Overview of Inter-corporate Charges (Including Charges to Non-Regulated Operations)

Introduction

There is a risk that regulatory control over rates will be undermined where a regulated utility provides goods or services to an affiliate or acquires goods or services from an affiliate. By overpricing what the utility acquires, or under pricing what it provides, the amount recoverable through allowed rates can be increased with a corresponding increase in return to the owner of the utility.

This is contrary to the cost of service standard. Customers would pay more than the cost required to provide them with service and the utility would have an opportunity to earn more than a fair rate of return.

In addition, regulatory boards have increasingly been concerned about fair competition in the markets that the affiliate operates in, especially where the utility provides a monopoly service to both the affiliate and unrelated companies.

Regulatory Standards for Inter-corporate Charges

The key standard, either explicitly or implicitly stated, is that the charges should reflect what would be established in an arms-length transaction. The best measure of this amount is market price.

Where available, regulatory boards generally prefer that inter-corporate transactions be priced at market. For example:

(1) In a 1996 decision dealing with Newfoundland Power (P.U. 7 (1996-97)), the PUB stated "The Board orders that inter-corporate transactions that can be obtained from a competitive market must be valued at market for regulatory purposes." (pg. 81-82)

(2) The Nova Scotia Power Inc.'s ("NSPI") Interim Code of Conduct that has been approved by the Nova Scotia Utility and Review Board ("NSURB") [1] states: "NSPI will charge and be charged prices which reflect fair market value for all non-regulated utility goods and services provided to affiliates or purchased from affiliates, provided that in no case shall NSPI supply such goods and services at a loss"

(3) The Ontario Energy Board's ("OEB") Affiliate Relationship Code for Electricity Distributors and Transmitters states: "Where a utility provides a service, resource or product to an affiliate, the utility shall ensure that the sale price is no less than the fair market value of the service, resource or product." It goes on to say that a utility shall not pay an affiliate more than fair market value.

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[1] Effective September 16, 2001

(4) The Alberta Energy and Utilities Board's ("AEUB") Code of Conduct Regulation for electric utilities states that goods and services must not be transferred to an affiliated retailer at less than fair market value or from an affiliate at more than fair market value.

Market-based prices generally represent the best price that a seller can expect to receive, and a purchaser to pay, in an arm's length transaction.

Practical Issues with Market Pricing

Where market prices are publicly available, market-based prices can be determined and verified objectively by comparison to other transactions taking place in the market. However, market-based pricing requires a well-established market in which services are offered similar to those covered by the inter-corporate charges and for which transaction prices are available.

Where a well-established market does not exist, a market price cannot be determined on an objective and verifiable basis. Well-established markets often don't exist for regulated entities' inter-corporate transactions, such as the provision of management services or specialized computer services. Even if one does exist, the specialized nature of the goods or services may make it difficult to identify market transactions with similar characteristics.

Where there are small differences between the affiliated transactions and those used to establish the market-based prices, adjustments can be made to the market prices to reflect the differing circumstances. However, the adjustments will usually require subjective judgement and regulators may question the reliability of market-based prices that require material subjective adjustments.

Similar sales to unrelated third parties may be an acceptable basis for establishing a market price. Such transactions are at arm's length; however, the transactions must be similar or an adjustment has to be made. Also regulatory authorities may insist on a significant volume of sales to unrelated third parties to ensure that the resulting prices truly reflect the market.

A bidding process may offer evidence of market prices. However, related companies cannot be given preferential treatment and the winning bidder must be accepted, even if it's an unrelated company. Without these conditions, it's unlikely that prospective suppliers would make serious bids, a situation that would compromise the validity of the whole process.

The bidding process has other drawbacks. It tends to be formal, which reduces flexibility and makes negotiations more difficult. It can also be time consuming and costly, especially for relatively small purchases.

As a result, market-based prices may not be a viable option for establishing inter-corporate charges.

Alternatives to Market Pricing

Where market-based pricing is impractical, regulators generally rely on cost-based pricing, which is based on the cost of providing a good or service, including a fair return. For example:

(1) The NSPI Interim Code of Conduct states: "Where prices based on market value cannot be established, NSPI will charge prices which reflect the utility's fully-allocated costs for the goods and services provided."

(2) The OEB's Affiliate Relation code for Electricity Distributors and Transmitters states that where a fair market value is not available a utility will charge no less than a cost-based price and shall pay no more than a cost based price. It goes on to say that a cost based price shall reflect the costs of producing the service or product, including a return on invested capital.

