BEFORE THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE



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

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## REPLY COMMENTS OF CONSUMER ADVOCATE DIVISION

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The Consumer Advocate Division of the Office of the Attorney General and Reporter hereby submits the following comments in reply to the comments of Kingsport Power Company and the Edison Electric Institute in Docket 98-00690.

### SECTION A COMMENTS

Under Section A of its comments, Kingsport Power Company proposes four reasons why the Authority should not proceed with the rulemaking in this docket[1]:

1. The proposed cost allocations 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 transactions 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.

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[1] Kingsport Power Company's Comments at page 2.

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 event.

The Consumer Advocate Division addresses each of Kingsport's reasons for delaying implementation of the proposed rules.

**1. The proposed cost allocations 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.**

Kingsport Power is mistaken in its assertion. The rules are not outside the scope of the TRA's jurisdiction. As explained in the Consumer Advocate Division's initial comments, it is well within the power of the Authority to prescribe rules that address the accounting and ratemaking treatments afforded transactions involving a regulated utility and either an affiliated or a non- affiliated entity. The proposed rules do not and are not designed to extend the jurisdiction of the Authority beyond that provided by statute. The proposed rules simply prescribe the procedure to be used by the regulated utility to record transactions on the regulated books and provide directions on the documentation required for revenues and costs to be considered for ratemaking purposes.

**2. To the extent the transactions addressed by the proposed cost allocation and affiliate transactions 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 stated in the proposed rules 1220-4-4-.55 (d) 2, and 3, the rules do not apply to affiliate transactions that are otherwise regulated by law or regulation.

1220-4-4-.55 (d). AFFILIATE TRANSACTIONS (NOT TARIFFED)

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 provision 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)).

3. Transfer of a capital asset 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 of market or net book value, except as otherwise required by law or regulation. An appraisal to date asset valuation may be required according to value thresholds as determined by the Authority.

Since the rules do not apply to those transactions regulated by the SEC or the FERC, the rules by definition are not preempted.

In footnote 1 on page 6 of its comments, Kingsport concedes that transactions between Kingsport Power and an affiliated exempt telecommunications company fall under the

jurisdiction of the Authority[2].

**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.**

Based on a quote from a request for proposal issued in relation to the 1996 management audit, Kingsport Power contends that the Tennessee Public Service Commission ". . . . declined to layer another level of regulation on affiliate transactions. . . ." To conclude that by limiting the scope of a management audit that the Commission made a conscious decision to limit its regulatory powers is a stretch to say the least. In the quoted document, the Commission was not issuing an order in a rulemaking proceeding but was addressing the scope of a proposed management audit. From the quote provided by Kingsport it is clear that the Commission concluded that transactions involving Kingsport Power and an affiliated company were subject to its jurisdiction since it directed that the auditor was to ". . . review and examine the Company's internal processes regarding these matters and to confirm the existence of methodologies governing the allocations." Since the statutory power of the Authority to regulate electric utilities is the same as that of its predecessor, the Commission's recognition that it had the authority to review and examine the Company's internal processes for dealing with affiliate transactions is in direct conflict Kingsport's argument that affiliate transactions are beyond the Authority's jurisdiction.

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[2] In its February 23, 1998 Order No. 74038 in Case 8747 the Maryland Public Service Commission found that the state regulatory authority has ". . . . jurisdiction concurrently with the SEC sufficient to order asymmetric pricing of asset transfers between a regulated utility and its affiliates in a registered holding company structure." [Maryland Order at page 797, Attachment C to Consumer Advocate Comments filed on May 20, 1999.]

**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 event.**

The Consumer Advocate Division agrees that there have been some modifications to the proposed guidelines adopted by the NARUC Subcommittee on Accounts in September 1998. As is apparent form the complete copy of the revised proposed NARUC guidelines attached as Exhibit A, the changes to the proposed NARUC guidelines do not alter the need for or require modification of the rules proposed in this proceeding. While the proposed rules are somewhat more specific than the general statements included in the proposed NARUC guidelines, the proposed rules are not inconsistent with the revised proposed guidelines.

