commission oversight and may use information obtained by mandated disclosure to the non-regulated affiliate's competitive disadvantage. Some commissions may contend that open access of all books and records of non-regulated affiliates is necessary and required. Many utilities contend that while the regulatory agency may have access to *jurisdictional* transactions (*i.e.*, those transactions with an impact on the cost of regulated services) between the regulated and non-regulated operations, transactions not pertaining to regulated operations should not be subject to regulator review.

Survey results indicated that while all commissions believe they have authority to access the regulated utility's books and records, significantly less, 61%, indicate they have access to the non-regulated affiliate's books and records with another 15% indicating access authority is not clear.



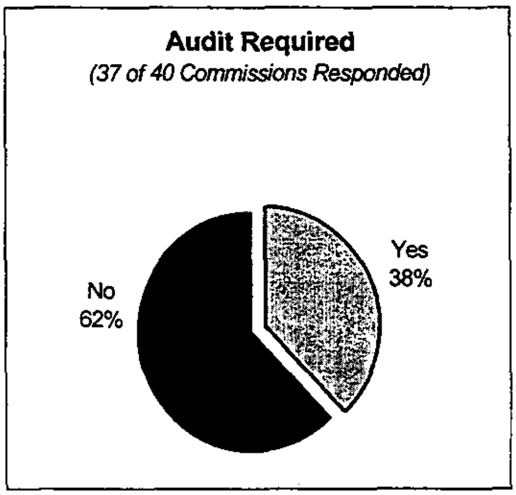
Audit Authority - Survey Results

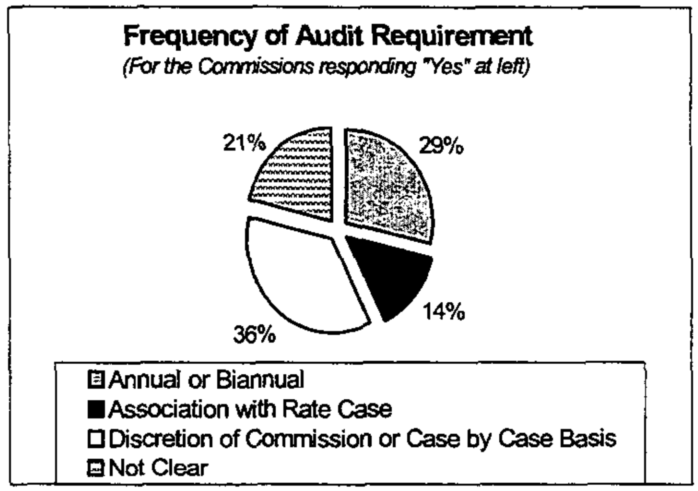
To ensure compliance with affiliate rules, the regulator may have the authority to mandate audits of the non-regulated affiliate, either by commission staff or by outside entities such as an independent audit firm. As mentioned previously, while 61% of commissions indicated they have access to a non-regulated affiliate's books and records, only 55% indicated they had the authority to mandate an audit of the affiliate. The states indicating authority to audit the non-regulated affiliate's books and records usually mandate an audit on an annual or biannual basis to ensure compliance with affiliate rules or in conjunction with a rate case.



Audit Requirements - Survey Results

Beyond the issue of authority to audit is the actual implementation of audit requirements in many jurisdictions. The survey indicated that 38% of the responding state commissions currently have some form of audit requirement in place. Of these commissions requiring an audit, 29% mandate an annual or biannual independent audit of compliance with affiliate transaction rules. The remaining commissions, which specified a frequency, only require an audit when one is warranted or in conjunction with a rate case.





Defining the Term "Audit"

A further concern relating to the states requiring an audit, is the definition of the term "audit". In the classic sense this term would imply performing procedures on a test basis which would give the auditor an appropriate level of assurance that information is correct. With regards to many aspects of affiliate rules this would be particularly difficult, time consuming and costly. An example would be the requirement found in many states' affiliate rules that employees of the regulated utility and non-regulated affiliate not share marketing information regarding customers. Given that much of this sharing could occur through discussions, it would be very difficult and costly to gain the necessary assurance that these discussions were *not* taking place. There are several other subjective requirements, which would be difficult to "audit".

Certified Public Accounting ("CPA") firms could potentially perform other attestation services under Statements on Standards for Attestation Engagements ("SSAE") 3, *Compliance Attestation*, as amended by SSAE 4, *Agreed-Upon Procedures Engagements*, and issue a report accordingly. Additionally, CPA Firms could perform an audit of a schedule of affiliated transactions under Statements on Auditing Standards ("SAS") 62, *Special Reports*.

The options for performing attestation services on the company's compliance with the affiliate transaction rules (or management's assertion thereof) would be as follows:

- Report on management's assertion of compliance
    - Agreed-Upon Procedures
    - Examination
    - Combination of above
- Report on management's assertion of the effectiveness of controls over compliance
    - Agreed-Upon Procedures
    - Examination

In all cases above, SSAE 3 requires that the auditor obtain a written assertion from management in order to provide attest services.

Under SAS 62 the auditor could perform an audit of a "Schedule of Affiliated Transactions." This would provide an "audit," as currently requested in some commission orders/proposals, however, this would only address financial concerns. Service under SAS 62 would obviously offer the highest level of assurance, on a limited area of compliance, however, the bulk of the requirements, which are qualitative in nature, would not be addressed. An agreed-upon procedure engagement as described above would remain the best option for addressing these qualitative concerns.

Conclusion

An agreed-upon procedures engagement concerning management's assertions regarding the utility's compliance with affiliate transaction rules is likely the lowest cost and best option, particularly given the possibly qualitative nature of the commission's requirements. The difficulty will be reaching an agreement with the regulators that such an engagement will satisfy the independent "audit" requirement as delineated in the orders/proposals.

A tangible economic cost exists for utilities required to undergo an audit or other procedures surrounding their compliance with affiliate rules, which must be considered. An alternative, which may prove less costly and still address regulator concerns, is utilized by the state of Illinois. The Illinois Commerce Commission requires the utility's internal audit department to perform an internal audit every two years. This provides some level of assurance that there is compliance at a cost to the company that should be less than that of an annual external audit. The policy of requiring audits or other procedures on an "as needed" basis, as adopted by many of the states, would also appear a reasonable and cost effective approach to assessing compliance.

CONCLUSION

As restructuring of the electric industry continues, an increasing number of utilities will enter competitive markets and engage in non-regulated business operations. Regulatory proceedings addressing issues discussed in this paper, either through Codes of Conduct or through separate rules will also increase. This paper is intended to be used as a resource for discussing and communicating the basic accounting and economic issues related to cost allocation policies and procedures and transfer pricing methods.

REFERENCES

[1] As of June, 1999 there were 19 Registered Public Utility Holding Companies including : Allegheny Energy, Inc.; Ameren; American Electric Power Company; Central and South West Corporation; Cinergy; Columbia Energy Group; Conectiv; Consolidated Natural Gas; Eastern Utilities Associates; Entergy Corporation; General Public Utilities Corporation; Interstate Energy Corporation; National Fuel Gas Company; New Century Energies, Inc.; New England Electric System; Northeast Utilities; PECO Energy; Southern Company; and Unitil Corporation.

[2] Examples of Exempt Holding Companies include: Duke Energy Corporation, FPL Group, PG&E Corporation, PacifiCorp, Reliant Energy, Sempra Energy, and TXU Corp.

[3] *Resolution Regarding Cost Allocation for the Energy Industry*, March 3, 1998 – NARUC Winter Meetings – Washington D.C.

[4] *Accounting Safeguards Under the Telecommunications Act of 1996,* Report and Order, CC Docket No. 96-150, FCC 96-490 (rel. December 24, 1996). FCC Joint Cost Orders, CC Docket No. 86-111, (December 23, 1986).

[5] Kenneth W Costello; "A Pricing Rule for Affiliate Transactions: Room for Consensus", *The Electricity Journal,* December 1998.

[6] Michael A Crew and Paul R. Kleindorfer; "The Economics of Public Utility Regulation"; MIT Press, 1986.

[7] Alfred E. Kahn; "The Economics of Regulation, Principles and Institutions", MIT Press, 1998.

[8] National Association of Regulatory Utility Commissioners; Electric Utility Cost Allocation Manual, February, 1991.

[9] Kenneth W Costello; "A Pricing Rule for Affiliate Transactions: Room for Consensus", *The Electricity Journal,* December 1998.

[10] Ibid. A similar example was used in the Costello article.

APPENDIX A – Copy of the Survey Sent to the State Commissions

We are undertaking a study of the status of Affiliate Transaction rules on behalf of the Edison Electric Institute. We will be happy to share the results of this study once it is complete. Please take a few moments to complete the following questionnaire and assist us in gathering information regarding the rules currently in place, or proposed rules or changes, regarding Affiliate Transactions. Please provide a name, fax and phone number of someone that could be contacted for follow up information if needed. Thank you for your assistance.

