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OFFICE OF THE
EXECUTIVE SECRETARY

EEI **EDISON ELECTRIC INSTITUTE**

Via overnight delivery

May 20, 1999

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

Re: **Docket No. 98-00690**

Dear Mr. Waddell:

Enclosed for filing in the above-referenced docket are the original and thirteen copies of the Initial 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: Service List (w/ enclosure)
Mathew J. Morey, Ph.D., EEI
Julia M. Valliere, EEI

PROOF OF SERVICE

I, Donna Crook, do hereby certify that copies of the foregoing Comments of the Edison Electric Institute were sent, on this 20th day of May, 1999, via next day delivery, to all individuals listed on the attached service list.

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Tennessee Regulatory Authority
Docket no. 98-00690

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BEFORE THE

TENNESSEE REGULATORY AUTHORITY

In the Matter of the Notice to Amend the Tennessee Administrative Code Part 1220	: : :	Docket No.98-00690

INITIAL COMMENTS OF THE EDISON ELECTRIC INSTITUTE

I. Introduction

The Edison Electric Institute ("EEI") commends the interest of the Tennessee Regulatory Authority (the "Authority") to ensure ratepayer protection against cross-subsidization of non-regulated activities by the customers of the utility's regulated services, one of the basic considerations of the regulatory process. However, specific provisions in the proposed guidelines, for example, reporting requirements in the cost allocation manual, access to books and records and affiliate transactions pricing rules are not in the public interest because they go far beyond what is necessary to achieve the Authority's goals of protecting consumers and competition. Some of the proposed guidelines, for example, the provisions calling for transfer prices to be set according to the "higher of" or "lower of" market or fully allocated cost would likely reduce the efficiency with which the utility and its unregulated affiliates could provide customers of regulated, as well as competitive, products and services, respectively. If adopted, these guidelines would lead to higher costs in the provision of regulated services and a reduction in the welfare of consumers of regulated products and services. This outcome would be directly contrary to the goals of the Authority. By treating the utility's affiliate -- a potentially efficient entrant in competitive product markets differently from all other participants, the proposed guidelines inadvertently protect particular <u>competitors</u> rather than efficient competition. EEI, for reasons we discuss below, therefore, respectfully urges the Authority to amend or strike those provisions in the proposed guidelines that harm consumers and competition.

EEI is the national trade association of the investor-owned electric utility industry. EEI serves its members by providing public policy advocacy, information compilation, analysis and distribution and the promotion of electric marketing. A super-majority of EEI's members establish EEI's positions regarding regulatory policy, although some members disagree with some aspects of those policies in some instances.

For over two years, EEI has been engaged in a spirited process with stakeholders throughout the electric and gas industries regarding the development of appropriate guidelines on cost allocations and the pricing of affiliate transactions. One outcome of this process has been the careful refinement of the position of the investor-owned electric utility industry regarding guidelines that are fair, not unnecessarily costly and competitively neutral. EEI respectfully submits these comments to urge the Authority to modify the proposed guidelines so that they protect ratepayers and competition while avoiding unnecessary sacrifices of efficient resource use and innovation in the development of new products and services for Tennessee consumers, or increases in the costs of business or regulatory compliance for regulated and unregulated affiliates

II. The Purpose of Adopting Guidelines on Cost Allocation and Affiliate Transactions

Preliminarily, EEI urges the Authority to consider the proposal only as guidelines, not as rules. The electric utility industry is currently in a great state of flux, requiring both regulatory and industry flexibility to uphold the high degree of reliability and stability of rates that consumers have come to expect. Guidelines regarding accepted accounting and transfer pricing of transactions between a utility and its affiliate are more appropriate than hard and fast rules because of the dynamism and speed of the industry's transition from regulated services to unbundled competitive services. Tennessee has not yet crossed the bridge into unbundled, competitive territory, but it will be better situated to permit efficient competition in suppling services that customers want if affiliates and utilities are not handicapped with onerous rules that unnecessarily raise the costs of potentially both regulated and non-regulated services.

