Basics of Missouri Public Service Commission Affiliate Transaction Rules

A Whitepaper

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The purpose of this whitepaper is to provide a basic understanding of affiliate transactions and the potential of these transactions to give a financial advantage to one affiliate while harming the other. These types of transactions are rare between competitive affiliates because each are struggling to show profits. However, when one of the affiliates is regulated with captive ratepayers, the potential for these types of transactions increases. Regulatory bodies have created rules to prohibit these types of transactions and require utilities to document their purchases from and sales to affiliates so the transactions can be reviewed to determine if there has been any harm to customers.

The Missouri Public Service Commission ("Mo PSC") promulgated affiliate transaction rules for its electric, natural gas, and steam heating utilities in 1999. These rules became effective on February 29, 2000. I was a member of the Mo PSC Staff team that developed these rules for the Mo PSC.

This whitepaper is not an exhaustive list of all of the types of affiliate transactions but is intended to provide a basic understanding of the potential for harm to captive ratepayers resulting from transactions of regulated utilities with their affiliates. Any views expressed in this whitepaper are my own and not necessarily that of the Missouri Office of the Public Counsel.

This whitepaper is dedicated to my friend and colleague Robert Schallenberg. I spent many hours listening to Bob discuss affiliate transactions and tried to understand just a smidgen of what he was explaining. He was tasked with writing this whitepaper but never seemed to get around to it. My attempt is feeble compared to what his would have been. Bob, you are missed every day by the OPC and the ratepayers of Missouri.

Introduction

In a competitive environment, consumers make purchasing decisions based upon prices and how the price compares to the value they place on the product. If they are willing to pay a price that is greater than the cost to produce the good or service then the producer of the product will be able to meet its goal of earning a profit. If the consumers are unwilling to pay above the producer's cost to produce the product (also known as fully distributed cost), then the producer of the product will either find a way to make the product at a lower cost or go out of business.

For monopoly utilities, regulatory bodies substitute for the competitive pressures that drive efficiency. Regulatory bodies determine the cost of providing the service and then set rates that are charged to customers that give the utility the opportunity to recover its costs and a return on the utility's investments. Ratepayers are unable to switch to different providers making them captive to the monopoly utility and the rates charged by that utility. If the utility can provide service at a cost less than what was set in the rate case, its shareholders profit. If it believes that the rates set by the regulatory body do not cover its cost and provide a return for its shareholders, then it can request an increase in its rates.

When a utility is a subsidiary of a holding company structure with numerous other subsidiaries or affiliates, both regulated and unregulated, an opportunity for abuse exists, intentionally or unintentionally, in the offering and receiving of services or goods between affiliates. There can be cost-savings achieved through affiliate transactions between competitive and regulated monopoly affiliates. However, there is also a potential to shift costs from the non-regulated competitive affiliates to an affiliate with regulated monopoly operations because recovery of costs is more certain from captive ratepayers of regulated companies.

This whitepaper explains affiliate transactions and how abuse in these transactions can result in harm to the captive ratepayers of a regulated utility resulting in increases in the profits to the shareholders of the utility's holding company. It incorporates definitions and rule provisions of the Mo PSC affiliate transaction rules for investor-owned electric (20 CSR 4240-20.015), natural gas (20 CSR 4240-40.015), and steam heating (20 CSR 4240-80.015) utilities in Missouri ("Affiliate Transaction Rules").[1]

Basics of Missouri Affiliate Transaction Rules

The purpose of the Affiliate Transaction Rules is to prevent regulated utilities from subsidizing their affiliates' operations by providing a financial advantage to them. This subsidization occurs when costs of operations of an affiliate shift to captive ratepayers of a regulated affiliate or where subsidies are provided to affiliates through preferential service or treatment, including pricing.[2] Staff stated the following in its reply comments in the electric affiliate transaction rule rulemaking case:

[1] These three rules are essentially the same. The only difference among the rules is the type of regulated utility to which the rule applies. Any specific references to the electric rule in this whitepaper are also references to the natural gas and steam heating affiliate transaction rules.

[2] Case No. EX-99-442, *Order of Rulemaking*.

