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May 20, 1999

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REC'D TN
REGULATORY AUTH.
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OFFICE OF THE
EXECUTIVE SECRETARY

Mr. David Waddell
Executive Secretary
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243-0505

RE: TENNESSEE CONSUMER ADVOCATE DIVISION REQUEST FOR RULEMAKING AFFECTING RULES FOR ELECTRIC COMPANIES (PROPOSED RULES FOR COST ALLOCATIONS AND AFFILIATE TRANSACTION; AND REVISIONS TO REFLECT NAME CHANGE OF THE TENNESSEE REGULATORY AUTHORITY, ETC.) DOCKET NO. 98-00690

Dear Mr. Waddell:

Enclosed please find the original and thirteen copies of **KINGSPORT POWER COMPANY'S REVISED COMMENTS ON THE CONSUMER ADVOCATE DIVISION'S REQUEST FOR RULEMAKING AFFECTING AFFILIATE TRANSACTION RULES FOR ELECTRIC COMPANIES** which I would appreciate your filing.

Should you have any questions or comments regarding same, please do not hesitate to contact me directly.

With kindest personal regards, we are

Very sincerely yours,

HUNTER, SMITH & DAVIS, LLP

T. Arthur Scott, Jr.

T. Arthur Scott, Jr.

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Enclosure

cc: Vance L. Broemel, Esq. (w/encl.)
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BEFORE THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

'99 MAY 21 AM 11 03
REC'D TN REGULATORY AUTH.
OFFICE OF THE EXECUTIVE SECRETARY

IN RE: TENNESSEE CONSUMER ADVOCATE DIVISION – REQUEST FOR RULEMAKING AFFECTING RULES FOR ELECTRIC COMPANIES (PROPOSED RULES FOR COST ALLOCATIONS AND AFFILIATE TRANSACTION; AND REVISIONS TO REFLECT NAME CHANGE OF THE TENNESSEE REGULATORY AUTHORITY, ETC.)	)	DOCKET NO. 98-00690

KINGSPORT POWER COMPANY'S REVISED COMMENTS ON THE CONSUMER ADVOCATE DIVISION'S REQUEST FOR RULEMAKING AFFECTING AFFILIATE TRANSACTION RULES FOR ELECTRIC COMPANIES

Comes Kingsport Power Company, d/b/a American Electric Power, and for revised comment on the Consumer Advocate Division's proposed cost allocation and affiliate transaction rules for electric utilities submits the following:

I. INTRODUCTION

Kingsport Power Company (hereinafter "Kingsport Power") filed a Request for Rulemaking pursuant to *Tennessee Code Annotated § 4-5-201* on October 2, 1998. The general substance of those proposed rule changes dealt with rules affecting the testing of meters.

On November 3, 1998, in response to Kingsport Power's Request for Rulemaking, the Consumer Advocate Division (hereinafter "CAD") filed its own Petition for Rulemaking. The substance of the CAD's petition deals with changes affecting, among other things, cost allocation and affiliate transactions for electric utilities.

The Tennessee Regulatory Authority ("TRA") combined parts of the CAD'S request with that of Kingsport Power, but established a separate proceeding for that portion of the CAD's request dealing with affiliated transactions.

Because the CAD's request was modeled on guidelines under consideration by the Subcommittee on Accounts of the National Association of Regulatory Utility Commissioners ("NARUC") , Kingsport Power submitted preliminary comments that might be useful to the TRA Directors at the February, 1999 NARUC meeting. A public hearing was held on April 22, 1999, at which time it was announced and agreed that Kingsport Power and the CAD as well as Edison Electric Institute would be allowed to file comments on the proposed rules by May 21, 1999. These comments are intended to supersede the preliminary comments. Kingsport Power's comments fall into the following two major categories: (i) the reasons why the TRA should not consider the proposed rules at this time, and (ii) substantive comments about the proposed rules if the TRA proceeds with rulemaking.

A. THE REASONS WHY THE TRA SHOULD NOT PROCEED WITH THE CAD'S PROPOSED RULEMAKING AT THIS TIME.

The reasons why TRA should not proceed with the CAD's proposed rulemaking at this time are as follows:

1. The proposed cost allocation and affiliate transaction rules are outside the scope of the TRA's jurisdiction because they address allocations with companies outside the statutory jurisdiction of the TRA.

2. To the extent the transactions addressed by the proposed cost allocation and affiliate transaction rules differ from applicable Orders and/or Regulations of the Securities and

Exchange Commission ("SEC") and the Federal Energy Regulatory Commission ("FERC"), the proposed rules are preempted.

3. The TRA's predecessor previously declined to layer another level of regulation on affiliate transactions when it ordered Kingsport Power's management audit in 1996.

4. Promulgation of the proposed rules on cost allocation and affiliate transactions would be premature because, at this time, the guidelines upon which the proposed rules are based are under revision by the Subcommittee on Accounts of the NARUC, and because the proposed rules are based on anticipated deregulation of an unknown extent.

1. THE PROPOSED COST ALLOCATION AND AFFILIATE TRANSACTION RULES ARE OUTSIDE THE SCOPE OF THE TENNESSEE REGULATORY AUTHORITY'S JURISDICTION BECAUSE THEY ADDRESS ALLOCATIONS WITH COMPANIES OUTSIDE THE STATUTORY JURISDICTION OF THE TRA.

The TRA's jurisdiction is found in *Tennessee Code Annotated § 65-4-104.* That statute reads in relevant part:

> The Authority has general supervisory and regulatory power, jurisdiction, and control over all public utilities, and also over their property, property rights, facilities, and franchises, so far as may be necessary for the purpose of carrying out the provisions of this chapter.

Additionally, *Tennessee Code Annotated § 65-4-106* governing construction of the statutes enabling the Authority states:

> This chapter shall not be construed as being in derogation of the common law, but shall be given a liberal construction, and any doubt as to the existence or extent of a power conferred on the authority by this chapter (4) or chapters 1, 3, and 5 of this title shall be resolved in favor of the existence of the power, to the end that the authority may effectively govern and control the public utilities placed under its jurisdiction by this chapter.

The aforementioned statutes define the broad extent to which the Authority can exercise jurisdiction over "public utilities". However, the Authority, like any other administrative agency, must conform its actions to its enabling legislation. BellSouth Telecommunications, Inc. v. Greer, 972 SWd 663, 680 (Tenn. App. 1997). It has no authority or power except that found in the statutes. Id. While its statutes are remedial and should be interpreted liberally, they should not be construed so broadly as to permit the Authority to exercise power not specifically granted by law. Id. Any attempts by the Authority to enact regulation that exceed that grant are void as a matter of law.

