



# Transfer Pricing Water and Wastewater

UN ECLAC - SISS - Chile

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# Background on the PUC

- Created in 1937
- 5 Commissioners
- Approximately 500 employees:
  - 11 offices and bureaus
  - Staff includes attorneys, rate and financial analysts, auditors, economists, engineers, motor vehicle and railroad specialists, safety inspectors, and enforcement officers
- Regulates approximately 6,000 utilities:
  - Electricity, Natural Gas, Water, Telecommunications, Transportation
  - 184 Water and Waste Water Companies



# PA Best Water Practices

- Acquisition Incentives
- Distribution System Improvement Charge
- Single Tariff Pricing
- Low-Income Rates
- Small Utility Filing Procedures
- Surcharges (Purchased Water)
- Mediation and Settlements

# PUC History of Transfer Pricing

- 1920's – pancaked layers of service co's.
- PUHCA - SEC rules at cost
- State level evolved to pricing must be reasonable – strongly cost based
- Pre-approval required outside of base rate case process
- Affiliated Interest Agreements, Financing Applications, Management Audits

# Energy Industry Transfer Pricing – A Model for Water ?

- Yes – “arms length” transactions a goal.
- No – 80% of service provided by investor owned utilities, goal to create competition where none existed and provide retail access to alternative suppliers. Rules for conduct in the context of deregulated energy markets.
- Water – investor owned serves 15% of the industry, highly fragmented, never achieved the economies of scale of energy utilities.
- Water industry goals – consolidation, economies of scale, more integrated approach to water resource management

# Pennsylvania Supreme Court

- “It is abundantly clear, therefore, that when, as here, a utility includes in its rate base an ascribed value of inter-affiliate transactions, whether as an item of fixed capital or of operating expense, section 701 © of Public Utility Law imposes on the utility a two-fold burden: first, to show that the inter-affiliate transaction was reasonably necessary, and second, to demonstrate that the amounts paid or payable there for “are not in the excess of the reasonable costs of furnishing such services”

# Solar Electric v. PUC

## Pennsylvania Superior Court

- “The desire of public utility management, evidenced by various methods, to secure the highest possible return to the ultimate owners is incompatible with the semi-public nature of the utility business, which the management directs. It therefore follows that the commission should scrutinize carefully charges by affiliates, as inflated charges to the operating company may be a means to improperly increase the allowable revenue and raise the costs to consumers of the utility service as well as an unwarranted source of profit to the ultimate holding company”.

# Multiple Cases/Mechanisms for Review, Control & Approval

1. Affiliated Interest Filings (AIA)
2. Financing Applications
3. Focused Management Audits
4. Base Rate Cases

# 1. Affiliated Interest Agreements (AIA)

# Affiliated Interest Agreement

- Approval required by PUC
- Reasonable
- In the Public Interest
- Approval is not a finding of reasonable and prudent costs for ratemaking
- Subject to subsequent audits & inquiries
- Case Study

# AIA Case Study (2 handouts)

- Data Requests from PUC Staff
- Is AIA based on competitive analysis ?
- Types of services?
- Costs if provided by non-affiliate?
- Revenue and Ratemaking Implications?
- Why in best interests of customers?
- Calculation of profit margin?

# Corporate Charges Allocations Manual – Case Study (handout)

- Service Billing – Review details
- Sundry Billing
- Customer Operations Billings

## 2. Financing Applications

# Financing Applications

- Financing applications and approval required
- Many factors, including capital structure, uses of funds, interest rates.
- One key metric for transfer pricing – internal dividends. Over 75% may be a red flag. Higher dividend payments to parent (short term) can be a recapitalization tool.
- “Provide parent with necessary cash to meet obligations to its subsidiaries and shareholders”
- “Designed to strike a balance between an appropriate capital structure for each subsidiary and maintenance of an appropriate dividend payout to shareholders.

# 3. Management Audits

# Management Audits

- Management and operational review required pursuant to 66 Pa. C.S. 516.
- PA PUC's general administrative power and authority to supervise and regulate all utilities in the Commonwealth.
- PUC can investigate and examine the condition and management of any public utility.

# Mgt Audit - Objectives

- Determine what improvements, if any, can be accomplished in the utility's management and operations.
- Encourage economies, efficiencies, or improvements and identify which, if any, cost saving measures can be instituted.
- Ultimate purpose – explore economically practical opportunities for giving customers lower rates and/or better service

# Mgt Audit Areas of Review

- Executive Management
- Financial Management
- Support Services
- Water Operations
- Corporate Governance
- Corporate Culture
- Customer Service
- Operational Performance
- Distribution Business Systems
- Human Resources
- **Affiliated Interests**

# Mgt Audit – Case Study

## Findings (2 handouts)

- Develop formal, comprehensive documentation for affiliate relationships and cost allocation, and assign the responsibility to the appropriate manager.
- Perform a detailed analysis to verify that the use of the number of customers for allocating Service Co. costs among the regulated utilities is reasonable and reasonably approximates the use of cost-causative factors; subsequently make the modifications, as appropriate.

# Mgt Audit Recommendations

- Regularly evaluate the cost of services provided by affiliates so as to verify that ratepayers are not being harmed by charging these services at cost rather than market.
- Update the affiliate agreement, as necessary, and submit it to the PA PUC for review and approval.

# Mgt Audit Recommendations

- Provide ongoing training updates to Service Co. employees on proper use of billing numbers for charging affiliates when reporting time.
- Regularly conduct internal audits of affiliate transactions and associated cost allocations.

# Model Code of Conduct (handout)

- Affiliate Transactions
- Equal Treatment
- Joint Marketing
- Assignment of Customers
- Intellectual Property
- Structural Separation
- Cost Allocation
- Reporting Requirements

# Cost Allocation

- Unless authorized by agreement approved by PUC, a utility shall not subsidize unregulated activities carried out by an affiliate
- All utilities engaging in unregulated activities, either directly or through an affiliate, shall keep separate accounts and allocate costs with procedures established by the PUC.

# 4. Base Rate Cases

# Transfer Pricing in Rate Cases

- The bottom line – inclusion in rates, adjusted level, or disallowance.
- Service Company charges – often a significant contested item in rate cases
- Overall Level of charges vs. Rate Year
- Asset Sales if any.
- Consolidated Tax Savings

# 1994 Case – Asset Sale

- Sale of office building from affiliate to utility
- Company Claim – DOC (Depreciated Original Cost)
- OCA – Reduced DOC by excess amount of lease payments due to shorter depreciation life.
- PUC – Customers will overpay if they paid lease costs and pay remaining DOC. OCA adjustment adopted.

# Transactions between Affiliates

## 1994 Water Case Order

- “Transactions between affiliated companies are not in and of themselves unreasonable or improper. They are only when the PUC lacks data and information from which the reasonableness and propriety of the services rendered and the reasonable cost can be ascertained.”

# Consolidated Tax Savings

- Savings due to filing a consolidated tax return
- Allocation to utility a huge issue
- Stand-alone vs. sharing savings of loss affiliates
- Loss savings allocated based on relative taxable incomes of income companies.

# Other States - Virginia

- Va. SCC policy, not adopted by formal rule
- Service from utility to affiliate – higher of cost or market.
- Service from affiliate to utility – lower of cost or market.
- Costs include reasonable return.
- “Where a utility can save money by purchasing from an affiliate at the affiliate’s cost, including a reasonable return for the affiliate on the sale, it should do that. When a utility sells services or goods at an affiliate, the utility must recover from the affiliate the greater of cost plus reasonable return or market price.”