Kingsport's argument that "[t]he CAD proposal asks the Authority to issue an advisory opinion on what rules and regulations should be if deregulation were to occur . . . " is also incorrect. The Consumer Advocate Division has not asked for an advisory opinion, but has asked for the adoption of rules that regulate the accounting and ratemaking treatment of affiliate transactions.

Kingsport's argument that "[b]ecause the proposed rules speculatively seek to address what may come to be, there are no "interested persons" at this time is inconsistent with the record in this proceeding. Kingsport Comments at page 9. If there are no interested persons, what is Kingsport's position in this proceeding? If Kingsport is not an interested person, it would appear that it has wasted a material amount of effort in this proceeding.

## SECTION B COMMENTS

Under Section B of its comments, Kingsport Power makes what it calls "Substantive

Comments" in four classifications:

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 Pricing Rules are Administratively Cumbersome and Unnecessarily Costly.

4. The CAD's Proposed Pricing Rules Unfairly Create Winners and Losers.

The following are the Consumer Advocate Division's responses to each of these comments.

**1. The CAD's Proposed Pricing Rules Lack Economic Justification and Are too Inflexible.**

The Consumer Advocate Division agrees with Kingsport that the purpose of the proposed rules is to protect the ratepayers of regulated utilities. Kingsport, however, is incorrect in stating that:

> . . . . 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. [Kingsport comments at page 12](Emphasis added.)

Kingsport is incorrect. The ratepayers are harmed if the utility's rates are increased to recover the cost of services purchased from an affiliate at market price if the utility can provide the service directly at a lower cost. The statement that the utility ". . . . does not otherwise have an opportunity to pay less than market price" fails to recognize that the corporate structure is a

largely a matter of discretion for the management of the utility and its parent. The utility has discretion in deciding the entity within its organization that will perform the various functions required to provide utility service. The utility can determine if it will provide all functions on an integrated basis or decide that certain functions will be provided under separate affiliates. The utility, therefore, does have an opportunity to pay less than market. It can elect to provide the utility services by integrating the affiliate into the utility and recognize actual cost instead of artificially spinning necessary utility functions into an affiliate in order to increase the cost to be recovered from the ratepayers. To accept Kingsport's position would allow the utility to circumvent regulation and unfairly increase rates. The current SEC rule which requires that services provided by affiliates be priced at cost is designed to prohibit improper markups when service is provided to the utility by an affiliate.

It is important to remember that the utility's captive ratepayers do not have a choice of selecting a service provider. In a competitive environment, the ratepayer would be free to choose to purchase service from another provider that elected to perform a function directly, or to purchase service from a utility that chose to purchase service from an affiliate that provided the service at cost. In a truly competitive environment such transactions would not be a major concern since the entity dealing with the end user would have an incentive to reduce its cost and resulting rates. However, where the utility has an exclusive right to provide service in an area there is no such incentive.

The requirement that goods and services provided to nonregulated affiliates be priced at cost is also proposed to protect the utility's ratepayers from subsidizing an affiliate that operates in a competitive market. To allow a nonregulated affiliate to purchase service from the

utility at less than cost shifts the competitive burden from stockholders to the regulated ratepayers. Such a shift adversely impacts not only the ratepayers but also competitors of the unregulated affiliates and consumers in general. As explained in the Consumer Advocate Division's initial comments, the Authority's present accounting rules for regulated telephone companies require nontariffed services provided to affiliates to be priced at higher of fully allocated cost or market. Similarly in September 1996, in docket ER96-2495-000 the Federal Energy Regulatory Commission (FERC) prohibited AEP from selling non-power goods or services to any affiliate at a price below its cost or market price, whichever is higher.

## 2. The CAD's Proposed Rules Unnecessarily Seek to Dictate the Pricing Terms of Transactions Between Utilities and Non-Regulated Affiliates.

The Consumer Advocate Division agrees with Kingsport's statement on page 14 of its comments regarding the TRA's broad power over utilities and affiliates:

> 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.