The purpose of adopting guidelines on cost allocation and affiliate transactions should be the need for a flexible, reasonable and economically sound approach to effectively and adequately safeguard against potential cross-subsidization between the regulated and non-regulated businesses of electric and gas utilities, while concurrently permitting utilities to use their economies of integration to their fullest extent to benefit consumers of regulated as well as competitive market services. The Authority should view the proposed guidelines in a broader context of accepted accounting policies and procedures for allocating costs and recording transfers of services and products and capital assets between the utility and its affiliates as well as the most efficient economic principles for pricing those transfers.

The Authority should not adopt the proposed guidelines on cost allocation and affiliate transactions in this proceeding without modifying specific sections for the following reasons. First, the proposed guidelines would raise the costs or reduce the incentives of only one type of competitor, i.e., affiliates of investor-owned utilities. Specifically, the guidelines would impair an affiliate's efforts to seek more efficient ways of providing products and services in competitive markets, including ways of sharing resources efficiently. Just as rules that unfairly favor particular market participants distort efficient market outcomes (either regulated or unregulated market outcomes), rules that disfavor a particular market participant produce similar effects. Second, specific provisions go well beyond what would be necessary to protect customers of the utility's regulated products and services from the possibility they would unwittingly subsidize the affiliate's unregulated activities. Third, compliance with some of the proposed guidelines would likely increase the cost of regulated products and services or lead to lost opportunities to lower the cost of regulated services and, therefore, the prices ratepayers pay for those services.

III. The Development of EEI's Policy Positions on Cost Allocation and Affiliate Transactions

At the request of representatives from the National Association of Regulatory Utility Commissioners ("NARUC"), EEI established a task force in 1997 comprised of industry accounting and other professionals to develop a cost allocation manual for electric and gas utilities that simplified and standardized allocations for services and products between regulated and non-regulated entities to assist regulators, regulated utilities and non-regulated affiliates when developing policies and procedures. EEI's industry Task Force on Cost Allocations further refined the project goal as the design of cost allocation guidelines that would provide electric utilities that offer both regulated and non-regulated products and services a common format for documenting their cost allocation methods and related accounting policies and procedures. These allocation and pricing methods should prevent cross-subsidization of non-regulated services or products by regulated entities unless expressly authorized by the jurisdictional regulators.

In 1998, NARUC passed a "Resolution Regarding Cost Allocation for the Energy Industry" (March 3, 1998) that, in part, directed interested stakeholders to prepare for NARUC's consideration "Guidelines for Energy Cost Allocations." A resolution adopting the Guidelines is expected at the NARUC Summer Committee Meetings in July of 1999.

IV. EEI's Initial Comments on the Authority's Proposed Guidelines for Cost Allocation and Affiliate Transactions

The following comments address specific sections of the proposed rules document in which EEI makes suggested additions, modifications or deletions. ***Bold italics*** represents language that EEI recommends for substitution and ~~strike-outs~~ represent language EEI recommends deleting from the proposed guidelines. In each section, we offer substantiating comments prior to the proposed modifications to the guidelines.

(1) Definitions

1. Comments

A "Definitions" section is important. However, technical words, especially when used to describe accounting and economic principles, require specific, carefully written definitions for clarity. Both definitions (h) "Direct Costs" and (m) "Non-Regulated" are acceptable with minor modification to clearly articulate the context of the technical application used in the proposed rules. EEI suggests the addition of the definition, "Negotiated," because it is referenced in Section (4), Affiliate Transactions, but is not defined, even though all other pricing options are.

2. Proposed Revisions

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

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

~~(m)~~
(n) **Non-Regulated** - refers to services or products that are not subject to ***price*** regulation by regulatory authorities.

(2) Cost Allocation Principles

1. Comments

EEI suggests the addition of a short preamble to this section to distinguish between tariffed and non-tariffed services and products and for consistency with all other sections. Section (4), Affiliate Transactions is specific in application to non-tariffed services or products. The basic principles in Section (2), Cost Allocation Principles, could apply in some cases to tariffed services or products, or in others to non-tariffed services or products. In addition, EEI has added the distinction of "category or class" of service or product to section (2)(a) to be consistent with standard industry practices of accounting for costs and revenues by category or class, rather than by each service or product. As discussed below, the reporting of revenue by each service and product provided is not cost effective and could potentially require significant and costly modifications or additions to existing accounting systems. The Authority should also require this classification for consistency with standard industry practices. If the Authority were to adopt this provision as proposed, it would potentially increase costs of compliance that the Authority should permit the affected utility to recover in rates.