Contact Name: ______________________________ **State:** ____________________

Phone Number: ______________________________ **Fax Number:** ____________________

If additional space is needed for any response, feel free to attach additional sheets.

General:

1. Does your state commission have any rules or regulations regarding affiliate transactions between a regulated utility and its non-regulated subsidiaries?

   Yes **No** **Under Consideration**

2. Does your state legislature have any laws regarding affiliate transactions

   Yes **No** **Under Consideration**

3. If "**Yes**" is the answer to either of the above, please indicate the best source of obtaining this information, *i.e.*, Codes of Conduct, Commission Orders, etc. Also, please reference the applicable state statutes and where possible provide copies of these documents, or indicate where these may be obtained (internet address, phone number, mailing address, etc.).

   ____
   ____
   ____

4. If the answer to either question 1 or 2 is "**No**", we would appreciate any information regarding possible upcoming discussions of the affiliate transaction issue.

   ____
   ____
   ____

5. If the answer to either question 1 or 2 is "**Under Consideration**", please reference any preliminary drafts or other public documents, which might be available for review. In addition, provide any dates that might be pertinent to the finalization of orders or legislation related to Affiliate Transactions.

   ____
   ____
   ____

The following questions address specific issues related to Affiliate Transactions. Where rules or changes have not been finalized, but likely will be soon, please indicate so in your answers.

6. Has your state commission recognized the confidentiality of sensitive and competitive information that utilities may be required to file with you in its rules?

   Yes **No**

   If yes, how has this been recognized and addressed?

   ____
   ____
   ____
   ____

7. Have any specific methods of pricing affiliate transactions been mandated for products and services provided to affiliates from the utility?

   Yes **No**

   ... products and services provided to the utility from affiliates?

   Yes **No**

   ... capital asset transfers from the affiliates to the utility?

   Yes **No**

   ... capital asset transfers from the utility to the affiliate?

   Yes **No**

   If "**Yes**" to any of the above, please indicate which methods are approved for each situation (*i.e.* fully allocated costs, lower of cost or market, market, etc.), reference the appropriate docket or statute providing the mandate, and provide the specific reasoning given by the commission for requiring the use of these methods?

   ____
   ____
   ____
   ____
   ____
   ____
   ____
   ____
   ____
   ____
   ____
   ____

8. Does the utility commission have authority to perform audits or some other form of review of the public-utility companies?

Yes **No** **Not Clear**

...of the affiliates?

Yes **No** **Not Clear**

Does the utility commission have statutory authority to obtain access to the books and records of the public-utility companies?

Yes **No** **Not Clear**

...of the affiliates?

Yes **No** **Not Clear**

Please provide details of applicable statute or rulings granting authority for any "**Yes**" answers. Explain further any "**Not Clear**" answers and give insight as to the most likely interpretation used by the commission.

9. Does the commission require an independent audit or review of affiliate transactions?

Yes **No** **Not Clear**

If yes, please describe this requirement (frequency, timing, and nature of review, etc.)

10. Does the commission mandate reporting of products and services or asset transfers between the regulated utility and non-regulated affiliates?

Yes **No**

If yes, what level of reporting is required? Is there a dollar threshold related to these disclosures?

Please return this survey by fax, at your earliest convenience, to the attention of Kent Francois at (202) 638-7844. *If you have any questions, Kent can be reached at (202) 879-5622. Any voluminous supporting documentation can be mailed to Deloitte & Touche, Attn: Kent Francois, 555 12th St. N.W., Suite 500, Washington, DC 20004.*

Thank you for your assistance in completing this questionnaire.

APPENDIX B – Matrix of Survey Results

The following matrix indicates the results of the survey performed on behalf of the Edison Electric Institute by Deloitte and Touche. The majority of the information contained in the matrix was obtained directly from the state commission's answers to the questionnaire shown in Appendix A.

Of the state commissions surveyed, 31 states (Alabama, Arkansas, California, Florida, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New York, North Carolina, North Dakota, Ohio, Rhode Island, South Dakota, Tennessee, Texas, Virginia, West Virginia, Wisconsin and the District of Columbia) completed the survey and returned their written responses. Another two states (South Carolina and Vermont) completed the survey by providing the information over the telephone. Additionally, information related to seven other states (Arizona, Connecticut, Delaware, Maryland, New Jersey, Pennsylvania and Washington) is included in the survey results as sufficient public information was available to substantially complete the survey questions. No responses were received from the remaining states (Alaska, Colorado, Georgia, Hawaii, Kansas, New Hampshire, New Mexico, Oklahoma, Oregon, Utah and Wyoming) and other publicly available information was not considered sufficient to answer the survey questions.

It is also important to note that some states did indicate their responses represented the views of the staff responding and not necessarily those of the commission.

	QUESTION \ STATE		Alabama	Arizona	Arkansas
1	Does the state commission have any rules or regulations regarding affiliate transactions?		No	Yes	Under consideration
2	Does the state legislature have any laws regarding affiliate transactions?		No	No	Yes
3	Describe any "yes" answers to questions #1 and #2	*Commission References*		Docket # RE-00000C-94-0165 requires companies to file a code of conduct subject to commission approval.	
		Legislation References	N/A		Act 1556 of 1999 General Assembly - sections 23-19-403 and 23-19-205(d).
4	Describe any "no" answers to questions # 1 and #2		See Docket 26427. APSC is now considering an investigation into restructuring the electric utility industry.		N/A
5	Describe any "under consideration" answers to #1 and #2		N/A	N/A	Act 1556 requires retail open access by January 1, 2002. Affiliate rules must be developed and implemented no later then 90 days prior to this date. Between now and then, the necessary rule making docket will begin.
6	Does the state recognize confidentiality of sensitive and/or competitive information?		Yes, if or when affiliate rules are issued by the APSC, this issue will be considered.		Yes, see Arkansas Code 823-2-316 & Rule 13.05 of the commission's Rules of Practice and Procedure.
7	Have specific methods been mandated for pricing the following affiliate transactions? If so, describe the method, the docket or statute providing the mandate, and the reasoning for requiring the method.				
	* Products and service provided *from* the affiliate *to* the utility		No		No
	* Products and services provided *from* the utility *to* the affiliates		No	Yes, higher of fully allocated cost or fair market value	No
	* Capital asset transfers *from* the affiliate *to* the utility		No		No
	* Capital asset transfers *from* the utility *to* the affiliate		No	Yes, higher of cost or fair market value.	No
8	Does the commission have the authority to:				
	* perform audits or other forms of review of the utility?		Yes	Yes	Yes
	* perform audits or other forms of review of the affiliate?		No		Yes
	* obtain access to books and records of the utility?		Yes		Yes
	* obtain access to books and records of the affiliate?		No		Yes
		References & Explanations	Alabama Code 37-1-32		The commission has the authority to audit gas, electric, water and sewer utilities. Implementation of Act 1556 of the 1999 Arkansas General Assembly may alter the traditional approach to conducting audits of electric utilities and affiliate transactions.
9	Does the commission require an independent audit or review?		Yes, the commission can and does require an independent audit of regulated utilities at its discretion.	Yes	No
10	Does the commission mandate reporting of products and services or asset transfers? If so, what level of reporting is required and is there a stipulated threshold?		No		No, rules will be developed as directed in Act 1556 of the 1999 Arkansas General Assembly.