The Consumer Advocate Division also agrees that the Authority has the legal jurisdiction to determine the cost that is to be recorded on the regulated books of the utility that arise from transactions with nonregulated affiliates. Contrary to Kingsport's previous arguments, however, it is also within the Authority's jurisdiction to prescribe rules that address how costs and revenues that arise from affiliate transactions will be recorded on the utility's regulated books; to prescribe the documentation required to support such transactions; and to determine

how the costs and revenues are to be treated for ratemaking purposes. The rules are not intended to unnecessarily dictate pricing terms of such transactions but are intended to provide directions relative to how such costs and revenues are to be recorded, supported, and treated for ratemaking purposes.

### 3. The CAD's Proposed Pricing Rules Are Administratively Cumbersome and Unnecessarily Costly.

While Kingsport apparently acknowledges that under current law the Authority can determine how revenues and costs that result from affiliate transactions are to be treated for ratemaking purposes, it questions the Authority's ability to determine the meaning of the term "adequate" information. It appears that while agreeing that the Authority has the jurisdiction to evaluate how such costs and revenues are to be treated, Kingsport objects to the Authority prescribing what information should be maintained and made available. Kingsport concedes that 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 affiliate. Kingsport, however, objects to the Authority prescribing rules that address the required documentation. As explained in the Consumer Advocate Division's comments filed previously, Kingsport and its affiliates must maintain cost allocation and pricing procedures for transactions involving affiliates. The requirement of the CAM is simply a codification of these procedures that provides the Authority the ability to review and audit such transactions. The codification of these accounting and documentation requirements into one source document should provide for more efficient accounting and auditing procedures. Rather than increase costs, development of a CAM

may result in cost savings.

## 4. The CAD's Proposed Pricing Rules Unfairly Create Winners and Losers.

Kingsport improperly equates the regulation of utilities to a game where there are winners and losers, and complains that under the proposed rules, the utility's shareholders will always be the losers and the ratepayers will always be the winners. This is an inaccurate characterization of the regulatory process and the proposed rules. By granting the utility a Certificate of Convenience and Necessity, the state has agreed that in exchange for the utility's agreement to provide service at just and reasonable rates, ratepayers will give up the opportunity of selecting an alternative provider. By accepting the Certificate of Convenience and Necessity, the utility's investors have accepted the responsibility for providing utility service in exchange for the opportunity to recover prudently incurred operating costs including a just and reasonable return on the investment devoted to utility service. The utility is not required to provide service at less than prudently incurred cost, and the ratepayers are not required to pay more. The proposed rules are consistent with this concept. The utility is provided the opportunity to recover prudently incurred costs and the ratepayer is protected from having to pay more as the result of the utility dealing with an affiliate.

The costs recognized in transactions involving the purchasing of services and goods from an affiliate are limited to the lesser of cost or market price. If market price is less than cost, the utility's stockholders are not losers. As the owners, the stockholders are in the position to change management or take other appropriate action to insure that costs are at or below market.

If the stockholders are unable or unwilling to make the necessary change they may not recover all of the costs incurred. However, the stockholders are entitled only the opportunity to recover prudently incurred costs even if the function is provided under the umbrella of the utility. Shifting the function to an affiliate does not modify this primary concept of utility regulation.

Similarly, if the cost to produce the product or service is less than market, the stockholders again are not losers. The stockholder has been given the opportunity to recover prudently incurred costs. By paying actual cost, the stockholders are recovering the prudently incurred costs. Again there is no loss and the stockholders are not losers.

Kingsport's position is contrary to this concept. If accepted, Kingsport's position would allow a utility, which is protected from the risk of competition, to earn more than the reasonable return by simply spinning a portion of its operations into an affiliate and charging prices that are equal to those of a highly profitable enterprise or speculative venture.[3] In addition, Kingsport's position would protect a utility that persists in purchasing a service or product from an inefficient affiliate when other sources could provide the service or product at some lesser cost.

