

STATE OF NEW YORK DEPARTMENT OF PUBLIC SERVICE

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PUBLIC SERVICE COMMISSION

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*Acting General Counsel*

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*Secretary*

September 6, 2007

SENT VIA ELECTRONIC FILING  
Kimberly D. Bose, Secretary  
Federal Energy Regulatory Commission  
888 First Street, N.E.  
Room 1-A209  
Washington, D.C. 20426

Re: Docket No. RM07-15-000 - Cross-Subsidization  
Restrictions on Affiliate Transactions

Dear Secretary Bose:

For filing, please find the Notice of Intervention and Comments of the New York State Public Service Commission in the above-entitled proceeding. Should you have any questions, please feel free to contact me at (518) 473-8178.

Very truly yours,

A handwritten signature in cursive script that reads 'David G. Drexler'.

David G. Drexler  
Assistant Counsel

Attachment

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

Cross-Subsidization Restrictions     )     Docket No. RM07-15-000  
On Affiliate Transactions            )

**NOTICE OF INTERVENTION AND COMMENTS OF  
THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF NEW YORK**

**NOTICE OF INTERVENTION**

On July 20, 2007, the Federal Energy Regulatory Commission (FERC or Commission) issued a Notice of Proposed Rulemaking (NOPR) proposing restrictions on transactions between utilities and their market-regulated or non-utility affiliates. The New York State Public Service Commission (NYPS&C) hereby submits its Notice of Intervention and Comments in the above-captioned proceeding pursuant to the Notice of Extension of Time issued August 17, 2007, and Rule 214 of the Commission's Rules of Practice and Procedure.

Copies of all correspondence and pleadings should be addressed to:

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## INTRODUCTION AND SUMMARY

The NOPR proposes to prevent cross-subsidization between franchised utilities with captive customers (utility) and their market-regulated power sales affiliates or non-utility affiliates (affiliated entities). According to the Commission, the goal of the NOPR is to protect against inappropriate cross-subsidization of market-regulated and unregulated activities by the captive customers of utilities.

In particular, the proposal would prohibit a utility from purchasing non-power goods or services from an affiliated entity at above-market prices. The Commission also seeks comment on whether to impose any after-the-fact reporting requirements on transactions covered by the NOPR, and if advisable, specific recommendations for reporting requirements.

The NYPSC supports FERC's actions to impose restrictions on utility transactions with affiliates. These requirements are necessary because of the increase in the number of large interstate holding companies after the repeal of the Public Utility Holding Company Act of 1935. These companies have the opportunity and incentive to combine utility and non-utility businesses and to use transactions among affiliated companies to benefit the holding company and the utilities' affiliates, at the risk of increasing costs recovered from captive utility customers. This may result in recovery of

excess charges from captive utility customers, since actual costs may be lower. Therefore, it is recommended that the Commission require utilities to record purchases of non-power goods and services from an affiliated entity at the lower of cost or market price. In addition, it is suggested that FERC require any utility that engages in transactions with an affiliated entity to disclose those transactions, along with supporting information, in FERC Forms 1 and 2. This requirement would allow regulatory oversight of the transactions and provide opportunities to verify compliance with the directive to charge the lower of cost or market price.

#### DISCUSSION

I. The Commission Should Require Utilities to Purchase Non-Power Goods and Services From An Affiliated Entity at the Lower of Cost or Market Price

The NOPR would allow utilities to purchase non-power goods or services from an affiliated entity at market price. Presumably, the market price would be based upon what the utility would pay an independent third party supplier in the marketplace. While a market price would be the result of a transaction between two independent parties negotiating terms and conditions that further their own interests, a utility purchase from an affiliate involves a transaction between non-independent, related parties, which are both controlled by a

holding company. Under the NOPR, the holding company could manipulate the terms and conditions of these affiliate transactions and overcharge utilities for non-power goods and services from affiliates. This would provide an improper source of cross-subsidy for utility affiliates and their parent holding companies.

In a market transaction with a third party, the price paid by the utility for non-power goods or services may be based on the utility's purchasing volumes. Where an affiliate makes central purchases on behalf of several utilities, the affiliate will likely obtain discounts in the prices it pays due to the combined volume of purchases. Despite paying a discounted price, the NOPR would allow the central purchasing affiliate to charge each utility up to the prevailing market price which would otherwise be incurred if the utilities made their own separate purchases. The result would provide a source of affiliate cross-subsidization in an amount equivalent to the incremental purchase quantity discount.

