

THE “NO-PROFITS-TO-AFFILIATES” RULE: A MISNOMER

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I. INTRODUCTION

When the Federal Power Commission (FPC) announced the “no-profits-to-affiliates” rule over fifty years ago, the rule absolutely prohibited a utility from recovering in rates any amount above actual costs paid to an affiliated company, either dollar-for-dollar as an expense or by inclusion of the amount in the rate base.¹ Hence the peremptory phrasing of the rule: “no profits to affiliates.” In more recent Commission² decisions, however, the rule has not been interpreted so literally, prompting one federal court to remark, quite accurately, that “[t]he so-called ‘no-profits-to-affiliates’ rule is more descriptively labeled the ‘no-automatic-acceptance-of-prices-paid-to-affiliates’ rule.”³ In other words, the rule as it is applied is not a substantive prohibition but a heightened level of scrutiny for utilities’ transactions with affiliates as opposed to non-affiliates. The rule simply makes heavier the burden of proof that utilities must meet in order to justify their rate change filings.

II. THE JURISPRUDENCE OF THE RULE

The “no-profits-to-affiliates rule” is premised on the Natural Gas Act and Federal Power Act requirement that the Commission “ascertain the actual legitimate cost of property” in determining cost of service for ratemaking purposes.⁴ The court in *Florida Gas Transmission Co. v. FPC*⁵ offered a concise summary of the rule’s theory and practice:

In the past . . . the Commission has excluded from “actual legitimate cost” those profits paid by a company to any other with which it is, either directly or indirectly, in a “control” relationship. This practice has become known as the “no-profits-to-affiliates” rule. The rationale behind the rule is relatively simple and highly pragmatic. If the relationship between the two contracting parties is so close that they lose their individual identity and are, in fact, *one*, there can be no “actual legitimate cost” involved in the payments of profits, since it would be tantamount to a company’s paying *itself* a profit for interdepartmental services.⁶

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1. The rule originated with *Alabama Power Co.*, 1 F.P.C. 25, 39 (1932), *aff’d sub nom.* *Alabama Power Co. v. McNinch*, 94 F.2d 601 (D.C. Cir. 1937), and *Louisville Hydro-Electric Co.*, 1 F.P.C. 130, 133 (1933), *aff’d sub nom.* *Louisville Gas & Elec. Co. v. FPC*, 129 F.2d 126 (6th Cir.), *cert. denied*, 318 U.S. 761 (1942).

2. The terms “Commission” and “FERC” are used interchangeably in this article to refer to both the Federal Energy Regulatory Commission and its predecessor the Federal Power Commission.

3. *Indiana & Mich. Mun. Distrib. Ass’n v. FERC*, 659 F.2d 1193, 1197 n.11 (D.C. Cir. 1981).

4. 15 U.S.C. § 717e(a) (1982); 16 U.S.C. § 824g(a) (1982).

5. *Florida Gas Transm’n Co. v. FPC*, 362 F.2d 331 (5th Cir. 1966), *modified on other grounds*, 391 F.2d 114 (5th Cir. 1968).

6. *Florida Gas*, 362 F.2d at 335-36 (footnote and citations omitted; emphasis in original).

So stated, the rule bars a utility from recovering from ratepayers not only profits paid to a controlled affiliate in excess of the utility's regulated rate of return, but any profits whatsoever.⁷

As noted, however, administrative and judicial decisions subsequent to *Florida Gas* have modified this statement of the rule. For example, in *Public Service Co. of New Mexico*,⁸ the Administrative Law Judge expressly rejected a cost-of-service standard in favor of the market test for rate treatment of prices paid to affiliates, remarking, "Commission precedent, commencing with *Florida Gas Transmission Company*, has consistently held that neither regulated companies nor their affiliates should receive less revenues for their sales due solely to the mere affiliation between supplier and purchaser."⁹

Thus, as long as the profiting affiliate is sufficiently operationally independent of the regulated one and the prices are deemed reasonable on the basis of market considerations, the prices may be fully recovered in rates.¹⁰ The FERC now determines the appropriate market-based price for the products or services purchased from an affiliate and permits recovery of the price actually paid to the extent that it does not exceed the market-based price. The Commission recently applied this comparative approach in *Ohio Power Co.*,¹¹ in which it judged the reasonableness of a wholesale electricity supplier's costs for coal purchases from a mining affiliate by reference to "comparable market prices" for coal of similar quality and availability in the same geographical area.¹² Indeed, even if there is a finding of both corporate and operational control, the FERC could allow recovery of profit to the extent of the allowed rate of return of the regulated utility, as the FPC did in *Trunkline LNG Company*.¹³

In these examples, the Commission views the totality of the relevant economic circumstances in determining whether or not to permit rate recovery of payments to affiliates; it does not magisterially apply the rule as an absolute bar to recovery. In fact, the no-profits-to-affiliates rule has long been construed as a factual balancing test, rather than a "bright-line" legal test.