The proposed rules provide that, to use Kingsport's terminology, there are no absolute winners and no absolute losers. The utility's stockholders receive their just compensation and

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[3] As stated by the U.S. Supreme Court in *Bluefield Water Works Co. v. Public Service Commission, 262 U.S. 679 (1923),* such a return is " . . . . equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in [262 U.S. 679, 693] highly profitable enterprises or speculative ventures". In *Federal Power Com'n V. Hope Natural Gas Co., 320 U.S. 591 (1944)* the Court found: ". . . . the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks."

the ratepayers pay the appropriate rates.

## EEI COMMENTS

On page 1 of its comments, the Edison Electric Institute (EEI) contends that:

> 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 competitors rather than efficient competition. (Emphasis provided by EEI.)

EEI did not identify the alleged particular competitor that the proposed rules supposedly protect. As a result, the Consumer Advocate Division is not in a position to directly address this contention.

Similarly, on page 4 EEI contends that ". . . .compliance with some of the guidelines would likely increase the cost of regulated products and service or lead to lost opportunities to lower cost of regulated services . . . ," but offers no specifics that the Consumer Advocate can respond to.

On page 5 of its comments, EEI proposed to modify the definitions of "Direct Costs," and "Non-Regulated." The Consumer Advocate Division does not object to the proposed modifications. EEI also proposes to define the term "Negotiated" as:

> 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.

The proposed definition is acceptable with minor modification to clearly articulate that such negotiations are between nonrelated parties:

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

On page 6, EEI proposes to add additional wording to 1220-4-4-.55 Cost Allocation and Affiliate Transactions, Cost Allocation Principles:

> *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 pricing.*
>
> (a) To the maximum extent practical, in consideration of cost benefit standards, cost should be collected and classified on a direct basis for each *category or class of* service product provided.
>
> [Proposed modification in italics.]

The proposed preamble could be interpreted to require electric utilities to develop detailed class cost of service allocation procedures for all services provided by a utility. This is well beyond the intent of the rules which are intended to address only those transactions that involve both regulated and non-regulated operations of an integrated utility or a utility and its nonregulated affiliates. When tariffed services are provided to nonregulated operations or a nonregulated affiliate, the proposed rule requires such services be provided at tariffed rates consistent with the provision of service to nonaffiliated customers. As a result the detailed allocation procedures proposed by the EEI are not necessary when the services involved are tariffed. The wording for the preamble as proposed by the EEI extends and complicates the rules well beyond that necessary to achieve the goal of insuring fair assignment of cost when both regulated and nonregulated operations are involved. The Consumer Advocate Division recommends that the Authority reject EEI's proposed preamble.

The Consumer Advocate Division does not agree that "*category or class of*" should be added as proposed by EEI. The Consumer Advocate Division agrees that is not necessary to

collect and classify cost on a direct basis for each tariffed service when such services are provided to nonregulated operations or nonregulated affiliates. As a result the Consumer Advocate agrees that for this purpose all tariffed services could be treated as one category or class. However, for non-tariffed services the cost should, to the maximum extent practical, in consideration of cost benefit standards, be collected and classified on a direct basis for each service product provided.

On page 7 of its comments, EEI addresses the requirement that regulated utilities report revenue for each service or product. The Consumer Advocate Division does not agree with EEI's proposal. EEI contention that the proposal would increase costs passed along to rate payers is not reasonable. When providing service to nonaffiliates, the utilities have the ability to identify the revenues by customer and by tariff classification. Surely a utility that provides service to affiliates will bill for such service and maintain records of such sales as it does when providing service to nonaffiliated customers. Simply reporting those sales should not be a major undertaking.

On pages 10 and 11 of its comments, EEI proposes major modifications that severely reduce the effectiveness of the proposed rules. The proposed language effectively removes a major portion of the limits on transfers of services and products between the regulated and nonregulated operations of a utility and its affiliates. If adopted EEI's proposed language will eliminate a good degree of the ratepayer protection that is the objective of the proposed rules. The Consumer Advocate Division recommends that the majority of EEI's proposed language be rejected. The Consumer Advocate Division does not object to EEI's proposal that the word "date" be changed to "determine" as proposed on page 11 of EEI's comments.