Cost-based pricing will tend to reflect what would occur in a competitive market. In theory, prices in such a market should equal cost, including a fair return.[2] In practice, prices may not equal cost; however, they should usually be reasonably close.

With cost-based pricing, there is the implicit assumption that the regulated entity is as efficient as alternative suppliers; however, this may not be the case. Accordingly, a regulatory board may seek evidence that costs are required and reflect efficient management.

An advantage of cost-based pricing is that it can generally be determined and verified objectively, with the exception of some cost allocations or where prices are not based solely on the regulated entity's costs (such as where a market-based operating margin is used).

Cost-based pricing is similar to cost allocation. When cost-based prices are used, they are usually based on embedded (or historical) costs and include a fair return. Where costs must be allocated, the preferred approach is causality – costs are allocated to a service to the extent that it causes the costs to be incurred. It's normally permissible to allocate non-avoidable costs that cannot be attributed to individual services or products. Further comments on cost allocation are provided below.

The Regulatory Significance of Cost Allocation

Cost allocation can be used to split costs between regulated and non-regulated operations and can affect inter-corporate charges where they are cost based. It can therefore affect the amount that will be recovered from customers through regulated rates.

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[2] In a competitive market, prices will equal cost in equilibrium; however, as the market moves to equilibrium, prices may be greater or less than cost.

Increasing regulatory interest in the issue is the incentive to allocate costs to regulated operations. The allocation of costs usually does not affect what can be charged in non-regulated markets, while amounts allocated to regulated operations usually results in higher revenues.

Cost allocation also affects the allocation of costs between current operations and capital and between customers groups within a given period. Although this should not affect what a utility is able to recover[3], it will impact what individual customers will pay.

Basis for Cost Allocation

The primary basis for allocating costs is causality. A cost should be allocated to the cost object (e.g., the service or activity being costed) that caused the cost to be incurred. This is supported by economic principles and would meet most people's definition of fairness.

Direct and variable indirect costs can be allocated on the basis of causality, but fixed indirect costs cannot.

A direct cost is a cost that is incurred for a specific cost object. For example, the cost of a transformer on a distribution pole in St John's is a direct cost of providing distribution service in St. John's. With a direct cost there is a cause and effect relationship between the cost object and the cost. In the case of the transformer, if distribution service were not provided in St. John's, the cost of the transformer would never be incurred; the cost exists only because the service exists.

Indirect costs, also called common costs, are incurred for two or more cost objects. For example the cost of the energy produced by a generating plant is a common cost since it is incurred for a number of customers.

Where common costs are variable, a cause and effect relationship can be established between the cost objects and the cost. For example, if a customer did not exist, less power would be produced resulting in cost savings. Therefore the costs that could be saved reflect the costs that are caused by that customer.

This leaves fixed common costs. These costs would not vary if an individual cost object did not exist. Therefore, there is no cause and effect relationship between the individual cost object and the cost. Since the cost object, in itself, has no impact on the cost, there is no economic basis for allocating the cost. The cost may be caused by a group of cost objects and can be allocated to the group on the basis of causality, but it cannot be allocated to individual cost objects on the basis of causality.

Where costs are being used to establish transfer prices or costs are being allocated between regulated and non-regulated operations, the fixed common costs should be allocated. A common

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[3] Allocating costs to services and customers group with a low elasticity of demand will tend to increase demand which may increase income, especially if it allows for an increase in rate base

approach, which probably meets most peoples' definition of fairness, is relative benefits received. This is often approximated by relative usage. However, regardless of how the fixed indirect costs are allocated, the allocation of fixed common costs often involves subjective judgment.

Challenges in Allocating Costs

A utility's information systems may not keep track of necessary information. For example, a cost may be a direct cost of individual customers; however, the costing system may not record the costs by cost object. As a result, some basis of allocation must be employed to allocate the costs to customers. Also a utility may not keep track of the ideal measures for allocating a variable common cost.

Complicating the issue is that the nature of a cost depends on the cost object – i.e., whether a cost is direct or common (i.e. indirect), whether it is fixed or variable, depends on what is being costed. For example, the generator in an isolated rural system is a direct cost of the rural system but a common cost for the individual customers of the system. Also costs may not fit completely within one classification, requiring an allocation between classifications. For example, a portion of the cost may be fixed while the remainder is variable.