	QUESTION \ STATE		California	Connecticut	Delaware
1	Does the state commission have any rules or regulations regarding affiliate transactions?		Yes	Yes	Yes
2	Does the state legislature have any laws regarding affiliate transactions?		Yes		
3	Describe any "yes" answers to questions #1 and #2	*Commission References*	Decision 97-12-088, as modified by D.98-08-035 - Address, generally, holding companies and their affiliates.		There is an approved code of conduct for Delmarva Power & Light
		Legislation References			
4	Describe any "no" answers to questions # 1 and #2		N/A	N/A	N/A
5	Describe any "under consideration" answers to #1 and #2		N/A	N/A	N/A
6	Does the state recognize confidentiality of sensitive and/or competitive information?		Yes, PUC Code 583 and a CPUC General Order provide for confidential filings if the presiding law judge agrees that information should be confidential.		
7	Have specific methods been mandated for pricing the following affiliate transactions? If so, describe the method, the docket or statute providing the mandate, and the reasoning for requiring the method.				
	• Products and service provided *from* the affiliate *to* the utility		Yes, see Rule V.H. which provide for pricing at no more then fair market value or the lower of fully loaded costs or fair market value (dependent on the nature of the goods and services).	Yes, shared services transfers are to be made at cost or as otherwise determined by the commission. All other products and services (not shared services), are to be made at fair market value.	Yes, on a case by case basis per CAM.
	• Products and services provided *from* the utility *to* the affiliates		Yes, see Rule V.H.. Pricing is generally at market, unless no market exists. If no market exists, products and services are priced at fully loaded cost plus 5% of direct labor.	Yes, for shared services transfers are to be made at cost or as otherwise determined by the commission. All other (not for shared services), are to be made at fair market value	Yes, on a case by case basis per CAM.
	• Capital asset transfers *from* the affiliate *to* the utility		No, non-discrimination is required but no pricing method is specified. See Rules III. B. 1.		Yes, on a case by case basis per CAM.
	• Capital asset transfers *from* the utility *to* the affiliate		No, non-discrimination is required but no pricing method is specified.		Yes, on a case by case basis per CAM.
8	Does the commission have the authority to:				
	• perform audits or other forms of review of the utility?		Yes		Yes
	• perform audits or other forms of review of the affiliate?		Yes	Not Clear	Yes
	• obtain access to books and records of the utility?		Yes	Yes	Yes
	• obtain access to books and records of the affiliate?		Yes	Yes	Yes
		References & Explanations	The commission may only audit or review the books of the affiliate when the issue involves the welfare of the ratepayer.		
9	Does the commission require an independent audit or review?		Yes, an annual independent audit is required at the shareholders' expense. See Rule VI. C-F	Yes, an audit is required annually at shareholder expense.	No
10	Does the commission mandate reporting of products and services or asset transfers? If so, what level of reporting is required and is there a stipulated threshold?		Yes, Rules III-F and IV-H. There is no threshold.	Yes	Yes, Code of Conduct Proposals/Decisions. There is an annual reporting requirement.

	QUESTION \ STATE		Florida	Idaho	Illinois
1	Does the state commission have any rules or regulations regarding affiliate transactions?		No	Yes	Yes
2	Does the state legislature have any laws regarding affiliate transactions?		No	Yes/Under consideration	Yes
3	Describe any "yes" answers to questions #1 and #2	*Commission References*		Statndads of Conduct for gas utilities - Orders #26051 and #27799, various Idaho court cases	Dockets # 98-0013 and # 98-0035
		Legislation References	N/A	Idaho Code Section 61-610	Article VII and Section 16-111g
4	Describe any "no" answers to questions # 1 and #2		The state requires that utility ratepayers do not subsidize utility operations. Staff has held two workshops and are drafting proposed rules - no date set or draft.	N/A	N/A
5	Describe any "under consideration" answers to #1 and #2			Idaho Code Section 61-610 was proposed to be amended by Senate Bill 1154; bill passed in Senate; withdrawn by sponsor in the House.	N/A
6	Does the state recognize confidentiality of sensitive and/or competitive information?		Yes, the commission has a confidentiality process by rule. Florida statutes stipulate what is considered to be confidential. See Statute 366.093.	Yes, see Idaho Code Section 48-801 and Section 9-340D. Also, see PUC Rule IDAPA 31.02.01.000 et seq.	Yes, the commission will provide adequate protection for confidential information filed. See Section 4-404 of the Public Utilities Act.
7	Have specific methods been mandated for pricing the following affiliate transactions? If so, describe the method, the docket or statute providing the mandate, and the reasoning for requiring the method.				
	* Products and service provided *from* the affiliate *to* the utility		No	No, there are not any mandated methods but several methods have been used on a case by case basis.	No, pricing of goods and services is addressed in Admin. Code Section 450.120 on a case by case basis.
	* Products and services provided *from* the utility *to* the affiliates		No	No	No, pricing of goods and services is addressed in Admin. Code Section 450.120 on a case by case basis.
	* Capital asset transfers *from* the affiliate *to* the utility		No	No	No
	* Capital asset transfers *from* the utility *to* the affiliate		No	No, gains on sale of depreciable property benefit ratepayers. Gains on sale of real property benefit shareholders.	No
8	Does the commission have the authority to:				
	* perform audits or other forms of review of the utility?		Yes	Yes	Yes
	* perform audits or other forms of review of the affiliate?		Yes	Not Clear	Yes
	* obtain access to books and records of the utility?		Yes	Yes	Yes
	* obtain access to books and records of the affiliate?		Yes	Not Clear	Yes
		References & Explanations	Statute 366.05	Idaho Code Section 61-610. The commission believes its authority probably extends to the books and records for affiliate transactions. (the Purpose of Senate Bill 1154 was to clarify authority.)	
9	Does the commission require an independent audit or review?		No	No	No, however, the commission requires a biennial internal audit.
10	Does the commission mandate reporting of products and services or asset transfers? If so, what level of reporting is required and is there a stipulated threshold?		Yes, annual filings are required with varying thresholds depending on the nature and amount of the transaction.	No	Yes, stipulated threshold varies depending on size of utility and type of transfer.

	QUESTION \ STATE		Indiana	Iowa	Kentucky
1	Does the state commission have any rules or regulations regarding affiliate transactions?		Yes	Yes	Under consideration
2	Does the state legislature have any laws regarding affiliate transactions?		Yes	Yes/Under consideration	No
3	Describe any "yes" answers to questions #1 and #2	*Commission References*	Order in Cause numbers 41210, 41094 and 39897	Iowa Admin Code 199-31	
		Legislation References	Title 8-1-2-49 through 52	Iowa Code Sections 476.71-.75, .78	N/A
4	Describe any "no" answers to questions # 1 and #2		N/A	N/A	
5	Describe any "under consideration" answers to #1 and #2		N/A	H.F. 740 - to be taken up by legislature in the fall of 1999.	The commission has an open docket ADM-369. Docket is on cost allocation and affiliate transaction guidelines and code of conduct for utilities with affiliates.
6	Does the state recognize confidentiality of sensitive and/or competitive information?		Yes, entities may file for confidential status subject to review by an Administrative Law Judge.	Yes, Iowa Code Section 22.7, Admin Code Chap. 199-1 p 4-7, 39	Yes, state statutes prescribe the process for establishing confidential material. The commission determines what material is confidential based upon the filing.
7	Have specific methods been mandated for pricing the following affiliate transactions? If so, describe the method, the docket or statute providing the mandate, and the reasoning for requiring the method.				
	* Products and service provided *from* the affiliate *to* the utility		Yes, pricing is typically associated with negotiated settlements on a case by case basis	Yes, see Iowa Code 476.78 and Iowa Admin Code 199-31. Products and services are priced at fair market value, or if not available, fully distributed cost.	Yes, transfer of products and services are priced at the lower of cost or market.
	* Products and services provided *from* the utility *to* the affiliates		Yes, pricing is typically associated with negotiated settlements on a case by case basis	Yes, see Iowa Code 476.78 and Iowa Admin Code 199-31. Products and services are priced at fully distributed cost.	Yes, transfer of products and services are priced at the higher of cost or market.
	* Capital asset transfers *from* the affiliate *to* the utility		Yes, pricing is typically associated with negotiated settlements on a case by case basis	Yes, see Iowa Code 476.78 and Iowa Admin Code 199-31. Assets are transferred at the lower of book value or market value.	Yes, assets are transferred at cost.
	* Capital asset transfers *from* the utility *to* the affiliate		Yes, pricing is typically associated with negotiated settlements on a case by case basis	Yes, see Iowa Code 476.78 and Iowa Admin Code 199-31. Assets are transferred at the greater of book value or market value.	Yes, assets are transferred at cost.
8	Does the commission have the authority to:				
	* perform audits or other forms of review of the utility?		Yes	Yes	Yes
	* perform audits or other forms of review of the affiliate?		Yes	Yes	Not Clear
	* obtain access to books and records of the utility?		Yes	Yes	Yes
	* obtain access to books and records of the affiliate?		Yes	Yes	Not Clear
		References & Explanations		Iowa Code 476.31 and .75	The commission has required access to books and records of affiliates in cases approving establishment of holding companies of major utilities.
9	Does the commission require an independent audit or review?		Yes, on a case by case basis.	Yes, Iowa 4+Q876.75 provides for an audit only if there is a good reason and not more than once every three years. The cost is to be included in rates.	No
10	Does the commission mandate reporting of products and services or asset transfers? If so, what level of reporting is required and is there a stipulated threshold?		Yes, thresholds vary on a case by case basis.	Yes, the threshold is the lesser of $50,000 or 5% of capital equity. Annual filing is required per references: Iowa Code 476.74 and Iowa Admin Code 199-31.	Yes, in certain cases approving the creation of holding companies, the commission established guidelines and filing requirements for some transactions.