The leading case on the no-profits-to-affiliates rule, *Florida Gas Transmission Co. v. FPC*,¹⁴ was decided in 1966. In that case, the gas utility entered into a construction agreement with four engineering and construction companies which collectively owned thirty-seven and one half percent of the utility's stock. Under the agreement, the companies were to construct a pipeline "at

7. *Accord, e.g., California Oregon Power Co. v. FPC*, 150 F.2d 25 (9th Cir.), *cert. denied*, 326 U.S. 781 (1945); *Alabama Power Co. v. McNinch*, 94 F.2d 601, 618 (D.C. Cir. 1937); *Susquehanna Power Co.*, 31 F.P.C. 74, 83, 96 (1964); *Pennsylvania Water & Power Co.*, 8 F.P.C. 1, 21 (1949).

8. *Public Serv. Co.*, 13 F.E.R.C. ¶ 63,041 (1981), *aff'd in relevant part*, 17 F.E.R.C. ¶ 61,123 (1982).

9. *Public Serv. Co.*, 13 F.E.R.C. ¶ 63,041, at 65,169 (footnote omitted).

10. *See Colorado Interstate Gas Co.*, 6 F.E.R.C. ¶ 63,003 (1976); *Indiana & Mich. Elec. Co.*, 59 F.P.C. 1383, 1397 (1976).

11. *Ohio Power Co.*, 39 F.E.R.C. ¶ 61,098 (1987).

12. *See id.* at 61,280, 61,287, 61,291 n.87.

13. *Trunkline LNG Co.*, 58 F.P.C. 726, 783-84 (1977) (involving shipping costs of liquid natural gas).

14. *Florida Gas Transm'n Co. v. FPC*, 362 F.2d 331 (5th Cir. 1966), *modified on other grounds*, 391 F.2d 114 (5th Cir. 1968).

the going rate."¹⁵ The Federal Power Commission refused to include the profits to those companies in the utility's cost of service, basing its decision on the no-profits-to-affiliates rule. The Fifth Circuit vacated the FPC's order. While the primary ground of the court's ruling was the relatively low percentage of the construction companies' ownership of the utility,¹⁶ the court made it clear that day-to-day control of the commercial operations of the company (referred to in this article as "operational control"), as well as legal control, is a key determinant of whether the no-profits-to-affiliates rule applies:

There was admittedly an interlocking directorate (four "firm" men on Houtex [the utility's] board of nine) and an intermingling of interests. While it may be true that the dealings between the parties involved did not meet the strictest standards required by "arm's length bargaining", it is not contended that they lost their true identity or that the relationship was such as to make them one. Arm's length bargaining is a general term. There is no substantial contention that the transactions in question were consummated under conditions of collusion, fraud, gross neglect or undue influence In our view, the record conclusively establishes that each of the principals involved was a clearly "identifiable" and independent entity, pursuing its individual business objectives at all times¹⁷

In sum, where complete operational control of one affiliate by another is lacking, the FERC, under *Florida Gas*, must employ a "market test" based on actual circumstances, rather than a rigid application of the no-profits-to-affiliates rule, to determine whether to permit rate recovery of profits to an unregulated affiliate.¹⁸

The effect of *Florida Gas* and its progeny, then, is that the no-profits-to-affiliates rule is not a mandatory *per se* rule but rather a discretionary "rule of reason." Indeed, the FPC considered the rule's dictatorial "no profits" phrasing a "misnomer,"¹⁹ and, as noted, the District of Columbia Circuit recently renamed it the less forbidding "no-automatic-acceptance-of-prices-paid-to-affiliates" rule.²⁰ Generally, what prices the FERC will accept as part of the rate base or as expenses will depend on what evidence the utility can present that the prices either were arrived at via arm's length transactions or would have resulted from such transactions had they occurred. Evidence of competitive, sealed bidding would reflect the fact that an arm's length transaction actually occurred and produced the prices in question; such evidence would provide substantial support for full rate base inclusion of the prices.