Also, *Tennessee Code Annotated § 65-2-102 (2)* states:

> The Authority is empowered to adopt rules implementing, interpreting, or making specific the various laws which it enforces or administers; provided, that the Authority shall have no power to vary or deviate from those laws, nor to extend its power or jurisdiction to matters not provided for in those laws.

The CAD's proposed rules exceed the Authority's limited grant of jurisdiction in one very important respect. The Authority has jurisdiction only over "public utilities". The CAD proposals on cost allocation and affiliate transactions impermissibly seek to regulate affiliates that are not public utilities. The proposed definition of "affiliates" is "companies that are related to each other due to common ownership or control". Kingsport Power is a subsidiary of American Electric Power Company, Inc. ("AEP"). The AEP system includes companies that are outside of Tennessee, but under the common control of AEP. AEP is a registered public utility holding company under the Public Utility Holding Company Act of 1935 ("PUHCA"). The only company within the AEP system over which the Authority has jurisdiction as to rates and, therefore, costs, is Kingsport Power. The Authority cannot extend its jurisdiction beyond the boundaries and confines of Tennessee. As such, the proposed cost allocation and affiliate transaction rules impermissibly seek to extend the Authority's jurisdiction beyond the jurisdiction granted in its enabling statutes.

2. TO THE EXTENT THE TRANSACTIONS ADDRESSED BY THE PROPOSED COST ALLOCATION AND AFFILIATE TRANSACTION RULES DIFFER FROM APPLICABLE ORDERS AND/OR REGULATIONS OF THE SECURITIES AND EXCHANGE COMMISSION ("SEC") AND THE FEDERAL ENERGY REGULATORY COMMISSION ("FERC"), THE PROPOSED RULES ARE PREEMPTED.

As a registered holding company under PUHCA, AEP and its subsidiaries, both regulated and unregulated, must comply with applicable SEC rules and regulations. Furthermore, certain power transactions between AEP companies are governed by the FERC under the Federal Power Act.

The CAD's proposed rules on cost allocation and affiliate transactions attempt to address transactions that are already covered by rules of the SEC and/or the Federal Power Act. Kingsport Power, as a member of the AEP system , operates under cost allocation guidelines imposed by the SEC. Furthermore, the Authority must accept the FERC-regulated cost of Kingsport Power's electricity purchased from its affiliates. Consumer Advocate Division v. Bissell, 1996 WL482970 (Tenn. App. 1996). In the proposed cost allocation and affiliate transaction rules, the CAD proposes part (d) regarding affiliate transactions. The proposed rule reads:

> 1. The price for services and products provided by a regulated entity to its non-regulated affiliates shall be at the higher of fully allocated costs or market prices. As required by regulators, utilities shall provide adequate market and other relevant information where services are provided at market. (Services that are provided to non-related parties under tariffed rates approved by the Authority or

other appropriate regulatory authority shall be provided to the affiliate at the tariffed rate.)

2. The price for services and products provided by an affiliated company to a regulated affiliate should be at the lower of fully allocated costs or market as determined by the Authority except as otherwise required by law or regulation. (Specific examples of such law or regulations are the provisions of the Public Utility Holding Company Act of 1935 which requires registered holding company systems to price "at cost" the sale of goods and services and the undertaking of construction contracts between affiliate companies, and transactions under tariffs approved by the Federal Energy Regulatory Commission (FERC).

The PUHCA preempts attempts by the Authority to control pricing of affiliate transactions covered under SEC Orders and regulations. [1]

As noted in Bissell, the Authority must accept the FERC-regulated cost of Kingsport Power's electricity purchased from its affiliates. Therefore, the CAD's proposed rules, which attempt to regulate the pricing of affiliate transactions already governed by Federal Law, are preempted.

3. THE TRA'S PREDECESSOR PREVIOUSLY DECLINED TO LAYER ANOTHER LEVEL OF REGULATION ON AFFILIATE TRANSACTIONS WHEN IT ORDERED KINGSPORT POWER'S MANAGEMENT AUDIT IN 1996.

In 1996, the Tennessee Public Service Commission ("TPSC") ordered a management audit of Kingsport Power. In the request for proposal that was sent out to auditors, the TPSC restricted the audit in this fashion:

> As indicated in the "Company Background" section of this RFP, the Company is an operating utility subsidiary of American Electric Power Company, Inc. (AEP), which is planned and operated as a single integrated public utility system in accordance with the Public Utility Holding Company act of 1935. AEP is currently undergoing a significant organization/management restructuring, to be effective January 1, 1996, although the various legal entities that comprise the AEP System will not be changed.

[1] Except for transactions with exempt telecommunications companies (ETC), transactions between Kingsport Power and its affiliates must be priced at cost in accordance with SEC Orders and Rules 90 and 91. Under federal law, Kingsport Power would need TRA authorization to enter into transactions with an affiliated ETC .

Under AEP's current structure, the Company obtains services from the AEP Service Corporation (AEPSC) and from another AEP operating subsidiary, Appalachian Power Company (APCo), from which it also obtains all of its electric power requirements at FERC approved rates. After January 1, 1996, when the new structure becomes effective, the Company will continue to obtain services and power from the same entities.

All services (other than electricity) provided to the Company by AEPSC or APCo are rendered at cost pursuant to the Public Utility Holding Company Act of 1935 and SEC orders and rules thereunder. Similarly, as part of the AEP System, the Company purchases all of its power requirements from APCo, at rates regulated by the FERC, as recognized by the Commission in its November 30, 1995 Order approving the Company's Purchased Power Adjustment Rider. The SEC and the FERC will continue to have jurisdiction over these transactions on and after January 1, 1996. <u>Given the Company's size relative to the AEP System, and the existing regulatory oversight over the services received from the Company's affiliates and the charges therefor, including purchased power charges, the scope of this management audit will not extend to these areas, except to review and examine the Company's internal processes regarding these matters and to confirm the existence of methodologies governing the allocations.</u> [Emphasis added]

4. PROMULGATION OF THE PROPOSED RULES ON COST ALLOCATION AND AFFILIATE TRANSACTIONS WOULD BE PREMATURE BECAUSE, AT THIS TIME, THE GUIDELINES UPON WHICH THE PROPOSED RULES ARE BASED ARE UNDER REVISION AND BECAUSE THE PROPOSED RULES ARE BASED ON ANTICIPATED DEREGULATION OF AN UNKNOWN EXTENT.