It should be noted that it would probably be inappropriate for a utility to keep track of the ideal level of information required for all of its costing requirements. The benefits associated with improved allocations must be weighed against the cost of collecting, verifying, maintaining and reporting the data. The above problems result in the need to apply subjective judgement.

Requirement for Subjective Judgement

Cost allocation involves a significant amount of judgment: judgment as to the allocators to be used and even the information to be collected to support the allocations.

As a general rule, a cost allocation methodology that affects regulated rates should avoid the use of subjective judgment. It should be possible to objectively apply the methodology and verify the results. This helps to ensure that the results are appropriate and in accordance with the principles and procedures approved by the regulatory board.

It appears that this is an issue with Hydro. On page 22 of its 1999 Annual Financial Review of Newfoundland and Labrador Hydro, Grant Thornton made the following comment in relation to Hydro's allocations to CF(L) Co:

"In reviewing the manner in which costs are allocated we observed that many of the methods of allocation are subjective and rely upon the judgement of Hydro management, consequently these allocated costs are not susceptible to proper verification"

Subjective judgment will be necessary in establishing the methodology, in choosing the allocators and in establishing how the allocators will be determined. However, this subjective

judgment should be an input to the development of the policies and procedures that the regulatory board approves. In this way the regulatory board has an opportunity to review the decisions based on the application of subjective judgment and review their appropriateness. To the extent practical, subjective judgment should be avoided in applying the policies and procedures.

In reviewing the cost allocations and the support for these allocations, a regulatory board must recognize the trade-off between the benefits of any improvements to the accuracy of the cost allocations and regulatory control and the costs of those improvements.

Support for Inter-corporate Charges

As part of its obligation to ensure that rates are just and reasonable, a regulatory board should review inter-corporate charges to establish whether they are just and reasonable and it should ensure that there is adequate support for the charges.

This issue was explicitly addressed in a 1990 decision by the CRTC dealing with Bell Canada (CRTC Telecom Decision 90-17):

"... the Commission is also of the opinion that section 340(1) of the Act, which specifies that rates should be just and reasonable, does provide sufficient authority for intervention with respect to pricing of inter-corporate transactions." (pg. 51)

"... the Commission considers that it should review cost-sharing arrangements between Bell and its affiliates, and any changes thereto. Bell is therefore directed to file details of new cost sharing arrangements and any changes to existing cost sharing arrangements already reviewed by the Commission, in all instances where Bell's share exceeds or is expected to exceed $500,000 in any year." (pg. 11)

The NSPI Interim Code of Conduct requires an annual reporting to the NSURB to support affiliate transactions. For example, it states: “Where cost allocations are involved, a description of the cost allocators and methods used to make the allocations should be included.”

The OEB’s Affiliate Relationship Code for Electricity Distributors and Transmitters requires a formal agreement where a utility shares services or resources and that agreement may be reviewed by the Board. Paragraph 2.2.1 states:

“Where a utility shares services or resources with an affiliate it shall do so in accordance with a Services Agreement, the terms of which may be reviewed by the Board to ensure compliance with this Code. The Services Agreement shall include:

(a) the type, quantity and quality of service;
(b) pricing mechanisms;
(c) cost allocation mechanisms;
(d) confidentiality arrangements;

(e) the apportionment of risks (including risks related to under or over provision of service); and
(f) a dispute resolution process for any disagreement arising over the terms or implementation of the Services Agreement."

In a 1999 decision (U99099), the AEUB ordered EPCOR Transmission Inc ("EPTI") to provide information on its relationships with non-regulated affiliates:

"The Board wishes to further understand the relationships between amounts that are charged to or received from the unregulated affiliates of the regulated affiliates. Accordingly, in future GTAs, the Board directs EPTI to provide the following information on contracts or services that result in amounts being charged to the regulated utility by unregulated affiliates or that the regulated utility charges to unregulated affiliates:

?? A list of services provided or received.
?? The annual amount associated with those services.
?? The contract or service agreement supporting those charges.
?? How the rate or charge was determined and how does it relate to a market assessment of the reasonability of those charges." (pg. 37).

The Board has also addressed this issue. For example in a 1996 decision dealing with Newfoundland Power (P.U. 7 (1996-97)), the Board stated:

> "…The Board continues to hold the position that inter-corporate transactions deserve special attention. … In cost allocations from affiliates and the parent, transactions must be supported by documentation, for example time sheets. The mark-up on cost must also be supported by reasonable documentation." (pg. 81-82).