As the NYPSC found, close scrutiny of transactions between a regulated telecommunications utility and its large holding company affiliates is necessary, given the lack of arm's-length bargaining. In finding that the utility "failed to demonstrate the reasonableness of the prices charged by its affiliated manufacturing, sales, and directory companies," the

NYPSC observed that the utility could have decreased its unit costs and prices through the purchase of added volumes in an open and competitive market.<sup>1</sup>

Allowing affiliates to charge utilities market prices may provide a cross-subsidy related to the cash flow benefits of the deferred tax on the capitalized inter-company gain. Under the consolidated tax reporting rules of the Internal Revenue Code, capitalized inter-company gains are deferred and no tax is due upon sale. Rather, payment of the tax is made by the consolidated group over the life of the utility plant, as it is depreciated, and the gain is realized through utility rates.<sup>2</sup> Outside suppliers include a profit element in their market prices, as well as the income tax owed on such profit, and must remit payment of the income tax to the government when the sale of the good or service is made to the utility and the profit is earned. Under the NOPR, affiliates would not be required to reflect this cash flow benefit in the prices it charges its utility affiliates. Instead, the NOPR would allow the affiliate to retain the benefit. This would result in a source of cross-

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<sup>1</sup> Case 21529, General Telephone Company of Upstate New York, Inc., 41 PUR 3d 1, (issued October 31, 1961) (indicating that "the benefits that might have accrued to the telephone companies and their subscribers have been pocketed by the parent").

<sup>2</sup> See 26 U.S.C. §1502; see also 26 C.F.R. 1.1502-13(c)(7)(ii) (Example 4).

subsidy for the unregulated operations of the holding company. Considering the capital intensity of utilities and substantial portions of plant with long depreciable lives, this cash flow benefit and the resulting cross-subsidy could be significant.

Thus, the application of a "market price" standard may allow holding companies to structure affiliate transactions, such that utilities with captive customers pay above-cost charges. To avoid the potential for this abuse, the Commission should require utilities to record purchases of covered items from their affiliates at the lower of actual cost (i.e., the fully allocated cost of the affiliate, including a reasonable rate of return on the purchasing affiliate's investment) or market prices.

This approach is reasonable. It would protect captive utility customers against paying affiliates more than the affiliate's actual costs. It would provide two independent benchmarks for ensuring that utility customers are not overcharged for goods or services purchased from affiliated entities, and help ensure that utility rates are just and reasonable.

## **II. The Commission Should Require Reporting of Transactions Between Utilities And Affiliated Entities**

The NOPR seeks comments on whether the Commission should impose any after-the-fact reporting requirements for

covered transactions and, if so, recommendations for specific requirements. FERC Forms 1 and 2 do not require any reporting related to affiliate transactions.

Since transactions between a utility and its affiliated entities are related party transactions, additional controls are needed. Therefore, we recommend revisions to Forms 1 and 2 to require utilities to describe, quantify, and provide the basis used to record each type of transaction with its affiliates. These reporting requirements are similar to those the Commission included in FERC Form No. 60 for centralized service companies.

#### CONCLUSION

In accordance with the above discussion, it is recommended that the Commission require utilities to record purchases of non-power goods or services from any affiliated entities at the lower of cost or market price. The Commission should also require the reporting of covered utility transactions in FERC Forms 1 and 2. These modifications will

assist the Commission in ensuring that captive customers of utilities do not pay unjust and unreasonable charges for goods or services.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Peter McGowan". The signature is written in a cursive style with a large initial "P".

Peter McGowan  
Acting General Counsel  
Public Service Commission  
of the State of New York

By: David G. Drexler  
Assistant Counsel  
3 Empire State Plaza  
Albany, NY 12223-1305  
(518) 473-8178

Dated: September 6, 2007  
Albany, New York

CERTIFICATE OF SERVICE

I, David G. Drexler, do hereby certify that I will serve on September 6, 2007, the foregoing Notice of Intervention and Comments of the New York State Public Service Commission upon each of the parties of record indicated on the official service list compiled by the Secretary in this proceeding.

Date: September 6, 2007  
Albany, New York

  
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David G. Drexler