The Petition for Rulemaking filed by the CAD proposes rule changes for cost allocation and affiliate transactions that are based on a previous draft of guidelines by the Subcommittee on Accounts of the NARUC. The earlier draft contains numerous provisions that have been revised by the Subcommittee and as such the earlier draft is no longer a reliable basis for guidelines and rule changes. By NARUC resolution dated March 3, 1998, the Staff Subcommittee on Accounts was directed together with the Staff Subcommittees on Strategic Issues and Gas to prepare for

NARUC's consideration, "Guidelines for Energy Cost Allocations". In addition, input was requested from other industry parties including, but not limited to, the Edison Electric Institute. Changes in the proposed guidelines from the earlier draft (upon which CAD's proposals are based) to the present are too numerous to list individually, but suffice it to say the proposed NARUC guidelines are not final. Any rule changes or adoption based on the earlier draft would be premature at best.

The most significant changes from the earlier draft are contained in section (d) regarding Affiliate Transactions. The CAD's proposal based upon the earlier draft states:

1. The price for services and products provided by a regulated entity to its non-regulated affiliates shall be at the higher of fully allocated costs or market prices. As required by regulators, utilities shall provide adequate market and other relevant information where services are provided at market. (Services that are provided to non-related parties under tariffed rates approved by the Authority or other appropriate regulatory authority shall be provided to the affiliate at the tariffed rate.)

2. The price for services and products provided by an affiliated company to a regulated affiliate should be at the lower of fully allocated cost or market as determined by the Authority except as otherwise required by law or regulation. (Specific examples of such law or regulations are the provisions of The Public Utility Holding Company Act of 1935 which requires registered holding company systems to price "at cost" the sale of goods and services and the undertaking of construction contracts between affiliate companies, and transactions under tariffs approved by the Federal Energy Regulatory Commission (FERC))

The most recent revised draft of the NARUC Subcommittee on Accounts reads:

1. Generally, the price for services and products provided by a regulated entity to its non-regulated affiliates shall be at prevailing market prices. In the absence of prevailing market prices, these prices should be based on fully allocated costs. Under appropriate circumstances, prices could be based on incremental, market-driven, negotiated pricing or other pricing mechanisms as determined by the regulator. Pricing below fully allocated costs but above incremental costs may be appropriate given market prices and regulatory approval. As required by regulators, utilities shall provide adequate market and other relevant information that justifies pricing below fully allocated costs.

2. Generally, the price for services and products provided by an affiliated company to a regulated affiliate should be at the lower of fully allocated cost or market as determined by the regulator. Under appropriate circumstances, prices for affiliated company

provision of services and products could be based on incremental, market-driven, negotiated prices or a competitive bidding process, as determined by the regulator.

The radical change discloses the abandonment of pure assymetrical pricing which had been espoused in the earlier draft. The relative merits of assymetrical pricing will be discussed in more detail in the section dealing with Substantive Comments, but the revised draft is in sharp contrast to the initial draft in both language and effect.

Additionally, the extent of deregulation has not been determined. PUHCA has not yet been repealed and the CAD asks that the Authority promulgate rules speculating as to the extent of deregulation that may or may not occur in the electric utility industry. By analogy, in the context of a court proceeding, a case or controversy is required prior to a court of law issuing an opinion. A court of law is not allowed to issue an advisory opinion. The CAD proposal asks that the Authority issue an advisory opinion as to what the rules and regulations should be if deregulation were to occur. Moreover, the enabling statutes for the Authority, while granting general jurisdiction, do not specifically grant the Authority the ability to enact rules which have no current application.

Tennessee Code Annotated § 65-2-102 (4) requires that, prior to adoption of any rule, the Authority must give notice to "interested persons". *Tennessee Code Annotated § 65-2-102 (4)* reads in relevant part:

> "Prior to the adoption of any rule, . . the Authority shall, so far as practicable and in such manner as it deems expedient, publish or otherwise circulate notice of its intended action, and afford interested persons opportunity to submit data or argument in such manner as the Authority shall prescribe . . . .".

Because the proposed rules speculatively seek to address what may come to be, there are no "interested persons" at this time. If deregulation were to occur, then there could be many persons who would become "interested persons". For example, electric cooperatives might become parts of bigger systems and the Legislature could place them under TRA jurisdiction. Are those persons to be denied input on these sweeping proposals because they were not affected at the time they were proposed? Such a stealth approach is hardly worthy of the due process that persons appearing before the TRA are entitled to expect.

Furthermore, should the TRA expend its resources in promulgating such regulations that might or might not leap into application in the future? Should it impose the costs of addressing such rules on Kingsport Power just because such rules <u>might</u> become applicable later?

B. SUBSTANTIVE COMMENTS ON THE CAD'S PROPOSED RULES

Kingsport Power's Substantive Comments to the CAD's Proposed Rules are arranged into four (4) sections. Those sections are:

1. The CAD's Proposed Pricing Rules Lack Economic Justification and are too inflexible.
2. The CAD's Proposed Rules Unnecessarily Seek to Dictate the Pricing Terms of Transactions Between Utilities and Non-Regulated Affiliates.
3. The CAD's Proposed Rules are Administratively Cumbersome and Unnecessarily Costly.
4. The CAD's Proposed Pricing Rules Unfairly Create Winners and Losers.

1. THE CAD'S PROPOSED PRICING RULES LACK ECONOMIC JUSTIFICATION AND ARE TOO INFLEXIBLE.

The asymmetric pricing principles contained in Section 1220-4-4-.55(d)(1) through (4) of the CAD's proposed rules are apparently an attempt to protect the ratepayers of regulated entities (in this case, the customers of electric public utilities regulated by the TRA). This protection is ostensibly accomplished by requiring the regulated entity to pay the lower of market or cost, when goods and services are provided from an affiliate; by preventing the utility from charging less than the higher of market or cost, when the goods and services are provided by the utility; by requiring that the transfer of capital assets from the regulated utility to a non-regulated affiliate be at the greater of market price or net book value, and by requiring that the transfer of capital assets from a non-regulated affiliate to the regulated utility be at the lower of market or net book value. Even leaving aside the issues raised in Part A of these preliminary comments, the CAD's proposed asymmetric pricing rules lack economic justification.