On page 11 of it comments, EEI also addresses the Authority's access to a utility's nonregulated affiliates' books and proposes the following modification:

> 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. [Addition identified in italic.]

EEI agrees that audit trails should exist with respect to all transactions between the regulated utility and its affiliates, but contends that the Authority's access to the affiliate books and records should be limited to relevant transactions that relate to the regulated business or ratemaking activities. The Consumer Advocate Division does not believe the modification is necessary. The Authority is aware of its jurisdiction and would not go beyond the review necessary to ensure that cost allocations and affiliate transactions are conducted in accordance with these rules. If the utility is not providing service, sharing assets, sharing personnel, or otherwise providing and/or obtaining service from an affiliate, access to the affiliate records should not be necessary. While the Consumer Advocate Division does not believe the modification is necessary it does not object to the proposed modification with the understanding that the Authority retains it rights to review both the regulated utility's and the affiliates' records as necessary to determine if such transactions have occurred.

## CONCLUSION

The proposed rules on affiliate transactions are needed for the protection of utility consumers from abusive policies and practices of public utilities which seek to circumvent regulation through dealings with their own divisions or unregulated affiliates. Unless properly

supervised, transactions between the monopoly operations and nonregulated operations can result in the utility customers bearing costs that should not be included in the cost of providing utility service. Through the use of such transactions, utilities would recover from their monopoly customers costs that would be disallowed if incurred directly by the utility operations and/or require consumers to pay higher rates than would otherwise be the case to cover the costs of transactions favorable to non-utility operations.

For the foregoing reasons, the Authority should adopt the proposed rules for affiliate transactions and cost allocations.

Respectfully Submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a copy of this Reply Comments of Consumer Advocate Division was served on the parties listed below by mail on this the 10th day of June, 1999.

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Vance L. Broemel

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Attachment A

NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

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April 6, 1999

To: Ms. Cynthia Marple of the American Gas Association
Mr. Mathew Morey of the Edison Electric Institute
Mr. John Anderson of the Electricity Consumers Resource Council
Ms. Julie Simon of the Electric Power Supply Association
Mr. David Keene of the Mechanical Contractors Association
Mr. A. M. Ponticelli of the National Alliance for Fair Competition
Mr. Charles Acquard of the National Association of State Utility Consumer Advocates
Mr. Steve Piecara of the National Rural Electric Cooperative Association
Mr. Ed Grenier of Process Gas Consumers

From: Tim Devlin of the Subcommittee on Accounts
Lou Ann Westerfield of the Strategic Issues Subcommittee
Bob Harding of the Gas Subcommittee

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Attached is the current draft of the NARUC Guidelines for Cost Allocations and Affiliate Transactions. We are interested in your comments regarding this matter. Please provide any comments by April 20, 1999, to Tim Devlin by e-mail-TDEVLIN@PSC.STATE.FL.US or by fax-850-413-6401 or by mail-Florida Public Service Commission, 2540 Shumard Oak Blvd., Tallahassee, FL 32399-0865.

We plan to prepare a side by side analysis of the various comments. This will be presented to Committee Chairs on Electricity, Finance and Technology, and Gas. We expect that the Guidelines will be presented for final resolution at the NARUC meetings in July of 1999. Thank you for your cooperation in this matter.

Attachment

Florida Public Service Commission, 2540 Shumard Oak Boulevard,
Tallahassee, FL 32399, (850) 413-6400, FAX (850) 413-6401

# GUIDELINES FOR COST ALLOCATIONS AND AFFILIATE TRANSACTIONS

The following Guidelines for Cost Allocations and Affiliate Transactions (Guidelines) are intended to provide guidance to jurisdictional regulatory authorities and regulated utilities and their affiliates in the development of procedures and recording of transactions Or services and products between a regulated entity and affiliates. The prevailing premise of these Guidelines is allocation methods should not result in subsidization of non-regulated services or products by regulated entities unless authorized by the jurisdictional regulatory authority. These Guidelines are not intended to be rules or regulations prescribing how cost allocations and affiliate transactions are to be handled. They are intended to provide a framework for regulated entities and regulatory authorities in the development of their own policies and procedures for cost allocation and affiliated transactions. Variation in regulatory environment may justify different cost allocation methods than those embodied in the Guidelines.