2. Proposed Revision

> ***The following cost allocation principles should apply to tariffed services and products and may be applicable to non-tariffed services and products depending on the transfer pricing policy choice, for example, when fully-allocated cost is used as the basis for transfer prices.***
>
> (a) To the maximum extent practicable, in consideration of cost benefit standards, costs should be collected and classified on a direct basis for each ***category or class of*** service or product provided.

(3) Cost Allocation Manual (CAM)

1. Comments

The proposed rules require utilities to report in the cost allocation manual ("CAM") annual revenue by each service or product. Reporting requirements at this level of detail do not reflect current standard accounting practices. The inclusion of specific operational data of revenue by each service and product would require continual updating within the CAM that, by definition, is "an indexed compilation and documentation of a company's cost allocation policies and related procedures" - not a financial report. In addition, requiring a utility to provide annual revenue breakdowns by each service and product provided to, or obtained from, a non-regulated affiliate is against standard industry accounting practice, excessive in light of the stated goals of protecting against cross-subsidization and, therefore, costly.

The standard industry practice for managerial and financial accounting purposes is to account for data related to services and products by category or class to avoid minutia and promote meaningful analysis. The reporting of revenue by each service and product provided is not cost effective and could potentially require significant and costly modifications or additions to existing accounting systems. If the Authority were to adopt this provision, it would potentially increase costs of compliance that likely would be passed along to ratepayers. Further, the Financial Accounting Standards Board ("FASB") has issued Statement of Financial Accounting Standards ("SFAS") No. 131, *Disclosures about Segments of an Enterprise and Related Information* that describes the manner in which entities must disclose revenues for services and products in a business segment.

The Authority should strike the proposed guideline that the utility include revenue reporting requirements in the CAM. In addition, EEI also suggests striking language in the proposed guidelines referring to compliance with SFAS 131 or any other FASB accounting standards, as companies under the jurisdiction of the Securities and Exchange Commission are already required to comply with FASB standards.

2. Proposed Revisions

> (b) A description of all services and products provided between the regulated entity and its affiliates. ~~Also, estimated annual revenue by each category or class of these services and products should be provided.~~
>
> (c) A description of all services and products provided ***by*** the regulated entity to non-affiliates. ~~Also, estimated annual revenue by each category or class of these services and products should be provided.~~
>
> ~~Entities will follow Statement of Financial Accounting Standards (SAS) No. 131, Disclosures about Segment of an Enterprise and Related Information as required and will make the disclosure available upon request to jurisdictional regulatory authorities.~~

(4) Affiliate Transactions

1. Comments

The Public Utility Holding Company Act of 1935 ("PUHCA") currently requires registered holding company systems to price the sale of goods and services and the undertaking of construction contracts between affiliate companies "at cost." Investor-owned utilities serving Tennessee are is subject to PUHCA, and, therefore, would not be subject to the asymmetric pricing guidelines as proposed. However, while Section (4)(b) of the proposed guidelines states that federal requirements would prevail over the proposed guidelines, repeal of PUHCA could possibly subject Kingsport Power and other utilities to asymmetric transfer pricing rules that EEI strongly opposes because of the significant deleterious effects such rules would have on the efficient use of resources and the subsequent harm to consumers, who would likely pay higher prices for regulated and unregulated products and services than they might otherwise. In addition, including the PUHCA language in subsection (4)(b) but not in subsection (4)(a) is inconsistent. Therefore, the Authority should strike these references.