QUESTION \ STATE		Louisiana	Maine	Maryland
1 Does the state commission have any rules or regulations regarding affiliate transactions?		No	Yes	Yes
2 Does the state legislature have any laws regarding affiliate transactions?		No	Yes	
3 Describe any "yes" answers to questions #1 and #2	*Commission References*		State Commission Rules Chapter 304, 820	Order No. 74038 (sets forth cost allocation principles and standards of conduct for gas and electric utilities)
	Legislation References	N/A	State Statutes 35-A M.R.S.A., Sections 707,708,713,714,715, and 35-A M.R.S.A Sections 3205, 3206,3207	N/A
4 Describe any "no" answers to questions # 1 and #2		No rulemaking or legislation is forthcoming	N/A	N/A
5 Describe any "under consideration" answers to #1 and #2		N/A	N/A	N/A
6 Does the state recognize confidentiality of sensitive and/or competitive information?		Yes, LPSC Order 8-31-92	Yes, the commission regularly issues protective orders on a case by case basis.	
7 Have specific methods been mandated for pricing the following affiliate transactions? If so, describe the method, the docket or statute providing the mandate, and the reasoning for requiring the method.				
• Products and service provided *from* the affiliate *to* the utility		No	Yes, rules require services be provided at market rates or fully allocated costs if market rates are unavailable.	
• Products and services provided *from* the utility *to* the affiliates		No	Yes, rules require services be provided at market rates or fully allocated costs if market rates are unavailable.	Yes, joint costs should be allocated based on a fully distributed cost methodology. Services from utility to affiliate which could be marketed by the utility and have value to the affiliate are transferred at market.
• Capital asset transfers *from* the affiliate *to* the utility		No	Yes	Yes, joint costs should be allocated based on a fully distributed cost methodology. Assets transferred from an affiliate to a parent should be at the lessor of book value or market value.
• Capital asset transfers *from* the utility *to* the affiliate		No	Yes	Yes, joint costs should be allocated based on a fully distributed cost methodology. Assets transferred from the parent to an affiliate should be at the greater of book value or market value.
8 Does the commission have the authority to:				
• perform audits or other forms of review of the utility?		Yes	Yes	
• perform audits or other forms of review of the affiliate?		Yes	Yes	
• obtain access to books and records of the utility?		Yes	Yes	
• obtain access to books and records of the affiliate?		Yes	Yes	
	References & Explanations			
9 Does the commission require an independent audit or review?		No	Yes. Technically, an independent audit is not required but, the commission is required to approve all affiliate transactions.	
10 Does the commission mandate reporting of products and services or asset transfers? If so, what level of reporting is required and is there a stipulated threshold?		Yes, the threshold is set at 1% of gross assets. See state commission General Order 3-18-94	Yes, approval is required unless exempt by rule or order.	Yes, quarterly earnings reports are required.

	QUESTION \ STATE		Massachusetts	Michigan	Minnesota
1	Does the state commission have any rules or regulations regarding affiliate transactions?		Yes	Yes	Yes
2	Does the state legislature have any laws regarding affiliate transactions?		Yes	No	Yes
3	Describe any "yes" answers to questions #1 and #2	*Commission References*	220 CMR 12.00 et seq	Rate Case # U-8678, U-8924, U-9197, Rate Case # U-10149, U-10150, and Rate Case # U-11682, U-11220	Order EG-999/CI-98-651, and Order EG-999/CI-90-1008
		Legislation References			Minnesota Rules 7825.1900 et seq., Minn. Statute 216B.48
4	Describe any "no" answers to questions # 1 and #2		N/A	U-11916, U-11290	N/A
5	Describe any "under consideration" answers to #1 and #2		N/A	See # 4	N/A
6	Does the state recognize confidentiality of sensitive and/or competitive information?		No	No	Yes
7	Have specific methods been mandated for pricing the following affiliate transactions? If so, describe the method, the docket or statute providing the mandate, and the reasoning for requiring the method.				
	• Products and service provided *from* the affiliate *to* the utility		Yes, affiliates may provide services to the utility at a price no greater than market	No, however, services from the affiliate to the utility are priced at the lessor of fully allocated cost + 10% -or- market value.	Yes, though fully allocated costing is required, in certain limited circumstances incremental costing may be permitted.
	• Products and services provided *from* the utility *to* the affiliates		Yes, the utility may provide services to an affiliate at no less than fully allocated cost.	No, however, market information, technical information or other data transferred from the utility to the affiliate is priced at the higher of cost or market.	Yes, though fully allocated costing is required, in certain limited circumstances incremental costing may be permitted.
	• Capital asset transfers *from* the affiliate *to* the utility		Yes, an affiliate may transfer assets to the utility at a price no greater than market.	No, however, assets transferred from the affiliate to the utility are priced at the lower of cost or market.	Not aware of any
	• Capital asset transfers *from* the utility *to* the affiliate		Yes, the utility can transfer assets (in rates) at higher of net book or market value affiliates.	No, however, assets transferred from the utility to the affiliate are priced at the higher of cost or market.	Yes, determined on a case by case basis.
8	Does the commission have the authority to:				
	• perform audits or other forms of review of the utility?		Yes	Yes	Yes
	• perform audits or other forms of review of the affiliate?		Yes	No	Yes
	• obtain access to books and records of the utility?		Yes	Yes	Yes
	• obtain access to books and records of the affiliate?		Yes	No	Yes
		References & Explanations	See GLC 164 Section 85	MCL 460.55 and .56, MSA 22.5 and .6, USOA pg 226B, 260B+W8, 358-359 and 360-363	Minnesota Statue 216B.10 and 216B.12
9	Does the commission require an independent audit or review?		No	Yes, audits are required in any rate case.	No
10	Does the commission mandate reporting of products and services or asset transfers? If so, what level of reporting is required and is there a stipulated threshold?		Yes, utilities must maintain a log to be filed annually - no later than Jan. 15th of each year for the previous year.	Yes, the threshold is $100,000 for asset transfers. Commission notification is required 30 days prior to transfer.	Yes, this is only required on a case by case basis.

	QUESTION \ STATE		Mississippi	Missouri	Montana
1	Does the state commission have any rules or regulations regarding affiliate transactions?		No	Under consideration	Yes
2	Does the state legislature have any laws regarding affiliate transactions?		No	Yes	No
3	Describe any "yes" answers to questions #1 and #2	*Commission References*			Docket # D97.7.90, Order 5986
		Legislation References	N/A	Missouri Statutes, Title XXV, Chapter 386	
4	Describe any "no" answers to questions # 1 and #2			N/A	The legislature is not addressing standards of conduct.
5	Describe any "under consideration" answers to #1 and #2		N/A	Rules have been submitted for comment and are awaiting Commission's final order. Rules are expected to closely mirror the state statute.	N/A
6	Does the state recognize confidentiality of sensitive and/or competitive information?		Yes, the commission has a rule providing for confidentiality that the utilities may file under.	Yes, per the proposed rules: as currently mandated. No special consideration deemed necessary at this time.	Yes, utilities may request a protective order from the commission for sensitive and competitive information.
7	Have specific methods been mandated for pricing the following affiliate transactions? If so, describe the method, the docket or statute providing the mandate, and the reasoning for requiring the method.				
	• Products and service provided *from* the affiliate *to* the utility		No	Yes, Per proposed rules and Statute 386.756.3. Products and services priced at the lesser of fair market value or fully distributed costs.	No
	• Products and services provided *from* the utility *to* the affiliates		No	Yes, Per proposed rules and Statute 386.756.3. Products and services are priced at the greater of fair market value or fully distributed costs.	No
	• Capital asset transfers *from* the affiliate *to* the utility		No	Yes, per proposed rules and Statute 386.756.3. Asset transfers are priced at the lesser of fair market value or fully distributed costs.	No
	• Capital asset transfers *from* the utility *to* the affiliate		No	Yes, Per proposed rules and Statute 386.756.3. Asset transfers are priced at the greater of fair market value or fully distributed costs.	No
8	Does the commission have the authority to:				
	• perform audits or other forms of review of the utility?		Yes	Yes	Yes
	• perform audits or other forms of review of the affiliate?		Not Clear	Not Clear	No
	• obtain access to books and records of the utility?		Yes	Yes	Yes
	• obtain access to books and records of the affiliate?		No	Not Clear	No
		References & Explanations		Per state statute, the commission is allowed to perform audits of utilities.	Title 69, Chap 3, Part 106 of the Montana Code authorizes the commission to inspect books, accounts, papers, records and memoranda of any public utility.
9	Does the commission require an independent audit or review?		No	No	Yes, the commission has the authority to examine/audit affiliate transactions and would do it if it is in the context of a rate case and there was a perceived need.
10	Does the commission mandate reporting of products and services or asset transfers? If so, what level of reporting is required and is there a stipulated threshold?		Yes, $1,000,000 or more. However, all transfers are reported by utilities in some type of form.	Yes, must be reported on or before March 15th annually. No threshold has been set at this time.	Yes, required reporting as part of affiliates annual report to the commission