The Guidelines acknowledge and reference the use of several different practices and methods. It is intended that there be latitude in the application of these guidelines, subject to regulatory oversight. The implementation and compliance with these cost allocation and affiliate

transaction guidelines, by regulated utilities under the authority of jurisdictional regulatory commissions, is subject to Federal and state law. Each state or Federal regulatory commission may have unique situations and circumstances that dictate affiliate transactions, cost allocations, and/or service or product pricing standards. For example, The Public Utility Holding Company Act of 1935 requires registered holding company systems to price "at cost" the sale of goods and services and the undertaking of construction contracts between affiliate companies.

The Guidelines were developed by the NARUC Staff Subcommittee on Accounts in compliance with the Resolution passed on March 3, 1998 titled "Resolution Regarding Cost Allocation for the Energy Industry" which directed the Staff Subcommittee on Accounts 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. Various levels of input were obtained in the development of the Guidelines from the Edison Electric Institute, American Gas Association, Securities and Exchange Commission, the Federal Energy Regulatory Commission, Rural Utilities Service and the National Rural Electric Cooperatives Association as well as staff of various state public utility commissions.

In some instances, non structural safeguards as contained within may not be sufficient in preventing market power problems in strategic markets such as the generation market. Market power is defined as the ability to raise prices above market for a sustained period and/or impede output of a product or service. Consideration should be given to any Aunique@ advantages an incumbent utility would have over competitors in emerging market such as the retail energy market. A code of conduct should be used in conjunction with guidelines on cost allocations and affiliate transactions. Such concerns have led some states to develop codes of conduct to govern relationships between the regulated utility and its unregulated affiliates.

A. DEFINITIONS

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

2. Attestation Engagement - one in which a certified public accountant who is in the practice of public accounting is engaged to issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party.

3. Cost Allocation Manual (CAM) - 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 regulated and non-regulated 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. Direct Costs - costs which can be identified with a particular service or product.

8. Fully Allocated - services or products bear the sum of the direct costs plus an appropriate share of indirect costs.

9. Incremental - pricing services or products on a basis of only the incremental costs added by their operations while one or more pre-existing services or products support the fixed costs.

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

11. Non-regulated - refers to services or products that are not subject to regulation by regulatory authorities.

12. Prevailing Market - a generally accepted market value that can be substantiated by clearly comparable transactions, auction or appraisal.

14. Regulated - refers to services or products that are subject to regulation by regulatory authorities.

15. Subsidization - the recovery of costs from one class of customers or business unit that are attributable to another.

B. COST ALLOCATION PRINCIPLES

1. 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.

2. The general method for charging indirect costs should be on a fully allocated cost basis. Under appropriate circumstances, regulatory authorities may consider incremental, market-driven, negotiated pricing or other methods for allocating costs and pricing transactions among affiliates.

3. To the extent possible, all direct and allocated costs between regulated and non-regulated products and services should be traceable on the books of the applicable regulated utility to the

applicable Uniform System of Accounts. Documentation should be made available to the appropriate regulatory authority upon request regarding transactions between the regulated utility and its affiliates.

4. The allocation methods should apply to the regulated entity's affiliates in order to prevent subsidization from, and ensure equitable cost sharing between, the regulated entity and its affiliates, and vice versa.

5. All costs should be classified to services or products which, by their very nature, are either regulated, non-regulated, or common to both.

6. 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.

7. The indirect costs of each business unit, including the allocated costs of shared services, should be spread to the services or products to which they relate using relevant cost allocators.