> The objective [of the electric utility affiliate transaction rule] is to reduce the occurrence of self-dealing and cross subsidization of affiliates by utilities, in order to protect monopoly ratepayers, while permitting competition in non-regulated areas. Preventing cross subsidization should encourage competition by allowing competing companies that cannot transfer costs to compete effectively and fairly.
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> * * *
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> The shifting of costs can include expenses for office space, computer time and data base development, advertising, employee hiring and training, vehicles, and purchasing and warehousing.[3]

The Mo PSC Affiliate Transaction Rules offer four ways financial advantage can be provided in affiliate transactions.

1. The regulated utility compensates an affiliate for goods and services above the lesser of:
   a. The fair market price; or
   b. The fully distributed cost of the regulated affiliate to provide the goods or services itself; or
2. The regulated utility transfers information, assets, goods or services of any kind to an affiliate below the greater of:
   a. The fair market price; or
   b. The fully distributed cost to the regulated utility.[4]

The Mo PSC defines fully distributed cost ("FDC") as a methodology that examines all costs of an enterprise in relation to all the goods and services that are produced. It includes recognition of all costs both direct and indirect used to produce a good or service. Costs are assigned either through a direct or allocated approach.[5] The rules do not include a definition of fair market price. Merriam Webster defines fair market value as "a price at which buyers and sellers with a reasonable knowledge of pertinent facts and not acting under any compulsion are willing to do business."[6]

The remainder of this whitepaper explains affiliate transactions and how affiliate transactions between a regulated entity and its affiliates can provide a financial advantage to its affiliates and harm to the regulated entity's captive ratepayers.

Transaction Basics

At its most basic, a transaction is an exchange or transfer of goods or services. A transaction is a benefit to the seller when it sells the product at a price greater than its cost to produce the product. This cost is the FDC of the seller. The diagram below shows this relationship.

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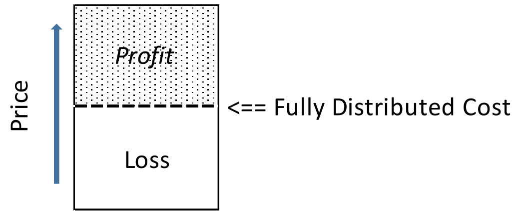
[3] EX-99-442, *Reply Comments of the Staff of the Missouri Public Service Commission Concerning Affiliate Transactions Rules for Electric Utilities,* page 2.
[4] 20 CSR 4240-20.015(2)(A).
[5] 20 CSR 4240-20.015(1)(F).
[6] Fair market value Definition & Meaning - Merriam-Webster

Figure 1
<u>Seller</u>

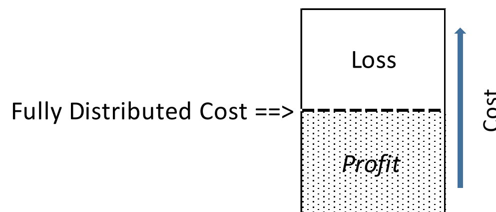


As the price the seller receives for the product increases, the profit the seller receives also increases. However, to make any profit the seller must receive a price greater than its FDC. If the price received is below its FDC to produce the product, the seller operates at a loss.

In a competitive market, to achieve the greatest efficiency for both the seller and buyer, the price for a product is set at market value. If the price is set above the FDC but below the market price, the seller is not acting in its best interest for it could achieve a greater profit if it received the market price. If the price is above the market, a buyer at that price is not acting in its best interest because it could purchase the product from someone else at the lower market price.

Buyers too have a fully distributed cost for each good or service that they require to do business. The buyer benefits when it purchases a product at a cost below the fully distributed cost of creating the product itself. Figure 2 shows this relationship.

Figure 2
<u>Buyer</u>



The buyer increases its efficiency and profits when it purchases a product at a cost below the FDC of making the product itself. If a buyer pays a price higher than its fully distributed cost, then it is increasing its costs since it could have produced the product or service at a lower cost. If a buyer purchases a product below its cost to produce the product, then the buyer is acting efficiently by purchasing the product as opposed to making the product.