QUESTION \ STATE		Nebraska	Nevada	New Jersey
1 Does the state commission have any rules or regulations regarding affiliate transactions?		Yes/Under Consideration	Yes	Under consideration
2 Does the state legislature have any laws regarding affiliate transactions?		Yes	Yes	
3 Describe any "yes" answers to questions #1 and #2	*Commission References*	Commission Orders C-2044 and C-1830	Docket # AC1997-5034, 12/30/98 Order	
	Legislation References		A.B. 366 (1997) and S.B. 438 (1999)	N/A
4 Describe any "no" answers to questions # 1 and #2		N/A	N/A	N/A
5 Describe any "under consideration" answers to #1 and #2		Commission Order C-2044, (Legislative Bill 150)	N/A	N/A
6 Does the state recognize confidentiality of sensitive and/or competitive information?		No	Yes, the commission has established rules for filing of purportedly proprietary information.	
7 Have specific methods been mandated for pricing the following affiliate transactions? If so, describe the method, the docket or statute providing the mandate, and the reasoning for requiring the method.				
• Products and service provided *from* the affiliate *to* the utility		No	Yes, affiliate to utility products and services are priced at the lower of cost or market.	Yes, priced at no higher than fair market value.
• Products and services provided *from* the utility *to* the affiliates		No	Yes, utility to affiliate products and services are priced at the higher of cost or market.	Yes, priced at no lower than fair market value.
• Capital asset transfers *from* the affiliate to the utility		No	Yes	Yes, priced at the lower of book value or fair market value.
• Capital asset transfers *from* the utility *to* the affiliate		No	Yes	Yes, priced at the higher of book cost or fair market value.
8 Does the commission have the authority to:				
• perform audits or other forms of review of the utility?		Yes	Yes	Yes
• perform audits or other forms of review of the affiliate?		Not Clear	Yes	
• obtain access to books and records of the utility?		Yes	Yes	Yes
• obtain access to books and records of the affiliate?		Not Clear	Yes	
	References & Explanations		Audits/review of affiliates for purposes of regulating the utility only.	Commission will audit affiliate transactions at least every two years
9 Does the commission require an independent audit or review?		No	Yes	Yes, audits are performed at the utilities' expense and filed every two years.
10 Does the commission mandate reporting of products and services or asset transfers? If so, what level of reporting is required and is there a stipulated threshold?		No	Yes	

QUESTION \ STATE			New York	North Carolina	North Dakota
1	Does the state commission have any rules or regulations regarding affiliate transactions?		Yes	No	No
2	Does the state legislature have any laws regarding affiliate transactions?		No	Yes	No
3	Describe any "yes" answers to questions #1 and #2	*Commission References*	New York State Consolidated Laws, Public Service, Article 6, Sections 66 and 110. Also, Title 16, Chapter I, Subchapter D, Part 61, Section 61.6 and Part II, Subchapter F, Part 166, Sectioon 166.14	Has historically been adressed on a utility by utility basis when merger applications are filed.	
		Legislation References			N/A
4	Describe any "no" answers to questions # 1 and #2				None Pending
5	Describe any "under consideration" answers to #1 and #2		N/A	N/A	N/A
6	Does the state recognize confidentiality of sensitive and/or competitive information?		Yes, a Records Access Officer rules on requests for confidential treatment.	Yes, if challenged, the utility has the burden of proof to show that certain information remains confidential. Confidential information is subject to the state's Public Records Act, N.C.G.S. Section 132-1	Yes, there are statutory trade secret protection provisions for any type of filing with sensitive information.
7	Have specific methods been mandated for pricing the following affiliate transactions? If so, describe the method, the docket or statute providing the mandate, and the reasoning for requiring the method.				
	* Products and service provided *from* the affiliate *to* the utility		Yes, determined on a case by case basis.	Yes, the rules have been established on a case by case basis with the two large utilities rather on a generic basis (asymmetric pricing - lower of market or fully distributed costs).	No
	* Products and services provided *from* the utility *to* the affiliates		Yes, determined on a case by case basis.	Yes, the rules have been established on a case by case basis with the two large utilities rather than on a generic basis (asymmetric pricing - higher of market or fully distributed costs).	No
	* Capital asset transfers *from* the affiliate *to* the utility		Yes, determined on a case by case basis.	Yes, the rules have been established on a case by case basis with the two large utilities rather than on a generic basis (lower of cost or fair market value).	No
	* Capital asset transfers *from* the utility *to* the affiliate		Yes, determined on a case by case basis.	Yes, the rules have been established on a case by case basis with the two large utilities rather than on a generic basis (higher of cost or fair market value).	Yes, state law provides that a public utility may not dispose of tangible property valued at $500,000 or more without commission approval.
8	Does the commission have the authority to:				
	* perform audits or other forms of review of the utility?		Yes	Yes	Yes
	* perform audits or other forms of review of the affiliate?		Yes	Yes	No
	* obtain access to books and records of the utility?		Yes	Yes	Yes
	* obtain access to books and records of the affiliate?		Yes	Yes	No
		References & Explanations			North Dakota law gives the commission power to investigate all methods and practices of public utilities, and to require copies of reports, rates, classifications, schedules and other information desired by the commission relating to an investigation.
9	Does the commission require an independent audit or review?		No	No	No
10	Does the commission mandate reporting of products and services or asset transfers? If so, what level of reporting is required and is there a stipulated threshold?		Yes. There is no generic mandate, however, settlement agreements generally require some form of reporting.	Yes, entities must file copies of contracts and their annual report (not a generic rule, rather on a case by case basis).	No

	QUESTION \ STATE		Ohio	Pennsylvania	Rhode Island
1	Does the state commission have any rules or regulations regarding affiliate transactions?		Yes	Under consideration	No
2	Does the state legislature have any laws regarding affiliate transactions?		Under consideration		Yes
3	Describe any "yes" answers to questions #1 and #2	*Commission References*			
		Legislation References		N/A	39-1-27.6 and 39-3-27 through 39-3-30 of the General Laws of the State of Rhode Island
4	Describe any "no" answers to questions # 1 and #2		N/A	N/A	
5	Describe any "under consideration" answers to #1 and #2		Legislation under consideration. Action expected by June 1999		N/A
6	Does the state recognize confidentiality of sensitive and/or competitive information?		Yes, information filed as confidential gets confidential treatment.		Yes, Rule 1.2(g)
7	Have specific methods been mandated for pricing the following affiliate transactions? If so, describe the method, the docket or statute providing the mandate, and the reasoning for requiring the method.				
	* Products and service provided *from* the affiliate *to* the utility		No, however, on a case by case basis, some methods have been mandated.	Yes	No
	* Products and services provided *from* the utility *to* the affiliates		No, however, on a case by case basis, some methods have been mandated.	Yes, generally priced at the higher of cost or market.	No
	* Capital asset transfers *from* the affiliate *to* the utility		No, however, on a case by case basis, some methods have been mandated.		No
	* Capital asset transfers *from* the utility *to* the affiliate		No, however, on a case by case basis, some methods have been mandated.		No
8	Does the commission have the authority to:				
	* perform audits or other forms of review of the utility?		Yes		Yes
	* perform audits or other forms of review of the affiliate?		Yes		Yes
	* obtain access to books and records of the utility?		Yes		Yes
	* obtain access to books and records of the affiliate?		Yes		Yes
		References & Explanations	Current statutes have given the commission authority to investigate and view source documentation. Merger agreements have given the commission access to affiliate books and records for transactions involving the operating utilities.		39-3-30 of the General Laws of the State of Rhode Island
9	Does the commission require an independent audit or review?		Yes		No
10	Does the commission mandate reporting of products and services or asset transfers? If so, what level of reporting is required and is there a stipulated threshold?		Yes, requirement is on a case by case basis during rate setting procedures.		Yes, threshold is set at greater than $500. References: 39-3-28 of the General Laws of the State of Rhode Island.