The assymetrical pricing scheme espoused in the CAD's proposed rules actually has a negative effect on the very ratepayers the CAD was created to protect. In the context of transfer pricing, CAD's concerns over subsidization of non-regulated affiliates by a regulated affiliate are generally concentrated in two areas: (i) A non-regulated affiliate selling products or services to a regulated affiliate at an inflated price and (ii) a regulated affiliate selling products or services to a non-regulated affiliate at an excessively low price. The mechanism CAD has proposed to combat the contingency of subsidization is assymetrical pricing. Under the assymetrical pricing scheme, the regulated affiliate is to purchase from the non-regulated affiliate at a price which is the lower of fully allocated cost or market. Conversely, the non-regulated affiliate is to purchase from the regulated affiliate at the higher of fully allocated cost or market. The assymetrical pricing scheme is unnecessary, counterproductive and fundamentally devoid of any sound economic principle.[2] The proposed rules do not constitute appropriate regulation for the benefit of ratepayers. The CAD's proposed structure of assymetrical pricing ensures that the ratepayers

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[2] Kenneth W. Costello, *A Pricing Rule for Affiliate Transactions: Room for Consensus*, THE ELECTRICITY JOURNAL, December 1998, at 59, 64. [Attached]

would not subsidize affiliate operations, but it also denies the ratepayers the potential benefits they would receive by discouraging some transactions between utilities and affiliates that would involve no subsidy by the ratepayers.

From an economic perspective, where an affiliate competes in a competitive market, market forces prevent the affiliate from manipulating market price to gain a subsidy from the regulated utility. The non-regulated affiliate cannot charge an inflated price for its services and remain a viable competitor in the marketplace. Furthermore, the ratepayers of a regulated entity are neither harmed nor subsidizing an affiliate if their utility rates reflect a market price for goods or services purchased from an affiliate that is greater than the affiliate's cost because the utility does not otherwise have an opportunity to pay less than the market price.

Moreover, contrary to the absolute proscriptions contained in the CAD's proposed rule, it would never be economically appropriate, when a regulated utility's fully allocated cost is above the market price, that the affiliate should pay the higher fully allocated cost. The affiliate is not required to buy services from the regulated utility, and would not do so if it were forced to pay an above market price. Paying an above market price would be irrational and would put the affiliate at a competitive disadvantage. Further, not allowing the utility to price below fully allocated cost, will result in ratepayers being worse off than if the transaction were priced at market, even if below fully allocated cost. The utility will only incur an economic loss in the provision of affiliate services if revenues from that service are below incremental costs. Any revenues obtained that are greater than incremental cost provide some contribution to fixed costs. This contribution benefits ratepayers, and would not be there if the affiliate is required to pay an above market price because the affiliate will then obtain the good or service from another supplier at market prices. If the CAD's proposed pricing rules are adopted, it is important to note that the Authority will be limiting its future options. Presumably, one reason that NARUC is considering guidelines rather than model rules is to preserve as much flexibility for the Authority as possible. Also presumably, all of these factors played a role in the NARUC Subcommittee on Accounts' abandonment of the inflexible assymetrical pricing scheme in their revised draft of the guidelines for cost allocation and affiliate transactions. As is apparent from the most recent draft of the Proposed Cost Allocation and Affiliate Transfer Guidelines, the NARUC Subcommittee on Accounts is becoming increasingly aware of the need for flexibility on the part of jurisdictional authorities in determining cost allocation and affiliate transfer guidelines for each jurisdiction.

Additionally, the proposed assymetrical pricing would degrade the efficiency of the market by placing a significant barrier to trade between the utility and its affiliates. A utility's affiliates would constitute a specially handicapped class of competitors in the market where they operate, prevented from doing business with the utility on the same terms that would be available to other firms operating in those markets. This would be particularly harmful to the affiliate if the utility were a large buyer or seller in those markets, because the inability to do business with a major customer (or supplier) on the same terms available to its competitors would be a most serious penalty to inflict upon the affiliate. Presumably, the inherent unfairness of the assymetrical pricing scheme was also a consideration of the NARUC Subcommittee on Accounts in their redraft of the proposed guidelines. The natural effect of assymetric pricing is to reduce competition and therefore negatively impact ratepayers.

<u>2. THE CAD'S PROPOSED RULES UNNECESSARILY SEEK TO DICTATE THE PRICING TERMS OF TRANSACTIONS BETWEEN UTILITIES AND NON-REGULATED AFFILIATES.</u>

The purpose of the CAD's proposed rules appears to be to reduce the risk that Tennessee electric public utility ratepayers would subsidize non-utility or non-regulated activities. The proposed rules, however, do not seek to regulate utilities' rates by excluding impermissible costs. Rather, the rules, among other things, seek to dictate the pricing terms of transactions between utilities and non-regulated affiliates. In this important regard, the proposed rules not only extend beyond the TRA's jurisdiction to regulate the "rates and service" of public utilities, but also are unnecessarily redundant given that authority.

Under current law, the TRA is able to exert sufficient control over the potential for affiliate subsidization through the ratemaking process by excluding those costs it deems improper.[3] The Authority has the ability to do so, and will continue to have that ability, without adopting unnecessary rules regarding the pricing of goods and services, without intruding upon the discretion of an unregulated affiliate to enter into transactions with a utility and without attempting to require such an unregulated affiliate to open its books to TRA inspection.

3. THE CAD'S PROPOSED RULES ARE ADMINISTRATIVELY CUMBERSOME AND UNNECESSARILY COSTLY.

Under the proposed rules, a utility would be required to provide "adequate" information where services are provided at market. Leaving aside the inevitable disputes about what is "adequate", this provision requires the review, compilation, and filing of market data, a task that would entail much cost, but little benefit. Much of this data may be confidential and competitively sensitive requiring additional, costly administrative controls. All of these

[3] If the Commission were to undertake to "re-price" a transaction with an affiliate in the context of a rate proceeding, it could only do so under accepted regulatory standards otherwise applicable for the disallowance of a particular cost. That is, the utility should have available to it all defenses normally available.

requirements would be burdensome and would unnecessarily increase the costs of both the utility and its affiliates.

The proposed requirements regarding the maintenance of a cost allocation manual (CAM) by a regulated entity,[4] and the imposition of additional audits, are also unnecessary and would be costly without providing any benefits beyond those already available under present practices. In any proceeding before the TRA involving a regulated entity, the burden is already on that entity to provide documentation regarding transactions between it and any affiliates. Finally, requiring additional layers of audits can only increase costs without any corresponding benefits beyond those already available under current regulation.

4. THE CAD'S PROPOSED PRICING RULES UNFAIRLY CREATE WINNERS AND LOSERS.

There is a bias or unfairness inherent in the CAD's proposed asymmetric pricing rules. Asymmetric pricing is based upon the "direction" of the transaction. Asymmetric pricing typically involves the pricing of goods or services: a) at the higher of cost or market if the "direction" is from the utility to another entity (i.e. the utility is selling a good or service); and b), at the lower of cost or market if the "direction" is towards the utility from another entity. Asymmetric pricing creates a winner and a loser in every transaction. Under the CAD's proposed pricing rules, the loser will always be the utility's shareholders and the winner will always be the utility's ratepayers. When applied consistently, the SEC's at-cost rules do not create this winner/loser situation and both the utility's customers and shareholders are able to benefit.