Affiliate Transactions

The Mo PSC defines an affiliated entity as:

> [A]ny person, including an individual, corporation, service company, corporate subsidiary, firm, partnership, incorporated or unincorporated association, political subdivision including a public

utility district, city, town, county, or a combination of political subdivisions, which directly or indirectly, through one (1) or more intermediaries, controls, is controlled by, or is under common control with the regulated electrical corporation.[7]

Affiliated entities may be regulated or unregulated. Affiliates may be separate legal entities or a division within the regulated utility based on the structure of the holding company.

The Mo PSC affiliate transaction rule defines an affiliate transaction as:

> [A]ny transaction for the provision, purchase or sale of any information, asset, product or service, or portion of any product or service, between a regulated electrical corporation and an affiliated entity, and shall include all transactions carried out between any unregulated business operation of a regulated electrical corporation and the regulated business operations of a[n] electrical corporation.[8]

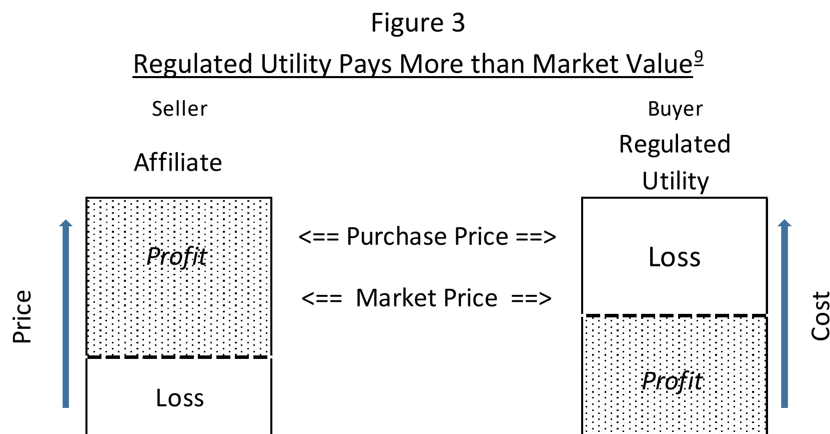
Not all affiliate transactions are bad. Affiliate transactions can benefit both the seller and the buyer in some circumstances. Even so, the potential exists for a regulated utility with captive customers and a fairly certain revenue stream to provide a financial advantage to its affiliates, many that may operate in a competitive environment. As provided above, the Affiliate Transaction Rules provide four ways that this could happen. An explanation of each of the four types of transactions that the Mo PSC defined as providing financial advantage to affiliates follows.

Regulated Utility Purchasing From Affiliate Above Fair Market Value

The first way that the Mo PSC Affiliate Transaction Rules describe the provision of financial advantage is when the regulated utility compensates an affiliate for goods and services above the fair market price. Figure 3 shows this type of transaction.

Figure 3

Regulated Utility Pays More than Market Value[9]



In this transaction, the fair market price for the product is above the FDC of the seller meaning that selling at the fair market price would provide a profit to the seller. If the regulated utility pays more than the

[7] 20 CSR 4240-20.015(1)(A).

[8] 20 CSR 4240-20.015(1)(B).

[9] In this figure and all the remaining figures in this whitepaper, the dashed line is the FDC.

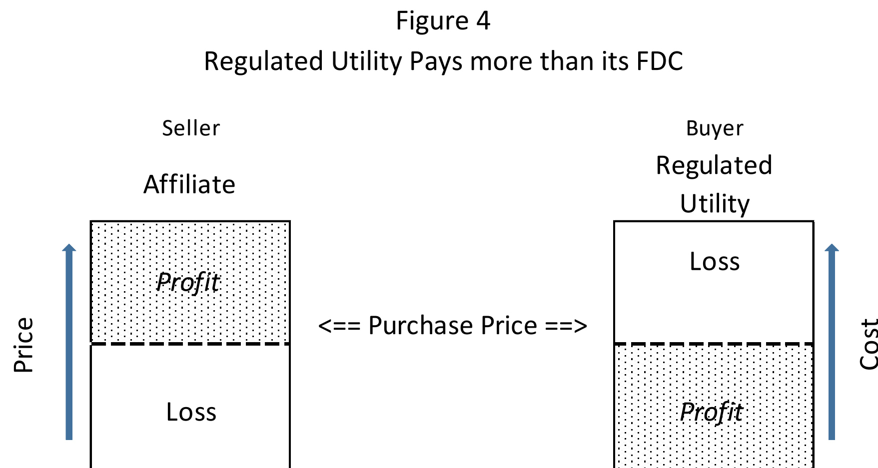
market price for the product, the profit to the seller is higher, which increases the profit for the seller affiliate. In this situation, the regulated utility is providing a financial advantage to the seller affiliate equal to the difference between the purchase price and the market price. Paying a price above the market price also increases the cost for the regulated utility – an increase in cost that is likely to be passed on to its captive ratepayers.

