



**Corporate Structure Regulation:  
Prerequisites for Accountability and Performance of Public Utilities**

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# **Corporate Structure Regulation: Prerequisites for Accountability and Performance of Public Utilities**

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## **I. Overview: Effective Corporate Structure Regulation Should Ensure Accountability and Performance**

### **A. Accountability and performance: Regulation's central concerns**

1. Over the past century, utility consumers have paid trillions of dollars to support utility infrastructure. The purpose of utility regulation is to make the recipients of those trillions -- owners, financiers and operators of that infrastructure -- accountable to the public for their performance.
2. Accountability for performance is central concern of utility regulators. A century of experience tells us that corporate structure -- involving issues of holding companies, affiliate relationships and the mixing of utility and non-utility businesses -- can affect both accountability and performance. In their struggles to develop regulatory policy in this area, legislators and regulators have asked five questions:
  - a. Who can acquire and own utilities?
  - b. What business activities may exist within the utility's corporate family?
  - c. What corporate structure may these corporate families have?

- d. What financial structure may these corporate families have?
- e. What interactions may occur among the members of the corporate family?

These five questions share a common purpose: to encourage efficient transactions and discourage inefficient ones; to ensure accountability and performance.

**B. Why is regulatory attention necessary?**

- 1. In this area of corporate structure, why not allow investors and corporate managers to do as they wish? We introduce regulation when there is a divergence between private interests and the public interest. Regulation intervenes to align private behavior with that public interest.
- 2. When monopoly and competitive businesses exist in the same corporate family, there are many opportunities for divergence, creating risks for utility customers. The first part of this presentation will explain the four main risks that result from this mixing. Those risks are: distortion of competition, cross-subsidies, financial risks and diversion of management attention. The second part of my presentation will discuss two categories of regulatory approaches: preventing risks before-the-fact, through structural solutions; and allowing risks, but mitigating their adverse effects, after-the-fact.

**II. Mixing Monopoly and Competitive Businesses within the Same Corporate Family: Four Types of Risks**

**Overview of the problem:** The task of regulating a monopoly utility is complicated by its affiliates' participation in competitive markets. When a utility has had a history of government protection from competition, it has resources and experience which many of its new competitors do not have. A short list includes:

- a name associated with government approval, reliable service;
- a monthly bill, providing an opportunity to communicate and cement loyalty;
- loyal employees trained with funds whose recovery was largely assured by the government;

- knowledge of the service territory, including load patterns, important sites for generation, transmission and distribution facilities;
- information on the consumption patterns of each household and each commercial and industrial customer;
- economic, professional, social and political relationships with important components of the local economy, such as banks, major manufactures, local and state government officials;
- working relationships with surrounding utilities; and
- a corporate infrastructure built with funds assured by the government.

**A. Risk #1: Distortion of competition occurs when the competitive business --**

1. receives favorable treatment from the monopoly business -- when the competitive business receives goods and services from the monopoly business on terms more favorable than what is available to competitors, or
2. is able to force the monopoly business to buy the competitive business's goods or services, thereby denying competitors this sales opportunity

**B. Risk #2: Cross subsidies occur when the competitive business --**

1. receives from the monopoly business goods and services at a price below the cost of providing those good or services, or
2. sells to the monopoly businesses goods and services at a price exceeding the cost of providing those goods or services.

**C. Risk #3: Financial risks associated with the competitive business are borne, in part, by customers of the monopoly business** when the competitive business enters into transactions that increase the risk profile of the corporate family, thereby increasing the monopoly utility's cost of capital; and when the monopoly business becomes guarantor of debt incurred by the competitive business.

**D. Risk #4: Diversion of management attention** occurs when the business opportunities and burdens associated with the competitive businesses reduce the time and talent devoted to the monopoly utility business.

### III. Two Categories of Regulatory Approaches

#### A. Prevent risks before-the-fact, through structural solutions

1. ***Limits on investments in non-utility businesses:*** The concerns here are management distractions, use of utility ratepayers to finance or guarantee debt associated with the nonutility business, and unearned competitive advantages for utilities entering nonutility markets.