[4] It is troubling that the proposed rules place no limitations on the TRA's access to affiliate records.

Respectfully submitted,

KINGSPORT POWER COMPANY
d/b/a AMERICAN ELECTRIC POWER

BY: T. Arthur Scott Jr.

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and exact copy of the foregoing Kingsport Power Company's Revised Comments on the Consumer Advocate Division's Request for Rulemaking Affecting Affiliate Transaction Rules for Electric Companies was served upon the CONSUMER ADVOCATE DIVISION at the Office of the Attorney General, 425 Fifth Avenue, North, Nashville, TN 37243-0485 by hand delivery on this the 21st day of May, 1999, and upon the EDISON ELECTRIC INSTITUTE at 701 Pennsylvania Avenue, N.W., Washington, D.C., 20004-2696 by depositing in the United States Mail, postage prepaid, on May 21, 1999.

T. Arthur Scott, Jr.

T. Arthur Scott, Jr., Esquire

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A Pricing Rule for Affiliate Transactions: Room for Consensus

Because it conforms to politically acceptable notions of "fairness," state and federal regulators have relied heavily on the concept of fully distributed cost to govern affiliate transactions. This should be leavened by alternative transfer-pricing measures to balance the goals of economic efficiency and fairness.

Kenneth W. Costello

Ken Costello *is associate director of the Electric and Gas Research Division of the National Regulatory Research Institute (NRRI), Columbus, OH. Mr. Costello has conducted research and has written widely on topics related to the energy utility industry and public utility regulation. He received B.S. and M.A. degrees from Marquette University and has done graduate work in economics at the University of Chicago.*

This article is based on a paper prepared by the NRRI with funding provided by participating member commissions of the National Association of Regulatory Utility Commissioners (NARUC). The views and opinions of the author do not necessarily state or reflect the views, opinions, or policies of the NRRI, NARUC, or NARUC member commissions. The author thanks Jaison Abel and Edwin Rosenberg for helpful comments, but takes full responsibility, of course, for any remaining errors or omissions.

Prices for affiliate transactions, or in the lexicon of economists and accountants, transfer prices, can be defined as prices charged by one segment of an organization for a product or service that it supplies to another segment of the same organization. Generally, transfer prices fall outside an arm's-length bargaining process—for example, they are commonly artificial prices established by a firm to allocate costs among divisions. Transfer prices encompass transactions between divisions of a firm or between a firm and its affiliates.[1]

In most cases, transfer prices are only a concern to the organization itself, not an outside matter. Exceptions to this include the situations where the Internal Revenue Service pays close attention to transfer prices established by multinational companies, and where public utility regulators become attentive when a regulated utility is affiliated with a non-regulated firm or is providing services in both monopoly (core) and competitive markets.[2]

Transfer pricing in the electric power industry will be an increasingly important issue for both state

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and federal regulators as utilities form separate subsidiaries and holding companies composed of regulated utilities and non-regulated affiliates.[3] As industry restructuring evolves, regulators will be faced with the dual challenge of promoting efficient competition and protecting utility customers from anticompetitive practices. The following discussion, particularly the principles set down, although focusing on products or services, is also relevant to the outright sale of assets by a utility to an affiliate or vice versa. A later section proposes language for the pricing of affiliate transactions that attempts to accommodate the widely divergent positions currently being debated in the regulatory arena.

I. Possible Transfer-Pricing Methods

A. Different Perceptions of a Cross-Subsidy

Transfer prices receive the attention of regulators because of the presumption that a utility company would have the incentive to exploit its monopoly position to favor a non-regulated affiliate and, in the process, impose higher costs on its regulated customers.[4] This possibility, by and of itself, does not necessarily constitute a problem. To the extent that regulators can detect such behavior and take appropriate action, no problem persists. In the real-world situation where detection is difficult and uncertain, however, regulators believe they need to establish rules or policies up front that would mitigate undesirable behavior, including transfer-pricing abuse.[5]

Abuse can obstruct the efforts of regulators to protect both a utility's customers from excessive rates and an affiliate's competitors from unfair competition.[6] Generally, protection means preventing cross-subsidies, a term that, as discussed later, has widely different interpretations. In their worst state, cross-subsidies have negative implications for both economic efficiency and "fairness." For example, cross-subsidized prices to one group of utility customers can erect harmful barriers to new entrants in addition to increasing prices to a group of customers. "Fairness" is an elusive term without a precise definition, but nevertheless plays an important part in regulatory decisions.

At worst, cross-subsidies have negative implications for both economic efficiency and "fairness."

Different meanings for cross-subsidies have been proffered in the regulatory arena. They include (1) prices below incremental costs, or equivalently, above stand-alone costs—according to this definition, which is endorsed by many economists, a product or service is being cross-subsidized when its deletion by a firm benefits consumers of other products or services provided by the same firm;[7] (2) proportional disparity between price and incremental cost (IC), or some other definition of cost such as fully distributed cost (FDC), across products or services—this would occur, for example, when the price-to-incremental-cost ratio differs among products or services;[8] and (3) any action by a utility that increases prices for some services while reducing them for other services—this is a general definition of a cross-subsidy, an example being the shifting of common costs by a utility from a regulated service to a service transacted with a non-regulated affiliate.[9]

In the context of transfer pricing, incentives for cross-subsidies are most often associated with:

- A non-regulated affiliate selling a product or service to a regulated utility at an *inflated* price, which requires defining and measuring the price above which the price would be regarded as "inflated."
- A regulated utility selling a product or service at an *excessively low* price, which requires defining and measuring the price below which the price would be regarded as "excessively low."

B. Fully Distributed Cost Versus Incremental Cost Prices: A Summary of the Arguments

FDC pricing seems attractive to many observers, including regulators, for three reasons.[10] First, it results in adequate revenues that cover total costs. In other words, FDC prices applied to each product or service would produce enough revenues to pay for the total costs.[11] Second, relative to IC prices, FDC prices offer more protection to a utility's customers as well as to an affiliate's competitors.[12] Third, FDC prices result in what many regulators perceive as a fair allocation of shared costs. The ultimate defense for FDC prices really comes down to the "fairness" standard that can be interpreted to say an affiliate must be charged the same price for shared inputs (e.g., computer system information) as a utility's customers are charged.