In the absence of formal bidding, cumulative evidence may support full or partial rate base inclusion, depending on the weight of the evidence. Such evidence must demonstrate: (1) that the utility does not operationally control the affiliate (or vice-versa), and (2) that the prices paid compare favorably to actual arm's length market prices. In determining whether operational con-

15. *Florida Gas*, 362 F.2d at 333.

16. *See id.* at 336-37 and n. 8.

17. *Id.* at 336 (footnote omitted). *See also* Safe Harbor Water Power Corp., 1 F.P.C. 230 (1935) (distinguishing "factual control," *i.e.*, operational control, from "stock control" in the context of the rule).

18. *See* Iowa State Commerce Comm'n v. Office of Federal Inspector of Ala. Natural Gas Transp. Sys., 730 F.2d 1566, 1574 (D.C. Cir. 1984) ("Based on this finding [that a control situation does not exist], the [rate authority] decided to apply a market test rather than a strict 'no profits to affiliates' rule.").

19. *Indiana & Mich. Elec.*, 59 F.P.C. at 1397.

20. *Indiana & Mich. Mun. Distrib. Ass'n v. FERC*, 659 F.2d 1193, 1197 n. 11 (D.C. Cir. 1981).

control exists, the FERC could consider the cumulative weight of a variety of factors, including, but not limited to, the following:

- (1) Interlocking directorates;
- (2) Common officers;
- (3) Stock ownership;
- (4) Market power of seller in industry;
- (5) Market power of buyer in industry; and
- (6) Any other factors relating to actual bargaining power of affiliate vis-a-vis utility.²¹

The FPC opinion that was appealed in *Florida Gas* suggests that competitive bidding conclusively authorizes favorable rate treatment of payments to affiliates under the no-profits-to-affiliates rule. In *Florida Gas Transmission Co.*,²² the FPC stated that "[t]he purpose of the rule is to prevent insiders from taking advantage of their position and creating costs which are not subject to the check of ordinary business relationships. Cf. Section 10 of the Clayton Act, 15 U.S.C. § 20."²³ Then, in the corresponding footnote, the FPC paraphrased section 10 of the Clayton Act:

This section makes it a crime for any common carrier to make any contracts for construction in an amount more than \$50,000 with another firm when the carrier shall have upon its board of directors or as its president, manager, or purchasing officer any person who is at the same time a director or manager or who has a substantial interest in the firm, *except under competitive bidding*.²⁴

The Commission was not directly quoting the statute, yet saw fit to include the competitive bidding exception. This indicates the Commission believes competitive bidding removes the reason for applying the no-profits-to-affiliates rule since it incorporates into an inter-affiliate transaction "the check of ordinary business relationships." In keeping with this inference, the FPC commented that static, objective criteria should not be exclusively employed in determining whether the rule applies by saying: "We do not think that some particular percentage of stock or of common officers or directors can be allowed to be determinative of whether the rule should apply, although these factors are relevant to determine when a relationship exists that calls for application of the exclusionary rule."²⁵

21. See, e.g., *Montana Power Co.*, 4 F.P.C. 213, 235-36 (1945). Under the current test, the absence of "the strictest standards required by 'arm's length bargaining,'" while relevant to whether profits to affiliates should be allowed, is not absolutely dispositive. See *Florida Gas*, 362 F.2d at 336. In this sense, *Florida Gas* represented a modification of the no-profits-to-affiliates rule as it had theretofore been applied by the FPC. See, e.g., *Alabama Power Co.*, 2 F.P.C. 479, 487 (1941); *Alabama Power Co.*, 2 F.P.C. 432, 444 (1941) (absence of arm's-length conditions absolutely barred recovery of profit to affiliate under cost-plus construction contracts regardless of changes in control relationship). On the other hand, arm's-length bargaining is the *sine qua non* of the market test: If it can be established, the utility will be allowed full recovery of its payments to the affiliate. If it cannot be established, the utility may still recover some or all of such payments by showing, via cumulative evidence, that operational control is lacking, and the effect of arm's length bargaining has somehow been achieved.

22. *Florida Gas Transm'n Co.*, 31 F.P.C. 1402 (1964), *vacated on other grounds*, *Florida Gas Transm'n Co. v. FPC*, 362 F.2d 331 (5th Cir. 1966), *modified on other grounds*, 391 F.2d 114 (5th Cir. 1968).