Policymakers can limit non-utility business investments, by prohibiting them entirely, or by limiting the dollars invested. Regulatory options, along with prohibition, and permission without review, include:

- a. limits on the percentage of total holding company assets, revenues or net income that can be attributable to nonutility businesses;
  - b. limits on holding company or utility financing of any acquisition of nonutility businesses; and
  - c. limits on the utility's ability to file for bankruptcy based on affiliate difficulties.
2. ***Limits on corporate structure:*** Policymakers can require corporate separation between the utility and nonutility businesses. The forms of separation between utility and nonutility businesses include separate affiliates, accounting, financing and financial statements.
  3. ***Rules for interaffiliate transactions***

##### a. *Overview*

Affiliate transactions fall into three major categories: sales of utility services, sales of nonutility goods and services, and financial transactions. Affiliate transactions move in both directions: to and from the utility, from and to the holding company or other affiliates.

Affiliate transactions involve multiple risks. "Cross subsidy" is a term frequently used but infrequently defined. Where the corporate family has both utility and nonutility businesses, a cross subsidy occurs when a utility ratepayer bears costs associated with nonutility activities; i.e., when the ratepayer pays a price for utility service higher than she would have paid in the absence of the nonutility activities. When a utility holding company buys a hotel and shifts acquisition costs to the ratepayers, a cross subsidy occurs. When a utility enters a risks nonutility business, and the utility recovers the higher cost of capital through utility rates, a cross subsidy occurs.

But cross subsidies are only part of the adverse effects of inappropriate interaffiliate relations. When utility customers have historically borne the economic cost of an asset, they should receive the full market value associated with that asset's use by others. But the common practice is for the nonutility affiliate to obtain rights to the asset at cost rather than at market value. The result is not a cross subsidy, technically, because the ratepayers' rates do not rise as a result of nonutility affiliate's use; but there is a mismatch of risk and reward. The utility ratepayers bear all the costs but receive only part of the benefits; the nonutility affiliate hits a single but advances to third base.

### ***b. Options***

The regulatory options again range from prohibition to conditional permissions to unconditional permissions. Examples: (a) prohibition on a public utility providing to an affiliate any financial loan, guarantee or other benefit other than the normal payment of dividends; (b) requirement that any goods or services sold by a utility to an affiliate be priced at the higher of book or market; © requirement that any goods or services sold to a utility by an affiliate be priced at the lower of book or market; (d) advance review of dividend payments to protect financial integrity of the holding company system and the working capital of in-state utility affiliate; and (e) advance approval for interaffiliate cost allocation practices and contracts above a minimum dollar level.

More detailed suggestions follow.

#### ***(i) Sales by the utility to the competitive affiliates:***

Regulators should ensure that the competitive affiliate of a utility has on advantage attributable to its history of government protection from competition. When a traditional utility seeks to enter competitive markets, it is possible for it to make use of resources whose cost has been recovered from ratepayers who were legally bound to pay those costs due to previous government-imposed limits on competition. To allow the utility to exploit those resources without fully compensating ratepayers for this use would create a mismatch of risk and reward.

The correct answer is as follows: If the nonutility affiliate is to have access to the utility affiliate's resources, compensation must reflect the market price for the resource. The principle should apply to all transfers, including real estate, plant, goods and services. Such services might include data processing as well as the transferring or detailing of employees. The principle also should apply to corporate support. For most elements of corporate support, there is a fair market value counterpart. Internal legal advice, internal accounting and bookkeeping assistance, office space and other forms of infrastructural support all have a fair market value. Requiring all such corporate sharing to be accomplished on a fair market value is consistent with the arm's-length principle.

***Comparing the market price requirement with other possible standards:***

Two other possible standards come to mind: ***incremental cost*** and ***fully-allocated book cost***. Both these standards fall short. An explanation appears in the Appendix to this paper.