Many economists, however, see the IC as the preferred cost for pricing affiliate transactions or as the benchmark for identifying cross-subsidies. First, IC does not arbitrarily allocate common or shared costs.[13] Second, it passes the antitrust test for non-predation.[14] Third, it satisfies the "burden test," whereby a utility's customers are held harmless when the utility sells a product or service to an affiliate at IC or above. Fourth, the fact that an affiliate is able to purchase a product or service from a regulated utility at a price corresponding to IC and lower than what its competitors have to pay, merely reflects economies of scope. Fifth, IC prices can avoid forgoing economically justified transactions and associated profits that could occur when, instead, a price floor is set at FDC or some other level above IC. To say it differently, requiring an affiliate transaction to be priced at the FDC may harm the regulated utility, its affiliate, and the customers of both the utility and the affiliate; the major beneficiary would be the competitors of the affiliate.[15]

Although compatible with promoting economic efficiency, IC prices are perceived by many as deficient in various ways: (1) a disproportionate allocation of the benefits of economies of scope may violate generally acceptable "fairness" standards; (2) some services may inadequately contribute to a utility's recovery of its overhead costs[16]; (3) IC is difficult to measure; (4) IC pricing fails the regulatory standard of setting rates that would allow a utility to satisfy its revenue requirements; and (5) competitors of a non-regulated affiliate may be unfairly disadvantaged in the process of over-allocating shared costs to a utility's customers.

By nature, transfer prices are artificial in that they are not set by the market but by a firm for internal use.

C. Market Price

According to economic theory, market price should be the preferred measure of transfer price. It reflects the value that the market places on a product or service at the margin. From the perspective of economic efficiency, under most circumstances the market price correctly takes into account the demand and cost aspects of a product or service. It is also compatible with the concept of "comparable pricing," whereby the price for a utility-affiliate transaction is the same price charged to an outside party for the identical product or service.

On the negative side, market prices often do not exist.[17] By nature, transfer prices are artificial in that they are not set by the market but by a firm for internal use to allocate resources among divisions or business units.[18] A market for an intra-firm product or service may, therefore, not exist. Frequently, a product or service may be customized for a particular buyer (a non-regulated affiliate or a utility), thereby making it difficult to determine a relevant market price. Finally, a market price may not reflect competitive conditions. For example, the price may be controlled by a single firm or a small group of firms engaging in collusive behavior.

D. Fundamental Principles

The previous sections point to the problem of establishing guidelines for the pricing of utility-affiliate transactions: Although market prices have theoretical appeal, they may be generally unavailable or extremely hard to measure; FDC prices have attractive features in promoting "fairness," but they violate fundamental tenets of efficient pricing; and, finally, IC prices, although consistent with promoting economic efficiency, may violate "fairness" standards and are difficult to measure.

Transfer-pricing guidelines, as with any guideline, should be premised on a set of principles. These principles largely relate to the effects of transfer pricing on a regulated utility's customers and the promotion of competition in non-regulated markets. Candidate statements of principles—although not necessarily endorsed here, they seem persuasive—include the following:

1. Transfer prices for "essential" products or services transacted between a utility and an affiliate should be the same as the prices for identical products or services sold to and purchased from outside parties. Whether such comparable pricing should apply to nonessential products or services is not as clear.[19]

2. "Fairness," at the bare minimum, requires that a utility's customers are not harmed by a utility-affiliate transaction. This means that transfer prices should satisfy the above-mentioned "burden test," where in the case of a utility selling a product or service to an affiliate, the price should not lie below the IC. Related to this idea is the contention that a true cross-subsidy exists only when a product or service is sold below its IC. Another way of looking at a cross-subsidy is that consumers of other products or services produced by the same firm would be better off if the said product or service were not provided.

3. All consumers of products or services produced under "economies of scope" conditions should benefit from this condition. This means that all products or services should be priced above the IC. How much above the IC the prices should be, and whether anything less than FDC prices would be unacceptable, are debatable issues.

4. In satisfying political objectives, a transfer price needs to balance economic-efficiency and "fairness" objectives. For example, FDC prices may be regarded as acceptable in achieving "fairness," although they sacrifice economic efficiency to some tolerable degree. Pure IC prices may be unacceptable on "fairness" grounds.

Some argue that FDC is the wrong cost measure since it is inherently arbitrary.

5. In addition to protecting a utility's customers from higher prices, transfer prices should also promote fair competition by not placing the affiliate at a disadvantage. The crucial question here is the minimum price that a utility should be able to charge its affiliate and not place its competitors in a position where they are unable to compete even though they may be more efficient.

II. Major Questions

The major policy issues surrounding transfer pricing confront regulators with difficult questions, and with answers that reasonable people can disagree over and debate. A list of the major questions along with a brief discussion follows:

1. *Should FDCs be used to identify and measure a cross-subsidy?*

At one end lies the argument that FDC is the wrong cost measure since it is inherently arbitrary and has no foundation in cost causality.[20] Thus, on the grounds of economic efficiency, some other cost measure, namely, incremental cost, should be the germane price floor to identify the existence of a cross-subsidy. At the other end is the argument that FDC is the correct measure since it fairly allocates the costs that are common to the provision of more than one product or service. By allocating costs on a fully distributed basis, the firm recovers just enough revenues to cover its total costs.

2. *Does IC pricing, in passing an economic-efficiency test, fail to pass a "fairness" test?*[21]

The most serious criticism against IC pricing is that it results in discriminatory pricing, where the price-to-incremental cost ratios for different products or services vary. The reason for this is that in the presence of economies of scope, a firm cannot recover its total costs when it prices all of its products or services at IC. Consequently, because it has to price some of those products or services above IC, consumers receiving IC prices are charged a lower price than other consumers. Although discriminatory prices would undeniably exist, they may not seriously violate a "fairness" test to

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which a particular regulator subscribes. We observe, for example, regulators approving of special contracts and economic development rates, which can be regarded as discriminatory, but acceptably so.[22]

3. *What price would permit the benefits of economies of scope to be "fairly" distributed?*[23]

"Economies of scope" refers to the cost savings that result from a single firm providing products or services rather than having separate firms provide each product or service (i.e., from joint production). When an individual product or service is priced at the IC and others are priced above the IC, all of the benefits of economies of scope go to the first product or service. If a new service, for example, is priced at the IC, it is treated as a by-product, with all the common costs allocated to existing services, or what can be called "basic services." A legitimate concern is what entitles one product or service to receive *all* of the benefits from economies of scope, while others receive none. One seemingly correct allocation is to divide up the benefits of economies of scope to all products or services proportionally, for example, on the basis of usage of the product or service.