The proposed guidelines would reduce economic efficiency, discourage efficient resource use, unnecessarily raise the costs for regulated and unregulated affiliates and discourage regulated and unregulated product and service innovation. In addition, the proposed guidelines do not contemplate alternate transfer pricing methods that, in at least some circumstances, may prove beneficial to regulated and non-regulated utility customers alike and that are currently in practice and endorsed by other state commissions, specifically, Delaware, Illinois and Maine. The increasing need to preserve and promote efficiency and enable competition to deliver benefits to consumers in a mixed regulated/competitive market environment calls for greater flexibility in transfer pricing policy and practices. The proposed guidelines seek to protect consumers of regulated services from cross-subsidization through asymmetrical pricing of transactions between the utility and its unregulated affiliate. While this approach protects consumers, it also strongly discourages transactions between the utility and its unregulated affiliate that could reduce the costs of regulated as well as unregulated operations. Other transfer pricing methods, however, also protect consumers of regulated services and would more effectively promote economic efficiency than an asymmetric guideline. A "one-size-fits all" pricing policy to cover all utility-affiliate transactions will make it more difficult for the Authority to seek the best outcomes to fit the circumstances of particular types of transactions. For the sake of consumers welfare, EEI recommends the Authority adopt a flexible transfer pricing policy that contemplates the application of a wide range of pricing options tailored to fit the transactional circumstances. Accordingly, EEI recommends the following revisions in proposed Section (4)(a)(b) and (c) consistent with our position that flexible transfer pricing will be more beneficial to consumers. EEI also proposes to change "date" to "determine" in the last sentence in Section (4)(c) to be consistent with conventional accounting technical terminology.

2. Proposed Revision

(a) The price for services and products provided by a regulated entity to its non-regulated affiliates shall ***depend on the nature and circumstances of the transaction(s) given consideration of various transfer pricing options including, but not limited to, those based on fully allocated cost, market-driven price, incremental cost, combinations of these methods or negotiated, except as otherwise required by law or regulation.*** ~~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.~~ ***(Specific examples of such law or regulations are the provisions of The Public Utility Holding Company Act of 1935 which require 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)).*** (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.)

(b) The price for services or products provided by an affiliated company to a regulated affiliate ~~should~~ ***shall depend on the nature and circumstances of the transaction(s) given consideration of various transfer pricing options including, but not limited to, those based on fully allocated cost, market-driven price, incremental cost, combinations of these methods or negotiated, except as otherwise required by law or regulation.*** ~~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)).

(c) Transfer of a capital asset ***between a regulated entity and an affiliate company, regardless of the transfer direction, should generally be at market price*** ~~from the utility to its non-regulated affiliate shall be at the greater of market price or net book value,~~ except as otherwise required by law or regulation. If no market exists for the asset, a negotiated price no lower than net book value is acceptable. ~~Transfer of assets from an affiliate to the utility shall be at the lower or market or net book value, except as otherwise required by law or regulation.~~ An appraisal to ~~date~~ ***determine*** asset valuation may be required according to value thresholds as determined by the Authority.

(5) Audit Requirements

1. Comments

Regulators should have access to all <u>relevant</u> information contained in the books and records of a regulated utility's non-regulated affiliate to ensure that cross-subsidization does not exist, consistent with state statutes. However, <u>complete access</u> to the books and records of the regulated utility's non-regulated affiliates is not required in order to make this evaluation. Specifically, audit trails should exist with respect to all transactions between the regulated utility and its affiliates and access to affiliate books and records should be limited to relevant transactions that relate to the regulated business or ratemaking activities. Non-regulated affiliates should not be subject to burdensome and intrusive examination of portions of their business records when the transactions at issue do not pertain to the regulated business and ratemaking. Audits of these jurisdictionally relevant transactions would reveal any inappropriate cost shifting or cross-subsidization.

2. Proposed Revision

1. An audit trail should exist with respect to all transactions between the regulated entity and its affiliates that relate to jurisdictional services and products. ***When such transactions exist,*** ~~T~~the Authority shall have complete access to all affiliate records necessary to ensure that cost allocations and affiliate transactions are conducted in accordance with these rules.

V. Conclusion

EEI respectfully urges the Authority to modify the proposed guidelines consistent with these initial comments.

Date: May 20, 1999

Respectfully submitted,

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