QUESTION \ STATE			South Carolina	South Dakota	Tennessee
1	Does the state commission have any rules or regulations regarding affiliate transactions?		No	Yes	Yes
2	Does the state legislature have any laws regarding affiliate transactions?		No	Yes	No
3	Describe any "yes" answers to questions #1 and #2	*Commission References*		Docket F-3126	Final Order on Phase I of United Cities Gas Company's Incentive Plan (dated 2/22/99)
		Legislation References	N/A		
4	Describe any "no" answers to questions # 1 and #2		Order 92-931 outlined affiliate rules relating to SCANA and its affiliates	N/A	Tennessee Regulatory Authority is considering affiliate rules for all gas and electric companies
5	Describe any "under consideration" answers to #1 and #2		N/A	N/A	N/A
6	Does the state recognize confidentiality of sensitive and/or competitive information?		Yes	Yes, ARSD 20:10:01:39	Yes, companies request confidential treatment on an as needed basis.
7	Have specific methods been mandated for pricing the following affiliate transactions? If so, describe the method, the docket or statute providing the mandate, and the reasoning for requiring the method.				
	• Products and service provided *from* the affiliate *to* the utility		No	Yes, court ruling in Docket F-3126 provided for pricing at fair market value.	No
	• Products and services provided *from* the utility *to* the affiliates		No	No	No
	• Capital asset transfers *from* the affiliate *to* the utility		No	No	No
	• Capital asset transfers *from* the utility *to* the affiliate		No	Yes	No
8	Does the commission have the authority to:				
	• perform audits or other forms of review of the utility?		Yes	Yes	Yes
	• perform audits or other forms of review of the affiliate?		Not Clear	No	No
	• obtain access to books and records of the utility?		Yes	Yes	Yes
	• obtain access to books and records of the affiliate?		Not Clear	Yes	No
		References & Explanations	The commission feels it has the authority necessary to review documentation related to the affiliate transactions.	SDCL 49-34A-40, 41 and 19.1	
9	Does the commission require an independent audit or review?		No	No	Yes, transactions with affiliates are audited in conjunction with the actual cost adjustment of the purchased gas adjustment rule.
10	Does the commission mandate reporting of products and services or asset transfers? If so, what level of reporting is required and is there a stipulated threshold?		SCANA is required to file annually and there are thresholds in place relating to asset transfers.	No	Yes, the company shall maintain sufficiently detailed records such that compliance with these guidelines can be verified at any time.

	QUESTION \ STATE		Texas	Vermont	Virginia
1	Does the state commission have any rules or regulations regarding affiliate transactions?		Yes	No	Yes
2	Does the state legislature have any laws regarding affiliate transactions?		Yes	No	Yes
3	Describe any "yes" answers to questions #1 and #2	*Commission References*	Public Utility Regulatory Act--Commission Substantive Rules 25.84 and 26.84 (a broader rule is expected this fall)		
		Legislation References	New legislative bill will have guidelines for affiliate rules	N/A	Chapter 4 of Title 56 (Guidelines for filing applications under Title 56, Chapter 4) of the Code of Virginia
4	Describe any "no" answers to questions # 1 and #2		N/A		N/A
5	Describe any "under consideration" answers to #1 and #2		N/A	N/A	N/A
6	Does the state recognize confidentiality of sensitive and/or competitive information?		Yes, procedures are in place to handle confidential information.		Yes, there are specific procedure for the filing of confidential information.
7	Have specific methods been mandated for pricing the following affiliate transactions? If so, describe the method, the docket or statute providing the mandate, and the reasoning for requiring the method.				
	* Products and service provided *from* the affiliate *to* the utility		No, there is no mandate. However, based on prior docket decisions, pricing guidelines are: affiliate to utility transfers shall be priced at cost or lower than cost and equal to or less than stand alone cost and no higher than the amount charged to a third party or other affiliate.		Yes, products and services are transferred at the lower of cost or market. There may be exceptions to the rules on a case by case basis pricing is addressed in each order.
	* Products and services provided *from* the utility *to* the affiliates		No, there is no mandate. However, based on prior docket deceisions, pricing guidelines are: utility to affiliate transfers shall be priced at cost or greater than cost and no less than the amount billed to a third party.		Yes, products and services are transferred at the higher of cost or market. There may be exceptions to the rules on a case by case basis as pricing is addressed in each order.
	* Capital asset transfers *from* the affiliate *to* the utility		No		Yes, assets are transferred at the lower of cost or market. There may be exceptions to the rules on a case by case basis pricing is addressed in each order.
	* Capital asset transfers *from* the utility *to* the affiliate		No		Yes, assets are transferred at the higher of cost or market. There may be exceptions to the rules on a case by case basis as pricing is addressed in each order.
8	Does the commission have the authority to:				
	* perform audits or other forms of review of the utility?		Yes		Yes
	* perform audits or other forms of review of the affiliate?		No		Yes
	* obtain access to books and records of the utility?		Yes		Yes
	* obtain access to books and records of the affiliate?		No		Yes
		References & Explanations	PURA sec 14.201 - 204 and 14.154. Broadly speaking, there is no authority to audit affiliates, however, if there are transactions between a utility and its affiliates, the commission believes it has the authority to audit such transactions.		Section 56-36 of the Code of Virginia gives the commission authority to audit or perform some other form of review. Orders approving transactions with utility's affiliates contain a condition that the commission has the right to examine books and records of affiliate with the approval granted.
9	Does the commission require an independent audit or review?		No	No	Yes, the commission requires an annual audit of Virginia Electric Power Company only. There are no other requirements at the present time.
10	Does the commission mandate reporting of products and services or asset transfers? If so, what level of reporting is required and is there a stipulated threshold?		Yes, the threshold is $100,000 per transaction. Service agreements with affiliates are filed with the commission. Commission Substative Rules 25.84, 26.84	No	Yes, the commission requires annual reporting of all products and services or asset transfers between the regulated utility and non-regulated affiliates.

QUESTION \ STATE		Washington	West Virginia	Wisconsin
1 Does the state commission have any rules or regulations regarding affiliate transactions?		Yes	No	Yes/ Under consideration
2 Does the state legislature have any laws regarding affiliate transactions?			Yes	Yes
3 Describe any "yes" answers to questions #1 and #2	*Commission References*			Order 05-GI-108 and 6680-UM-100, any orders designated with "AU," "AE" or "AG"
	Legislation References		Public Service Commission Section 24-2-12(f)	State Statute Section 196.52 and State Statute Section 196.795
4 Describe any "no" answers to questions # 1 and #2		N/A	Affiliate transaction was major workshop topic in electric restructuring docket	N/A
5 Describe any "under consideration" answers to #1 and #2		N/A	N/A	Docket 05-BU-101 in progress
6 Does the state recognize confidentiality of sensitive and/or competitive information?			Yes, utilities may request confidential treatment and it is granted on a case by case basis.	Yes, there are procedures in place to file information as confidential. The commission also requires, to the extent possible, filing of a non-confidential summary. Confidentiality can also be challenged. Procedures are in place to handle confidential material during hearings.
7 Have specific methods been mandated for pricing the following affiliate transactions? If so, describe the method, the docket or statute providing the mandate, and the reasoning for requiring the method.				
• Products and service provided *from* the affiliate *to* the utility		Yes, products and services are priced at the lesser of fair market value or cost plus a fair return.	Yes, PUHCs are required by the SEC to use cost as the transfer price. Other issues are addressed on a case by case basis, but generally allocated cost is used.	Yes, State Statute Section 196.795, 196.52. Pricing is generally at the lower of fully allocated cost or market.
• Products and services provided *from* the utility *to* the affiliates		Yes, products and services are priced at the higher of fair market value or cost plus a fair return.	Yes, PUHCs are required by the SEC to use cost as the transfer price. Other issues are addressed on a case by case basis, but generally allocated cost is used.	Yes, State Statute Section 196.795, 196.52. Pricing is at greater than fair marker value or fully allocated cost.
• Capital asset transfers *from* the affiliate to the utility			Yes, PUHCs are required by the SEC to use cost as the transfer price. Other issues are addressed on a case by case basis, but generally allocated cost is used.	Yes, State Statute Section 196.795, 196.52. Pricing is generally at the lower of fully allocated cost or market.
• Capital asset transfers *from* the utility *to* the affiliate			Yes, PUHCs are required by the SEC to use cost as the transfer price. Other issues are addressed on a case by case basis, but generally allocated cost is used.	Yes, State Statute Section 196.795, 196.52. Pricing is at the greater of fair marker value or fully allocated cost.
8 Does the commission have the authority to:				
• perform audits or other forms of review of the utility?			Yes	Yes
• perform audits or other forms of review of the affiliate?			Yes	Yes
• obtain access to books and records of the utility?			Yes	Yes
• obtain access to books and records of the affiliate?			Yes	Yes
	References & Explanations		Pursuant to review of costs that flow from contracts previously submitted for approval	See State Statute Section 196.795(5)(b) and (7). Access to records and audits of affiliates are allowable if necessary for the commission to perform its duties.
9 Does the commission require an independent audit or review?			No	No
10 Does the commission mandate reporting of products and services or asset transfers? If so, what level of reporting is required and is there a stipulated threshold?		Yes, reports must be filed by June 1st each year and is to include affiliate transactions.	No, not generally. After approval of contracts, information is obtained as needed within formal case filings.	Yes, the threshold is $25,000 for non-holding companies (there is no threshold for holding companies). See State Statute Section 196.52.