***(ii) Sales by the competitive affiliate to the utility:***

When services are provided by the affiliate to the monopoly, they should be priced at the lower of fully allocated cost or market. This rule ensures that the nonutility affiliate does not provide goods or services to the utility at a price exceeding the cost the utility would have incurred had the utility purchased the good or service prudently from a third party or provided it in-house. If the affiliate could produce the good or service below market price, so can the utility. Without this rule, the affiliate would perform for a profit services which the utility is obligated, under its franchise, to perform at cost. The utility would be using corporate form to increase the shareholder return above allowed levels.

*The connection between interaffiliate pricing rules and rate-setting:* The purpose of interaffiliate pricing rules is to ensure that costs and risks are assigned appropriately between shareholders and ratepayers. But -- merely establishing interaffiliate pricing rules does not achieve this result, because it does not ensure that the payments made by the nonutility affiliate are received by ratepayers. An additional step is necessary.

One approach is for the regulator, in establishing the base rates for the distribution utility, to make projections as to the volume of interaffiliate transactions and their prices, reflect the resulting revenues in the distribution utility's revenue requirement, and set rates accordingly. This approach is unsatisfactory because any projections of the volume of interaffiliate transactions, and the market price that would prevail for the good or service transferred in the transaction, would be speculative. Moreover, in the rate cases the utility will have an incentive to under-project its sales to the nonutility affiliate (so as to minimize the resulting reduction to its revenue requirement); conversely, between rate cases (which is to say, all the time, since the utility is always between rate cases), the utility will have an incentive to allow the affiliate to make maximum use of utility resources (because any incremental between rate cases will not reduce the revenue requirement).

A better approach, therefore, would be to create a special account to reflect these transactions, and flow the revenues from the account to ratepayers periodically.

## **B. Allow risks, but mitigate their adverse effects, after-the-fact**

1. The concept here is that the corporate family would be free to structure itself, and conduct interaffiliate transactions, as it wishes. The role of the regulator would be to (a) set rates in a way that protects utility customers from adverse effects; and (b) establish quality of service standards that ensure that management distraction does not reduce the quality of service.
2. Supporters of this approach assert that structural complexity poses no risk because ratemaking will catch problems. This view is not fact-based. Ratemaking depends on auditing. Auditing is not a trip to the dentist, who checks every tooth. Auditing is sampling. It cannot promise 100% coverage -- especially with limited regulatory resources. Allowing structures that invite cross subsidies, complicate auditing or both increases the probability of problems.
3. Reliance on after-the-fact disallowance also invites too-big-to-fail situations. In the competitive world, poor decisionmakers fail. But not always. We all are familiar with situations in which a company's size of national importance pressures regulators to prop them up. State commissions whose residents depend on the incumbent will tend to save the company rather than exact the ultimate penalty -- especially since bankruptcy law addresses creditor rights, not consumer protection. Given the inherent uncertainty of "back-end" accountability in the form of rate review, "front-end" accountability in the form of advance review of financial risks remains even more critical.

## **IV. Conclusion**

Policymakers should have in mind a vision for corporate structures. Absent a vision, there will be no limits on geographic remoteness, the mixing of utility and nonutility business, financial leveraging, or interaffiliate transactions. Anyone can try anything. Results will be determined by private opportunism rather than public interest.

Policymakers therefore should inquire, systematically, into the nature of the new transactions and to determine the appropriate regulatory response, if any. The attached table, "*Corporate Restructuring by Public Utilities: How Should Regulators Prepare and Respond?*," displays the necessary analysis. Listed on the left are corporate structure events: 7 categories and 21 subcategories. Listed across the top are the 3 categories of regulatory options -- prohibition, permission without review, and permission subject to reviews, limits and conditions. By completing this table, the regulator determines, systematically, the types of companies and corporate structures permitted to provide utility service.