23. *Florida Gas*, 31 F.P.C. at 1408.

24. *Id.* at n.9 (emphasis added).

25. *Id.* at 1408. See also *Colorado Interstate Gas Co.*, 6 F.E.R.C. ¶ 63,003, at 65,022 (1976) (showing

Court decisions support a liberal reading of the rule. For example, in *Pennsylvania Power & Light Co. v. FPC*,²⁶ the court applied the no-profits-to-affiliates rule to deny the utility rate recovery of profits paid for the construction of a hydroelectric project. Phoenix Utility, the construction company, was wholly owned by the utility's holding company, Electric Bond and Share Company. The facts were egregious.

Since the incorporation of Phoenix in 1906 as a construction company Electric Bond and Share has owned its total outstanding stock of 20 shares having a par value of \$100 each. Aside from its name Phoenix has no genuine corporate existence. It operates with no funds of its own, has no construction equipment, no officers or employees of its own but only such as are supplied by Electric Bond and Share or by the generating companies, and pays none of their salaries. *It operates only within the Electric Bond and Share system and obtains none of its contracts as a result of competitive bidding.*²⁷

Thus, the *absence* of competitive bidding and of operational control dictated the court's denial of rate recovery.

Indeed, the federal courts have demonstrated some inclination to allow profits to affiliates from transactions *not* made at arm's length. In *Mississippi River Fuel Corp. v. FPC*,²⁸ the District of Columbia very reluctantly remanded the FPC's order allowing a gas supply and transmission company to recover from its wholesale purchasers profits paid to its affiliates for wellhead gas. The prices paid were admittedly not arm's length transactions. Moreover, those prices were occasionally increased by the producer. The court ordered the FPC to confirm its inclusion of those increases in cost of service simply by establishing "more factual justification" for them.²⁹ The court elaborated:

We do not say that all benefits, in total amounts, due to initial advantageous arrangements at the wells or to astute original operational arrangement belong to the customers and none to the stockholders. But we do say that the whole of

of reasonableness of payments to subsidiary requires less burdensome presentation of evidence where the parties dealt "at arm's length and in the general and open market, subject to the usual safeguards of bargaining and competition"). More broadly, *Florida Gas* should be read not so much as a departure from the previous applications of the no-profits-to-affiliates rule as an expansion of the rule to meet new factual circumstances. In most of the cases applying the rule decided by the FPC up until the decision appealed in *Florida Gas*, the utility asked the FPC to allow as cost of service prices paid to captive affiliates either for securities or for services under cost-plus contracts awarded on a strictly non-competitive (i.e., exclusive) basis. *E.g.*, *United Gas Pipe Line Co.*, 25 F.P.C. 35 (1960); *United Gas Pipe Line Co.*, 19 F.P.C. 1011 (1958); *Columbian Fuel Corp.*, 19 F.P.C. 479 (1957); *Colorado Interstate Gas Co.*, 19 F.P.C. 1012 (1957); *Pennsylvania Water & Power Co.*, 8 F.P.C. 1 (1949), *aff'd*, 193 F.2d 230 (D.C. Cir. 1951), *aff'd*, 343 U.S. 414 (1952); *Minnesota Power & Light Co.*, 7 F.P.C. 98 (1948), *modified on other grounds*, 9 F.P.C. 472 (1950); *The Montana Power Co.*, 4 F.P.C. 213 (1945); *The Susquehanna Power Co.*, 4 F.P.C. 74 (1944), *modified on other grounds*, 4 F.P.C. 1034 (1945); *Mississippi Power & Light Co.*, 3 F.P.C. 521 (1943); *Pacific Power & Light Co.*, 3 F.P.C. 329 (1942), *modified on other grounds*, 6 F.P.C. 652 (1947); *Alabama Power Co.*, 2 F.P.C. 479 (1941), *modified on other grounds*, 3 F.P.C. 621 (1942), and 6 F.P.C. 1116 (1947); *Alabama Power Co.*, 2 F.P.C. 432 (1941).

26. *Pennsylvania Power & Light Co. v. FPC*, 139 F.2d 445 (3d Cir.), *cert. denied*, 321 U.S. 798 (1943).