If the price paid to the seller affiliate is the fair market price, there would be no financial advantage provided to the seller affiliate from the utility. If the fair market price is below the FDC of the regulated utility, then purchasing the product at the fair market price provides value to the utility. The transaction, in that instance, would provide value to both the seller affiliate and the regulated utility.

Regulated Utility Purchasing from Affiliate Above Its Fully Distributed Cost

The next affiliate transaction the Mo PSC defines as providing a financial advantage is the situation in which the regulated utility pays more than its FDC for a product from an affiliate. Figure 4 shows this transaction.

Figure 4
Regulated Utility Pays more than its FDC



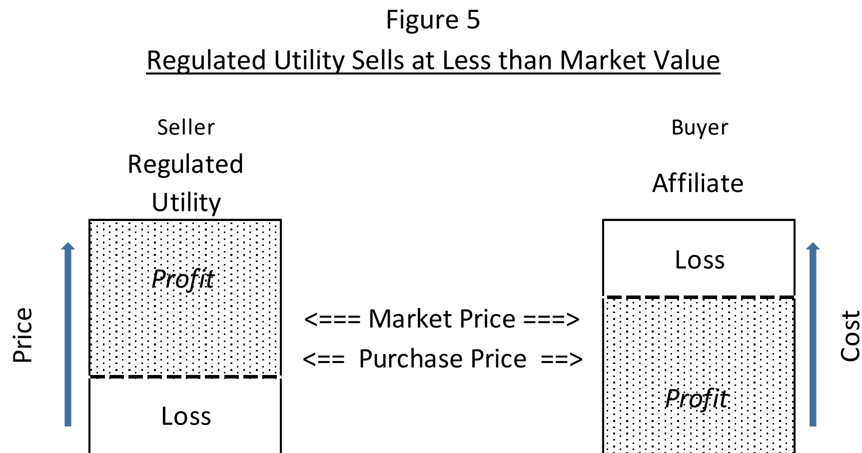
In this transaction, the regulated utility is paying more for a product than its FDC to produce the product. This alone should bar the transaction because the regulated utility can produce the product at lower cost than the price it is paying its seller affiliate to purchase the product.

In this situation, financial gain is provided to the seller affiliate because the seller is achieving a profit from the utility buying the product when the utility should be producing the product itself. The captive ratepayers of the regulated utility are harmed because the utility—the buyer affiliate—is buying the product at a price above its cost to produce the product.

Regulated Utility Provides a Product to an Affiliate below Market Price

The next transaction the Mo PSC defines as providing a financial advantage to an affiliate is when the regulated utility provides a product to its affiliate at a price below the fair market price for the product. Figure 5 shows this transaction. In this figure, the regulated utility on the left because it is the seller of the product.

Figure 5
Regulated Utility Sells at Less than Market Value



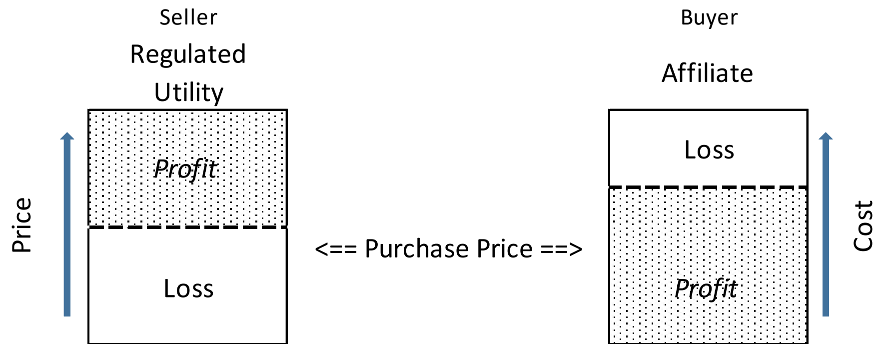
As this figure shows, by providing the product at a price below the fair market price the regulated utility provides a financial advantage to the buyer affiliate equal to the difference between the market price and the purchase price. This figure shows that the regulated utility is making a profit from selling the product above its FDC. However, the profit is lower than if the product was sold at fair market value. The difference between the profit the regulated utility would realize if it sold the product at fair market value and the profit the regulated utility realizes if it sells the product at the purchase price is equal to the financial advantage provided to the buyer. This results in harm to the regulated utility's captive ratepayers because the revenues generated to offset costs—here, the profits realized from the sale—is lower than it would have been if the regulated utility had obtained the market price for the product.