4. *When can market prices serve as an appropriate measure of transfer prices?*

As discussed later, market price, whenever it is readily available and reflects competitive conditions, should be the preferred price for affiliated transactions. Of course, because for many affiliate transactions a market price may not exist, some kind of cost measure needs to be identified.

5. *What level of transfer prices would adequately protect a utility's customers and promote competition?*

The disagreement over the word "adequately" is the important issue here. On one side, some argue that IC prices fail in protecting both a utility's customers and an affiliate's competitors: Utility customers receive no benefits and an affiliate's competitors are placed at a disadvantage if they cannot purchase a utility's product or service at such a low cost. On the other side are those who argue that IC prices make the utility's customers no worse off and point out that the fact that the affiliate receives an IC price for a utility's product or service simply reflects economies of scope from which a firm (e.g., a holding company) has the right to benefit. According to this argument, firms are entitled to the internal benefits from economies of scope that firms in all sectors constantly, and in many instances for survival reasons, strive to achieve.[24]

The most serious criticism is that IC pricing results in discriminatory pricing.

6. *How should the price floor for products or services sold by a utility to an affiliate be defined?*

The question correlates with some of the above questions in that an appropriate price floor depends on one's perception of fairness and what constitutes a cross-subsidy. More than anything, regulators are concerned about the effects of affiliate transactions on a utility's customers. They therefore tend to hedge on the side of setting a "high" price floor for products or services sold by a utility to an affiliate. Frequently, their objective is to maximize the prices, as exhibited by the proposed rules in certain states where the required price is the higher of market price and FDC.[25]

7. *How should the price ceiling for products or services sold by an affiliate to a utility be defined?*

For an affiliate sale of a product or service to a utility, regulators are concerned about the utility paying too much[26]; consequently, they tend to set a "low" price ceiling. Some states, for example, require or propose the price to be the lower of market price and FDC.[27]

8. *Is a "burden test" appropriate for transfer pricing?*

The burden test says that a utility's customers should not be worse off when a utility sells a product or service to an affiliate. This requires that the minimum price be set at the IC. Many regulators would argue that the burden test is not sufficient for achieving "fairness" in the way they define it—a utility's customers should not only be held harmless but actually benefit from a utility-to-affiliate transaction. This view goes back to the argument that IC should not be used to set price but, instead, either FDC or the higher of FDC and market price should be the appropriate price.

III. A Proposal

The previous discussion supports the following language on the pricing of affiliate transactions.[28]

> "Generally, *the price for services and products provided by a regulated entity to its non-regulated affiliate* should be at FDC. When readily available, market prices should be considered the preferred pricing method. In other situations, prices can be less than FDC but at or above IC. The latter requires regulatory approval after a utility provides adequate market and other relevant information and after consideration of the tradeoff between economic efficiency and 'fairness' goals."

> "Generally, *the price for services and products provided by a non-regulated entity to a regulated affiliate* should be at FDC. When readily available, market prices should be considered the preferred pricing method. In other situations, prices can be less than FDC based on incremental, negotiated prices or a competitive bidding process, as determined by the regulator after consideration of the tradeoff between economic efficiency and 'fairness' goals."

The above language recognizes the long tradition in regulation, at both the state and federal levels, to place heavy emphasis on FDC for affiliate transactions. This emphasis stems largely from the politically acceptable "fairness" aspect of FDC and the tractability and the verifiability of these costs.[29] The language proposed here, however, acknowledges situations for which alternative transfer-pricing measures would be preferable, thereby giving utilities flexibility in pricing affiliate transactions. One situation would be when market prices for identical or similar products or services exist. Another is when costs differing from FDC may be more appropriate in view of prevailing market conditions and a regulator's balancing of economic efficiency and "fairness" goals.[30] Economists have shown that FDC prices can cause economic inefficiencies and represent the wrong measure for detecting cross-subsidies.

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.[31] In the first case, where the affiliate of a utility pays the "higher of FDC or market prices" for products or services from a utility, the utility may forgo profits that it could otherwise earn. For example, assume that the market price for a service provided by a utility to its affiliate is \$10, but the FDC to the utility is \$13, and the IC to the utility is \$8. Under the "higher of" language, the affiliate would be required to pay \$13. But since the market price for the same service is only \$10, the affiliate would purchase the service from someone else and save \$3 (\$13 − \$10). From the utility's perspective, it loses the opportunity to sell the service to its affiliate at a profit. For example, by selling the service at the market price of \$10, the utility makes \$2 in profits (the market price minus the utility's IC, or the contribution to fixed and common costs). All or a portion of the \$2 may be credited to the utility's customers in lower rates.[32]

As a general rule, when FDC exceeds the market price, with the affiliate having to pay the former, the affiliate will look to other providers, if available, to buy the service. Buying elsewhere, as shown in the above example, can deprive the utility and its customers of economic gains. Of course, this assumes that the utility is unable to sell the service to another consumer at the market price. To the extent it can, however, the utility is left harmless with the only effect being on the affiliate who has to look elsewhere for the service.

In the "lower of" situation with regard to sale of a product or service by an affiliate to a utility, the affiliate may decide not to make such a sale. Let us assume that the affiliate's FDC for a service is less than the market price.[33] The affiliate would then be better off by selling to someone else since it could receive the market price instead of the lower FDC. The utility would have to acquire the service from someone else at the market price. The "lower of" provision merely discourages the sale of a service or product from an affiliate to a utility. The utility is unaffected when it can purchase the same service from another party at the market price, with the affiliate forced to sell its service or product to someone else.

In sum, the "higher of" or "lower of" provision has the intended purpose of maximizing the economic gains to the utility from affiliate transactions (presumably, some or all of which can be credited to the utility's customers). In reality, however, the provision would have no effect or, in the worst case, a negative effect on the utility's profits.[34]

IV. Conclusion

The pricing of affiliate transactions will gain importance for state public utility regulators as restructuring of the electric power industry evolves. In the new environment, regulators would want to assure the protection of a utility's customers from abusive practices including those associated with affiliate transactions. As a secondary concern, regulators would want to avoid conditions where utility affiliates have unfair advantages over their competitors in non-regulated markets. Overall, pricing rules for affiliate transactions will affect competition and economic efficiency in the electric power industry.