27. *Pennsylvania Power & Light*, 139 F.2d at 450 (emphasis added). *Accord*, *American Power & Light Co. v. SEC*, 158 F.2d 771 (1st Cir. 1946), *cert. denied*, 331 U.S. 827 (1947) (applying rule in the context of PUHCA).

28. *Mississippi River Fuel Corp. v. FPC*, 252 F.2d 619 (D.C. Cir.), *cert. denied*, 355 U.S. 904 (1957).

29. *Mississippi River Fuel*, 252 F.2d at 622.

such benefits, as measured by increasing fair field prices, cannot be assigned to the stockholders by unexamined increases in interaffiliate prices accepted as costs of the affiliate-purchaser.³⁰

In other words, the ultimate consideration in applying the no-profits-to-affiliates rule is cost justification.³¹ Case law suggests that when a price is the result of an arm's length transaction, it is presumptively cost-justified.

III. SEMANTIC CONSIDERATIONS

If the FERC were to distinguish costs from profits and decide to allow only costs, and no profits in rates, a separate question would arise as to precisely how it would define costs. The Natural Gas Policy Act of 1978 (NGPA), the Public Utility Holding Company Act of 1935 (PUHCA), and relevant case law suggests that the FERC should and will permit recovery of a reasonable return on investment in addition to actual cost. As a practical matter, this makes the difference between allowing and disallowing profits meaningful only to the extent that cost plus reasonable return differs from market price.

Under section 601 of the NGPA, the FERC is flatly prohibited from denying an interstate pipeline any wholesale price paid for natural gas to an affiliate if that price does not exceed any federal statutory price ceiling currently in place, and does not exceed comparable wholesale prices to non-affiliates.³² There is one rather nebulous exception: the FERC may deny a pipeline this "guaranteed passthrough" if it "determines that the amount paid was excessive due to fraud, abuse, or similar grounds".³³ The Commission held that the exception applies where the pipeline's gas acquisition policies and practices "reflect reckless disregard of the pipeline's fundamental duty to provide service at the lowest reasonable cost" and have "significant, adverse consequences."³⁴ In the *Consumers' Counsel* case, however, the District of Columbia Circuit struck down the "significant adverse consequences" prong, since it expanded Congress' intent to only prohibit excessive payments due to fraud, abuse, or similar grounds.³⁵

The court went on to say that gas purchases in excess of supply requirements (excessive purchases) are a factor in determining whether payments are excessive. Whether purchases are excessive depends on (1) projections of demand and supply and (2) the effect that the prices paid by the pipeline would, in turn, have on those projections if passed through to ratepayers.³⁶ The upshot of *Consumers' Counsel* is that the FERC will permit interstate pipeline rate recovery of any prices paid to affiliates that were reasonably dic-

30. *Id.* at 623.

31. See *Indiana & Michigan Elec. Co.*, 59 F.P.C. 1383; 1397 (1976) (pointing out that no-profits-to-affiliates rule is "misnomered" [sic], but disallowing adjustment to expense for power purchased from affiliates on the ground that it was "not . . . cost justified").

32. 15 U.S.C. § 3431(b)(1)(A), (b)(1)(E), (c)(2)(A) (1982).

33. 15 U.S.C. § 3431(c)(2) (1982).

34. *Columbia Gas Transm'n Corp.*, 26 F.E.R.C. ¶ 61,034, at 61,100 (1984).

35. *Office of Consumers' Counsel v. FERC*, 783 F.2d 206, 222 (D.C. Cir. 1986).

36. See *id.* at 226-28.

tated by existing demand and supply conditions, as gauged by prevailing market prices paid by pipelines to non-affiliates. That such prices may be burdensome to ratepayers does not by itself constitute an excessive payment due to fraud, abuse, or similar grounds.³⁷

Regulations promulgated by the Securities and Exchange Commission (SEC) pursuant to sections 13(b) and 13(c) of the Public Utility Holding Company Act of 1935,³⁸ also embrace a rather liberal definition of cost. Rule 90(a)(2)³⁹ prohibits a utility holding company subsidiary from performing a service for an affiliate at more than cost as determined pursuant to Rule 91.⁴⁰ Rule 91 defines a transaction at cost as one whose price "does not exceed a fair and equitable allocation of expenses (including the price paid for goods) plus reasonable compensation for necessary capital procured through the issuance of capital stock"⁴¹ Reasonable compensation is accorded captive subsidiaries as well as those whose securities are publicly traded.⁴² Generally, the SEC will set reasonable compensation for holding company subsidiaries at a rate of return corresponding to the one set by FERC for the regulated cost of service.⁴³ When a specific debt-equity ratio is specified for the service affiliate, the SEC will determine reasonable compensation by taking a weighted average of the FERC-regulated return on debt and return on equity for the utility.⁴⁴