	QUESTION \ STATE		District of Columbia
1	Does the state commission have any rules or regulations regarding affiliate transactions?		Under Consideration
2	Does the state legislature have any laws regarding affiliate transactions?		No
3	Describe any "yes" answers to questions #1 and #2	*Commission References*	
		Legislation References	
4	Describe any "no" answers to questions # 1 and #2		The D.C. Council has Bill "Retail Electric Competition and Consumer Protection Act of 1999", it could affect affiliate transactions.
5	Describe any "under consideration" answers to #1 and #2		Formal Case No. 944, Order No. 10635.
6	Does the state recognize confidentiality of sensitive and/or competitive information?		Yes, per 15 D.C.M.R. Sec. 150 (1992), confidential and proprietary information is to be filed under seal and handled confidentially by the Comission.
7	Have specific methods been mandated for pricing the following affiliate transactions? If so, describe the method, the docket or statute providing the mandate, and the reasoning for requiring the method.		
	* Products and service provided *from* the affiliate *to* the utility		No
	* Products and services provided *from* the utility to the affiliates		No
	* Capital asset transfers *from* the affiliate to the utility		No
	* Capital asset transfers *from* the utility *to* the affiliate		No
8	Does the commission have the authority to:		
	* perform audits or other forms of review of the utility?		Yes
	* perform audits or other forms of review of the affiliate?		Not Clear
	* obtain access to books and records of the utility?		Yes
	* obtain access to books and records of the affiliate?		No
		References & Explanations	D.C. Code Ann. Sec. 43-514 supports yes answers, authority to auditaffiliate is not clear, but as a matter of courtesy, some public utility companies have allowed the Commission a limited review.
9	Does the commission require an independent audit or review?		No, there is no requirement , but the Commission has requested audits in the past.
10	Does the commission mandate reporting of products and services or asset transfers? If so, what level of reporting is required and is there a stipulated threshold?		No

APPENDIX C – Examples of Cost Allocation and Cost Assignment

The following are examples of how companies currently assign costs to both regulated and non-regulated affiliates. The examples also reflect how the services are provided (i.e., by the parent and/or utility or through a service company) and how the costs of such services are assigned or allocated.

I. Example of Exempt Holding Company with No Service Company - Services Provided to Affiliates by the Parent and /or the Utility

Employee time is coded directly to specific projects. Direct labor is fully loaded (*i.e.*, includes all labor costs such as employee benefits and payroll taxes) and allocated to various functions and operations, including both regulated and non-regulated based on time reports.

Corporate and departmental overhead costs are accumulated and allocated to affiliates using a three factor formula based on assets, employee numbers, and O&M costs excluding fuel.

The concept of fully allocated costs is an important one. For example, if a service is provided to a non-regulated affiliate by a regulated utility and the non-regulated affiliate is only charged for the direct labor associated with providing the service but none of the related labor overheads or other overheads of the utility incurred in providing the service, then the costs of providing the service are understated. Even though the direct labor costs of providing the service to the non-regulated affiliate are charged below the line (*i.e.*, to non-regulated operations), since the total costs are understated, the non-regulated affiliate receives a subsidy from the regulated affiliate providing the service because labor and other overheads remain above the line (*i.e.*, to regulated operations) at the utility.

The following is an example of a fully loaded or fully allocated labor rate calculation. Employee benefits and payroll taxes are allocated in an amount equal to an overhead rate multiplied by base pay. The overhead rate is equal to employee benefits plus payroll taxes divided by base pay.

Annual Base Pay (Direct Labor)	=	\$41,600	÷	2,080 =	\$20.00 per hour
Annual Employee Benefits	=	\$10,000	÷	2,080 =	\$ 4.81 per hour
Annual Payroll Taxes	=	\$ 6,000	÷	2,080 =	\$ 2.88 per hour
Total direct labor, employee benefits and payroll taxes		\$57,600			\$27.69

$$\text{Overhead Rate} = \frac{\text{Employee benefits plus payroll taxes} = \$16{,}000}{\text{Base Pay} = \$41{,}600} = .384615$$

Fully Loaded Labor Rate = \$20 x 1.384615 = \$27.69 per hour;

(\$27.69 per hour x 2,080 = \$57,600)

II. Example of Exempt Holding Company with no Service Company - Services Provided to Affiliates by the Parent and/or the Utility

Identified costs of administrative and support services provided to the non-regulated affiliate(s) are charged to the non-regulated affiliate(s). As an example, the affiliate is charged for a portion of accounts payable costs based on the number of invoices processed using an estimated standard cost.

Costs for corporate governance which cannot be specifically identified and directly assigned are allocated based on labor dollars. For example, the non-regulated affiliate would be allocated a portion of the corporate governance costs based on the ratio of the non-regulated affiliate's labor costs to the total company labor costs.

III. Example of an Exempt Holding Company – Services Provided to Affiliates by a Service Company

Each project is identified by a project number and a description of the activity (service) provided. A billing method for allocating the costs associated with providing the service to the affiliate receiving the service is also assigned to the project.

Costs are therefore allocated or billed based on an analysis of the activity or service provided and the recipient of the service. For example, the cost of services related to developing and administering employee records and systems are allocated to both regulated and non-regulated affiliates based on the number of employees in each affiliate to total system employees.

IV. Example of Registered Holding Company – Services Provided to Affiliates by a Service Company

A Project Costing System uses project codes (PC) to accumulate and allocate costs. A project code in the Project Costing System is established when a department or functional area begins a new process, project, or initiative and the department is required or wants to capture the costs associated with the new activity separately. The PC contains a descriptive title for the project and is assigned a billing method, which may directly bill one legal entity, or allocate costs to several affiliates. The PC also contains a description of the PC, including its overall purpose, the primary activities to be performed, the products or deliverables expected, and an explanation of the billing method selected. The PC may accept actual and/or budget costs including overhead costs. The PC contains information as to which legal entities may use the project code. If the charges billed under the PC are to be billed to a specific account, state, or product, those requirements are entered on the PC to ensure that charges are billed correctly. After charges are accumulated in a PC, they are either directly billed or allocated through the project billing process.

The billing method assigned to a PC ultimately determines which affiliate(s) will be billed for the project. Project costs are distributed based on the allocation percentage for each affiliate (legal entity) covered by the assigned billing method. Exhibit A provides a hypothetical example of Project Codes used for billing or allocating services to affiliates.

Exhibit A

The following is a hypothetical example of Project Codes for billing or allocating accounting services to affiliates:

Project Code	Description	Billing Method (allocation factor)
A1001	Accounting Services - All Companies	1 - Allocate to all companies
A1002	Accounting Services - All Regulated Companies	2 - Allocate to all regulated companies
A1003	Accounting Services - All Non-regulated Companies	3 - Allocate to all non-regulated companies
A1004	Accounting Services - Bill directly (100%) to regulated Company A	4 - Directly assign to Company A
A1005	Accounting Services - Bill directly (100%) to regulated Company B	5 - Directly assign to Company B
A1006	Accounting Services - Bill directly (100%) to non-regulated Company X	6 - Directly assign to Company X
A1007	Accounting Services - Bill directly (100%) to non-regulated Company Y	7 - Directly assign to Company Y
A1008	Accounting Services - Regulated Company A and non-regulated Company X	8 - Allocate to Company A and Company X
A1009	Accounting Services - Regulated Company A and non-regulated Company Y	9 - Allocate to Company A and Company Y
A1010	Accounting Services - Regulated Company B and non-regulated Company X	10- Allocate to Company B and Company X
A1011	Accounting Services - Regulated Company B and non-regulated Company Y	11 - Allocate to Company B and Company Y
A1012	Accounting Services - All regulated companies and non-regulated Company X	12 - Allocate to all regulated companies and to Company X
A1013	Accounting Services - All regulated companies and non-regulated Company Y	13 - Allocate to all regulated companies and to Company Y
A1014	Accounting Services - All non-regulated companies and Company A	14 - Allocate to all non-regulated companies and to Company A
A1015	Accounting Services - All non-regulated companies and Company B	15 - Allocate to all non-regulated companies and to Company B

Billing Method Example - How the Charges are Allocated

Project Codes ➔ Billing Method ➔ Charges to Client Company

Project Code	Billing Method	Client Company
A1001 Accounting Services	1 - Allocate to all companies	Charged to all companies based on each company's ratio of revenue, assets, and employees to total system revenues, assets, and employees
A1002 Accounting Services	2 - Allocate to all regulated companies	Charged to all regulated companies based on each regulated company's ratio of revenues, assets, and employees to total regulated company revenues, assets, and employees
A1005 Accounting Services	5 - Directly assign to Company B	100% of the project costs directly billed to regulated Company B

Another example would be a PC established to capture the costs of providing transmission engineering services to all of the affiliated regulated operating companies in the system. Based on the descriptive title contained in the PC, a billing method (allocation factor) would be assigned to allocate costs to the regulated operating companies for which the service was provided and the costs were incurred. In this example the billing method (allocation factor) could be transmission line miles. The project costs for the transmission engineering services provided would, therefore, be allocated to each of the regulated operating companies based on the ratio of each operating company's transmission line miles to the total transmission line miles of the entire system.