In view of the political reality of regulatory affairs, the pricing of affiliate transactions entails balancing economic efficiency and "fairness" goals. The tension between these two goals requires regulators to make tough decisions for which there are no clear answers. This article provides a rationale for a pricing rule that attempts to accommodate the positions of those who fall on opposing sides of

the economic efficiency and "fairness" spectrum. To that end, it attempts to provide guidance to regulators who in the years ahead will be contemplating or re-considering their policies on the pricing of affiliate transactions. ■

Endnotes:

1. An example is the price for materials calculated by a firm for internal use in order to allocate materials among its divisions. The seminal article on the rationale for intra-firm transfers was written by Ronald H. Coase, "The Nature of the Firm," ECONOMICA, Vol. 4 (November 1937), at 386–405.

2. Transfer pricing may also be of interest in antitrust matters (e.g., allegation of predatory pricing) and international trade policy with regard to antidumping rules.

3. Transfer pricing has also become an issue in the natural gas sector, where industry restructuring has occurred over the last several years.

4. This presumption is more valid as the utility's market and the affiliate's market diverge with respect to the degree of competitiveness and the incentive for cost minimization. Transfer-pricing abuse, for example, is more likely to occur under rate-of-return regulation than price-cap regulation, which gives firms a strong incentive to minimize their costs.

5. Several state public utility commissions (PUCs) have already established rules for the pricing of affiliate transactions. NARUC is currently drafting guidelines for energy cost allocations and affiliate transactions. One part, the pricing of products and services transacted between a utility and a non-regulated affiliate, has received much, if not the most, attention.

6. One interpretation of "unfair" is that an affiliate's competitors are not given equal opportunities to compete for retail customers. "Equal" opportunities have different connotations among the various interest groups, as well as among economists.

7. See Gerald R. Faulhaber, *Cross-Subsidization: Pricing in Public Enterprises*, AMER. ECON. REV., Vol. 65 (1975), at 966–77.

8. For example, under some definitions of cross-subsidy, industrial customers would be subsidizing residential customers when the price they pay for electricity is 40 percent above incremental cost, while residential customers are only paying 30 percent above incremental cost. Economists would refer to such pricing as price discrimination.

9. This meaning fails to account for the possibility that the service whose price has risen may have previously received favorable treatment relative to the service whose price has declined.

10. FDC refers to the accounting-based method for measuring costs, whereby costs are defined as the sum of direct costs and common costs (e.g., overhead and sunk costs). The prominent feature of the FDC method is that common costs

are allocated to different products and services without much or any consideration given to economically defensible standards.

11. As noted elsewhere in this article, under the assumption of economies of scope, IC prices would not satisfy this condition.

12. The question to be addressed later in this article is whether such protection constitutes "overprotection" from the perspective of promoting efficient markets.

13. Common costs occur when two or more products or services are provided using the same inputs of the firm. The presence of shared inputs means they cannot be unambiguously assigned to any one or combination of products or services.

14. A commonly cited predation rule is that a firm sells a product or service above its short-run marginal cost or average variable cost, cost measures that correspond more closely to IC than FDC. See Philip Areeda and Donald Turner, *Antitrust Law*, Vols. 1–5 (Boston: Little, Brown & Company, 1980).

15. The would-be transaction, priced at above IC (but below FDC), would earn profits for the utility-seller, part or all of which could be credited to its customers and would allow the affiliate to purchase a product or service that it requires at a price that may be below that of an alternate provider. To the extent that the affiliate's costs are higher, it becomes less competitive.

16. Recently, the Maryland Public Service Commission in Order No. 74038, In the Matter of the Investigation by the Commission into Affiliated Standards of Conduct of Companies Providing Gas or Electric Service in Maryland dated Feb. 23, 1998, commented that:

> "If an incremental cost methodology were used, affiliates could be charged little or nothing for use of . . . utility assets, equipment, and personnel. This would mean that utility ratepayers would be subsidizing affiliate activities with no offsetting benefit to them (at 28)."

17. See, for example, Robert E. Burns, Regulating Electric Utilities with Subsidiaries (National Regulatory Research Institute, 1986), Chapter 7.

18. Transfer prices are generally efficient in view of transaction costs that make market participation uneconomical. See Coase, op cit..

19. See, for example, Alfred E. Kahn, *Electric Deregulation: Defining and Ensuring Fair Competition*, Elec. J. (April 1998), at 43. One can argue that savings may occur for the organization, in the form of lower transaction costs, when dealing internally rather than with an outside party.

20. For example, FDC does not take into account the concept of opportunity cost, which measures the true cost to the firm from providing a product or service.

21. The "fairness" test would require identifying the winners and losers of a regulatory action. Fairness is sometimes associated with the concept of economic justice. See Edward E. Zajac, Political Economy of Fairness (MIT Press, 1995).

22. These so-called discounted rates generally make some contribution to fixed and common costs.

23. The benefits of economies of scope can be defined as the difference between the stand-alone cost (the cost of providing a particular product or service, assuming the firm provides no other product or service) and the IC of producing a particular product or service when another service or product is produced simultaneously.

24. Kahn.

25. For example, the "higher of" pricing method, as of this writing, has been proposed in Missouri and Texas. The general feeling in those states is that the affiliate would be given an unfair advantage if it receives a product or service from a utility below the greater of market price and FDC.

26. This concern is more valid under rate-of-return regulation than price-cap regulation.

27. These states include Missouri, Nevada, and Texas.

28. Some of the wording in the language was borrowed from a draft of the NARUC guidelines for energy cost allocations and affiliate transactions.

29. Also, from an economic perspective FDC prices are subsidy-free, in that they fall within the range of IC and stand-alone cost.

30. One example would be the situation where the affiliate would only buy a service from a utility at a cost lower than FDC, but higher than IC. A regulator could argue that in the absence of the lower price the transaction would not have been made. The utility would, therefore, lose profits that could otherwise be used to lower the price of regulated service. In approving a price that is below FDC, the regulator could argue, as PUCs have done with regard to special rate discounts and contracts for large customers, that "something is better than nothing" in terms of the utility earning profits.

31. As of this writing, the draft NARUC guidelines for energy cost allocations and affiliate transactions contain this language. Proposed regulations in Texas also contain it, and the "lower of" provision is being proposed in Nevada for products and services transferred by an affiliate to a utility. In Maryland, such language applies to asset transfers but not to products or services.

As evident by the following examples, the "higher of" and "lower of" provisions discourage transactions between a utility and its affiliate. Such discouragement, as also argued, may run counter to dispensing the benefits of affiliate transactions to a utility's customers.

32. This assumes rate-of-return regulation, whereby prices for a particular service depend on the revenues the utility receives from other services.

33. One issue in determining FDC is whether the allowed rate of return should be equal to the utility's allowed rate of return or should it be something higher.

34. One state PUC staff member mentioned to the author that the intent of the asymmetric price rule is to discourage any transaction between a utility and its non-regulated affiliate.

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