Regulated Utility Provides Product to an Affiliate below its FDC

The last transaction the Mo PSC defines as providing a financial advantage to an affiliate is the regulated utility providing a product to its affiliate below its FDC to make the product. Figure 6 shows this transaction where the regulated utility is the seller.

Figure 6

Regulated Utility Sells Below its FDC



In this transaction, the regulated utility sells the product below its FDC. If the regulated utility sold the product above its FDC, then the profit, if any, to the buyer affiliate would be lower. Thus, this transaction provides a financial gain to the buyer affiliate because the cost the buyer affiliate pays is less than if the utility charged above its FDC. This transaction generates losses for the regulated utility that would be borne by the captive ratepayers of the regulated utility.

Shared Services

One of the benefits of having affiliates is efficiencies from shared services. These shared services could take the form of administrative, legal, maintenance, and computer services to name a few. While there is not an exchange of goods or services with shared services, there is potential for a regulated affiliate to provide financial advantage to its affiliate by subsidizing the shared services utilized by its affiliate. Figure 7 shows how the allocation of shared services between a regulated utility and its affiliate could result in financial advantage to the affiliate.

Figure 7

Shared Billing Services Example

Regulated Utility | Affiliate

Shared Billing Service

40 | 60 # of hours of programing

600 | 400 # of customers billed

This example shows two different ways of allocating the cost of a shared billing service. In this example, if the number of hours of programing is used to determine the allocation of the billing service company's costs, then 40% of the costs would be allocated to the regulated utility and 60% to the affiliate. If the number of customers billed determines the allocation of costs, then the regulated utility would be

allocated 60% of the costs and the 40% would be allocated to the affiliate because the regulated utility has 600 customers while the affiliate has only 400.

Either one could be the appropriate allocation based on the services provided. For instance, if the affiliate needed its billing system reprogramed and therefore used more of the programmers' time, the number of hours of programming would be the appropriate allocation. However, in this situation, if the number of customers billed was used to allocate the costs, then the regulated utility would be subsidizing its affiliate, *i.e.* providing its affiliate a financial advantage, because the utility would pay a percentage of the costs greater than the percentage of the services it received. Specially, the regulated utility would have received only 40% of the services, but would pay 60% of the costs.

To avoid a regulated utility providing a financial advantage to its affiliate, each shared service needs to be examined and records need to be kept to justify the allocation factors used.

Conclusion

Affiliate transactions are often difficult to discern and quantify. Yet they can increase the cost to captive ratepayers and provide competitive advantage and greater profits for a regulated utility's affiliates.

The intention of the Mo PSC Affiliate Transaction Rules is to provide electric and natural gas ratepayers the assurance that the rates they pay are not adversely impacted by the utility's affiliate transactions or non-regulated activities when effectively enforced. When the Affiliate Transaction Rules were challenged by the Missouri utilities, the Missouri Supreme Court ruled the Commission had the authority to promulgate rules that prohibit utilities from providing financial advantages to affiliates.[10]

Cost allocation manuals as required by the Mo PSC's Affiliate Transaction Rules provide the information necessary to determine the appropriate costs and revenues to include in captive customers' rates. The rules define affiliate transactions that provide financial advantage to affiliates that are not allowed in rates. The basics presented in this whitepaper constitute the understanding necessary to protect captive customers.

[10] *See State ex rel. Atmos Energy Corp. v. Pub. Serv. Comm'n*, 103 S.W.3d 753 (Mo. banc 2003).