C. Each entity that provides both regulated and non-regulated services or products shall maintain a cost allocation manual (CAM) or its equivalent and notify the jurisdictional regulatory authorities of the CAM's existence. The determination of what, if any, information should be held confidential should be based on the statutes and rules of the regulatory agency that maintains the information. Any entity required to provide notification of a CAM(s) should make arrangements as necessary and appropriate to ensure competitively sensitive information derived therefrom be kept confidential by the regulator. At a minimum, the CAM should contain the following:

1. An organization chart of the holding company, depicting all affiliates, and regulated entities.

2. A description of all services and products provided between the regulated entity and its affiliates. Also, annual revenue by each of these services and products should be provided.

3. A description of all services and products provided the regulated entity to non-affiliates. Also, annual revenue by each of these services and products should be provided.

4. A description of the cost allocators and methods used by the regulated entity and the cost allocators and methods used by its affiliates related to the regulated services and products provided to the regulated entity.

Additional information such as cost of service data, may be necessary to evaluate subsidization issues.

Entities will follow Statement of Financial Accounting Standards (SFAS) No. 131, Disclosures about Segments of an Enterprise and Related Information as required and will make the disclosure available upon request to jurisdictional regulatory authorities. SFAS 131 only requires disclosure for business operations that exceed 10% of total business operations.

## D. AFFILIATE TRANSACTIONS (NOT TARIFFED)

The affiliate transactions pricing guidelines are based on two assumptions. First, affiliate transactions raise the concern of self dealing where market forces do not necessarily drive prices. Second, utilities have a natural business incentive to shift costs from non-regulated competitive operations to regulated monopoly operations since recovery is more certain with captive ratepayers. Too much flexibility will lead to subsidization. However, if the affiliate transaction pricing guidelines are too rigid, economic transactions may be discouraged.

The objective of the affiliate transactions= guidelines is to lessen the possibility of subsidization by providing preferences in pricing to protect the ratepayers. It provides ample flexibility to accommodate exceptions where the outcome is in the best interest of the utility and its ratepayers. As in any transactions, the burden of proof for any exceptions stays with the utility.

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 case where the affiliate=s costs is less than market may be due to its relationship with the utility. Large volume transactions, certainty in purchases, reduced administrative costs (ordering, inventory, etc.) are factors related to the relationship with the utility. Therefore, efficiencies should inure to the utility and ratepayers unless it can be shown they are not related to the relationship with the utility. Market pricing is less reliable when the majority of sales are between affiliates for a particular service or product.

Since affiliates may not have the same accounting detail as a regulated utility, affiliate costs may need to be calculated on a total company basis where an overall rate of return is calculated and compared to regulated return.

3. Generally, transfer of a capital asset from the utility to its non-regulated affiliate should be at the greater of market price or net book value, except as otherwise required by law or regulation. Generally, transfer of assets from an affiliate to the utility should be at the lower of market or net book value, except as otherwise required by law or regulation. An appraisal to date asset valuation may be required according to value thresholds as determined by regulators.

4. Entities should maintain all information underlying affiliate transactions with the affiliated utility for a minimum of three years, or as required by law or regulation if longer than three years.

E. AUDIT REQUIREMENTS

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. The regulator should have complete access to all affiliate records necessary to ensure that cost allocations and affiliate transactions are conducted in accordance with the previously mentioned guidelines. Regulators should have complete access to affiliate records consistent with state statutes to ensure that the regulator has access to all relevant information necessary to evaluate whether subsidization exists. The auditors not the audited utilities should determine what is relevant for a particular audit objective. Limitation of access would compromise the audit process and impair audit independence.

2. Each regulated entity's cost allocation documentation should be made available to the company's internal auditors for periodic review of the allocation policy and process and to any jurisdictional regulatory authority when appropriate and upon request. Further, any jurisdictional regulatory authority may request an independent attestation engagement of the CAM.

3. The cost of any independent attestation engagement associated with the CAM, should be shared between regulated and non-regulated operations consistent with the allocation of similar

common costs.

4. Audit of the CAM does not otherwise limit or restrict the authority of state regulatory authorities to have access to the books and records of and audit the operations of jurisdictional utilities.

5. Any entity required to provide access to its books and records should make arrangements as necessary and appropriate to ensure that competitively sensitive information derived therefrom be kept confidential by the regulator.

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