Once the charges billed to each affiliate for a transaction are determined, the respective affiliates receiving the services record each transaction amount to a designated FERC account and record a corresponding payable for the amount due to each affiliate service provider. The receivable and payable balances are relieved when each legal entity pays its affiliates for services rendered.

The project billing system insures that: services are always billed at cost; every affiliate that receives the service, and thus causes and/or benefits from the cost in the PC, is appropriately included in the allocation of costs; and since each PC has only one billing method associated with it, all affiliates that receive the service are charged at the same rate for a given PC, therefore, the cost for a given unit of service is equal for all affiliates receiving the service.

Billing methods (allocation factors) either directly bill costs to affiliates or allocate costs based on an SEC-approved formula. Billing methods (allocation factors) are assigned to a PC based on the driver of the costs (cost causation principles) and the services received by the affiliate(s).

Therefore, all services performed under a PC are allocated among affiliates using the same criteria. Each allocation formula is developed or based on data for each of the participating affiliated companies such as number of employees, number of customers, kilowatt-hour energy sales, transmission line miles, distribution substations, etc. The use of a single billing method ensures that all affiliates causing costs to be incurred and receiving the service pay an appropriate portion of the costs. This also ensures that the affiliates are, in total, charged no more and no less that 100% of the costs for services provided under the PC. Also, the use of a single billing method, which is assigned based on cost causation principles, ensures that each affiliate is paying the same per unit price for the same service, and that the prices charged to one affiliate are no higher than the prices charged to the other affiliates for similar services.

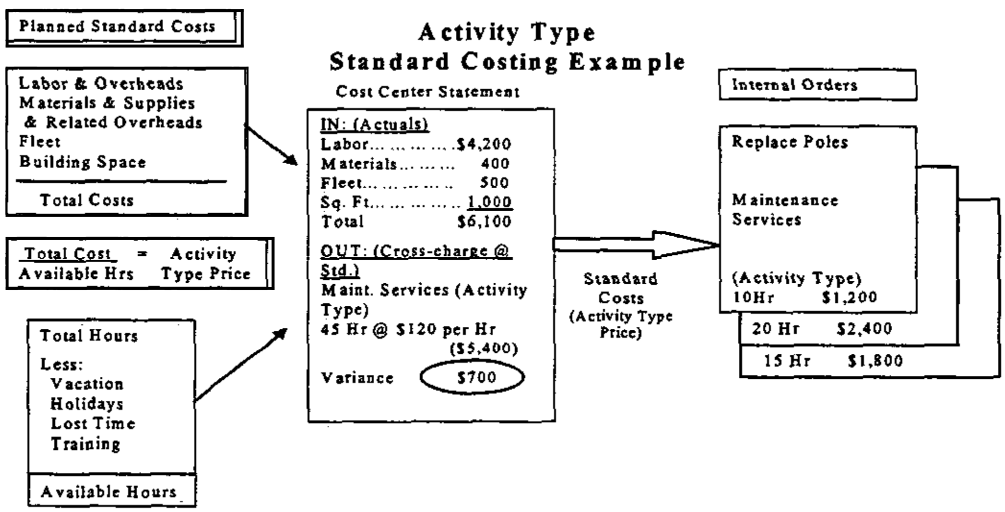
V. Example of Registered Holding Company – Services provided to affiliates by a Service Company. Company has Public Service Commission approved CAM and Code of Conduct.

A Company uses a fully allocated costing method for assigning costs to services and products. As an example, certain employees can be specifically attributable to a particular business or service and directly aligned with an operating company. Under the full costing approach, the indirect labor costs such as fringe benefits, employee taxes, and building space are also included with the direct labor costs in performing services. Under a Company's accounting system, these costs are determined based on standard rates, known as activity type prices which reflect full costs. Exhibit B provides an example of a standard cost calculation for an activity type.

Exhibit B

Example of Activity Types

The following exhibit shows how activity types are used to charge an internal order. The example shows an electric distribution resource cost center performing pole maintenance services. The activity price is set based on planned standard costs for the resource cost center. The total planned costs, listed on the left hand column, are divided by the available hours to determine a rate. Available hours typically exclude vacation time, sick time, or other "lost time".



In the example, a crew charged 45 hours at $120 per hour ($5,400) to replace poles maintenance services on an internal order. At the end of the month, the order would "settle" along with similar orders to the T&D cost management function within the regulated delivery business line.

The variance or residual of $700 in this example could be due to several factors. It is anticipated that not all costs incurred in a resource cost center will be used in determining an activity type. An example is a contractor's costs charged to a Resource Cost Center which does not relate to services provided by that Resource Cost Center. If the residual is due to a variance between actual and planned costs used in developing the activity type rate, the rate will be revised if the impact is significant. Residuals would "roll up" to the Cost Manager level (one level above the resource Cost Center), and become part of the overhead costs of the Business Group.

The primary goal of attributing costs to the correct business groups is accomplished through direct assignment of specific costs, typically employees and related costs, to cost centers residing within the various regulated and non-regulated entities. Therefore, the majority of operating costs incurred are directly reflected in the individual operating companies.

Certain shared services (*e.g.*, accounting, finance, human resources, engineering, legal), performed mainly by the Service Company cannot be directly aligned within individual operating companies. These shared services are charged to individual companies based on direct charging for specific identifiable services and through allocation for those shared services benefiting multiple operating companies. For services that are shared (*i.e.*, allocated) between companies, cost allocations are based on relevant cost drivers for each type of shared cost. Employee Benefits Plan Administration is an example of a shared service because the service is performed for all of the system companies (*i.e.*, all companies within the organization), both regulated and non-regulated. The costs of administering the employee benefits plan must be allocated to the system companies so that each company is allocated or charged a representative portion of the costs incurred based on a relevant cost driver or activity. In this example, the relevant cost driver is the number of employees because the costs incurred for administering the employee benefits plan are dependent upon or "driven by" the number of employees in the plan. Each company within the system is appropriately billed or charged for its share of the costs of administering the employee benefits plan based on the ratio of the number of employees in each company to the total number of employees in the system.

APPENDIX D – Transfer Pricing Policy Choices: Pros and Cons

METHOD	PROS	CONS
Prevailing Market Price	• Captures actual market demand and supply conditions • Preferred method according to economic theory because *prevailing market price* simultaneously reflects suppliers' costs of production and consumers' measure of value • Compatible with comparable pricing, price to affiliate comparable to price for any third party competitor	• May not exist for certain products and services • May not always reflect conditions consistent with a robust competitive market • Prevents utility-affiliate umbrella company from receiving the benefits of scope economies because it forces an "arms length" transaction between the affiliate and utility that would normally be internal
Fully Allocated Cost	• Familiar to regulators because of extensive historical application • Typically considered by regulators to be fair to consumers of regulated services • From an economic perspective, eliminates cross subsidization because the affiliate bears some of the fixed costs • Incorporates identifiable and verifiable costs	• From an economic perspective, the incorrect threshold price for detecting and defining cross subsidies • Prevents utility-affiliate umbrella company from receiving the benefits of scope economies • May prevent or discourage otherwise economical utility-affiliate transactions that can benefit consumers of regulated and non-regulated services
Incremental Cost	• From an economic perspective, the proper threshold price for detecting and defining cross subsidies • Avoids discouraging or preventing economically justified utility-affiliate transactions	• Does not permit the benefits of economies of scope that arise from the transaction to be shared with regulated services customers • Deviates from traditional regulatory cost-based pricing rules developed for utility services • Competitors may find it more difficult to compete against a relatively more efficient affiliate
Negotiated Price	• Sensitive to changing market (supply and demand) conditions • Avoids economic distortions caused by rigid transfer prices	• Leads to discrimination in pricing across customer classes and within customer segments • May not be viewed by regulators as fair to all consumers of regulated services
Tariff Based Price	• Pre-approved by the commissions • Allows for the up front resolution of issues • Nondiscriminatory since all customers generally pay the same price	• Can be burdensome if they do not allow prices to be quickly modified. • May prevent or discourage otherwise economical utility-affiliate transactions that can benefit consumers of regulated and non-regulated services
Asymmetrical - Higher of Cost or Prevailing Market/ Lower of Cost or Prevailing Market Pricing	• Ensures that no cross subsidies will flow between utility and non-regulated affiliate • May lead to less regulatory oversight	• Incompatible with comparable pricing • May discourage otherwise economical transactions • Inconsistent with normal cost-based regulatory pricing rules for utility services • May go beyond necessary measures to address cross subsidy concerns • Potentially higher cost-of-service for utility customers