## **Appendix on Interaffiliate Pricing Comparing Fair Market Value to Two Alternatives**

*Incremental cost* is defective because it gives the affiliate an advantage denied to the nonaffiliates: access to resources which were financed under low-risk circumstances in which most costs were assured recovery. One can defend incremental cost on grounds of economic efficiency: since the price does not fall below incremental cost, it does not result in overconsumption of the good or service, and protects the monopoly ratepayers from paying more than they would have in the absence of the affiliate's existence. But incremental pricing fails the other key criterion: effective competition. It grants one competitor access to important infrastructure services on terms not available to competitors, with the difference being attributable not to the incumbent's skill but to its history of government protection. (To the extent the costs of the infrastructure have been borne by shareholders rather than ratepayers, if for example the costs had been denied rate base treatment, then this rule should not apply and the incremental cost approach is appropriate.).

The other alternative is *fully allocated book cost*. Fully allocated book cost, like incremental cost, will prevent cross subsidies. Moreover, fully allocated book cost can eliminate the utility's advantage because at least some of its competitors will have access to their own existing infrastructure at fully allocated book cost. But not fully. To the extent the utility incumbent incurred its book costs under a regime in which it was protected from competition, and in which its costs enjoy the relative certainty of recovery associated with government regulation, the utility retains an advantage not available to those of its competitors who did not enjoy similar histories of government protection.

Moreover, fully allocated cost is not consistent with the utility's obligation to extract full value from all assets and passing that value on to the ratepayers who are being required to pay for the book costs which exceed market value. The utility, conversely, by charging the affiliate a sum (allocated cost share) lower than it would charge a nonaffiliate (fair market value), has obtained less for its ratepayers than it could had it dealt with a nonaffiliate. By definition, this is not an arms-length relationship.

Some argue that the fully allocated cost approach is common in unregulated industries. This argument confuses the differing roles of cost allocation in the regulated and unregulated contexts. In unregulated industries, businesses use cost allocation to assess the productivity of cost centers or profit centers. This assessment is impossible unless there is a home for every cost. Cost allocation determines the location of those homes. Cost allocation does not set prices; the market sets prices. In regulated industries, cost allocation serves a very different purpose: it sets prices for the regulated service. Regulators allocate costs to different products or customers to establish the prices for those products or customers.

In summary: The fair market value standard achieves all objectives: economic efficiency, avoidance of cross subsidy, promotion of effective competition and mitigation of stranded cost. It aids the implementation of effective competition by ensuring that the

incumbent utility's affiliate does not receive a discount, relative to market price, which is unavailable to the nonaffiliates. It carries out the utility's obligation to minimize ratepayer cost. The converse of cost minimization is revenue maximization. A utility with surplus capacity has a duty to obtain maximum value for it.

The rate treatment of the utility should be to assess the highest price consistent with fair treatment to the nonutility affiliate and consistent with commercial reality. The commercial reality is that but for the utility, the nonutility affiliate would have to buy the goods and services at fair market value. Pricing the interaffiliate transaction at fair market value leaves the nonutility affiliate no worse off, and it minimizes required charges to utility ratepayers by maximizing utility revenues.

## Corporate Restructuring by Public Utilities: How Should Regulators Prepare and Respond?

Regulatory Action			
Corporate Event	Prohibition?	Reviews, Limits and Conditions?	Permission w/o Review?
1. Utility merger with another utility			
a. operationally integrated			
b. not operationally integrated			
2. Utility acquisition of nonutility			
a. for utility purpose			
b. not for utility purpose			
3. Nonutility acquisition of utility			
a. acquirer has operational relationship to utility			
b. acquirer has no operational relationship to utility			
4. Interaffiliate transactions			
a. goods and services: sale to utility			
b. goods and services: sale by utility to nonutility			
c. financing: loan or guarantee to utility			
d. financing: loan or guarantee from utility to nonutility			
5. Issuance of debt or equity			
a. at the holding company level, for utility purposes			
b. at the holding company level, for nonutility purposes			
c. at the utility level, for utility purposes			
d. at the utility level, for nonutility purposes			
e. at the nonutility level, for utility purposes			
f. at the nonutility level, for nonutility purposes			
6. Divestiture or spin-off			
a. of utility assets serving your state			
b. of utility assets serving other states			
c. of nonutility assets or businesses			
7. Use of utility assets for non-utility business			
a. utility assets in your state			
b. utility assets in other states			