As for "a fair and equitable allocation of expenses", SEC regulations state more precisely:

Direct charges shall be made so far as costs can be identified and related to the particular transactions [sic] involved without excessive effort or expense. Other elements of cost, including taxes, interest, other overhead, and compensation for the use of capital procured by the issuance of capital stock (or similar securities of an unincorporated company) shall be fairly and equitably allocated.⁴⁵

37. Subject, of course, to any federal statutory price ceiling under 15 U.S.C. § 3312 (1982).

38. 15 U.S.C. § 79m(b) (1982).

39. 17 C.F.R. § 250.90(a)(2) (1988).

40. 17 C.F.R. § 250.91 (1988). Note that if neither affiliate involved is a "public-utility company" or "holding company" as defined in 15 U.S.C. § 79b(a)(3)-(5), (7) (1982), the transaction is exempt from this requirement. 17 C.F.R. § 250.90(d)(1) (1988). A company that owns and operates facilities used only for wholesale gas transactions is not a "public utility" under 15 U.S.C. § 79b(a)(4) (1982).

41. 17 C.F.R. § 250.91(a) (1988).

42. See, e.g., Appalachian Power Co., PUHCA Release No. 18363, 4 SEC Docket (U.S. Gov't Printing Office) 50 (Apr. 3, 1974).

43. See, e.g., Southern Ohio Coal Co., PUHCA Release No. 21537, 19 SEC Docket (U.S. Gov't Printing Office) 1309 (Apr. 25, 1980); The Columbia Gas System, Inc., PUHCA Release No. 20729, 15 SEC Docket (U.S. Gov't Printing Office) 1288 (Oct. 11, 1978).

44. See, e.g., Ohio Power Co., PUHCA Release No. 20515, 14 SEC Docket (U.S. Gov't Printing Office) 928 (Apr. 24, 1978). The FERC's jurisdiction is independent of the SEC's jurisdiction, and the FERC is not bound by the SEC's cost determination in setting rates. Ohio Power Co., 39 F.E.R.C. ¶ 61,098, at 61,276-78 (1987). The FERC, however, has recognized that unregulated affiliates as well as regulated utilities are entitled to a reasonable return on investment. See, e.g., Algonquin SNG, Inc., 49 F.P.C. 345 (1973) ("[A]n affiliate is entitled to a reasonable return on its investment since the financing of this project is based on its economic viability"). *Id.* at 349. The FERC, of course, is empowered to determine cost recovery on the basis of such economic viability, and in doing so will apply the more flexible market test. 39 F.E.R.C. ¶ 61,098, at 61,276-85.

45. 17 C.F.R. § 250.91(b) (1988).

The regulations provide further guidance on the appropriate allocation of capital for purposes of determining compensation for capital:

Interest on borrowed capital and compensation for the use of capital shall represent a reasonable return on only the amount of capital reasonably necessary for the performance of services or construction for, or the selling of goods to, customers for whom transactions are required by the rules of the Commission to be performed at cost.⁴⁶

Thus, under the SEC rules, three categories of expenses compose "cost": (1) direct actual expenses associated specifically with a particular transaction; (2) allocated general expenses representing the fixed costs of doing business and not directly related to any particular job; and (3) allocated compensation for capital. Direct costs are computed simply on a dollar-for-dollar basis. General expenses over a given time period are "fairly and equitably allocated" to each particular transaction. Compensation for capital is also allocated to each particular transaction.

As to allocation of general expenses, the SEC has stated:

Registered [holding company] systems and service company operations are too diverse to permit the adoption of a general formula for overhead allocation. Allocation methods have been dealt with by order in the application process for authorizing service company operations under Sections 13(c) and 13(d) of the [Public Utility Holding Company] Act. We have made express reference to this procedure by adding § 256.01-11 (Methods of allocation), directing that indirect costs and compensation for use of capital shall be allocated in accordance with the service company's applicable and currently effective methods of allocation filed with the Commission.⁴⁷

Section 256.01-11, in turn, requires that "[i]ndirect costs and compensation for use of capital . . . be allocated to work orders in accordance with the service company's applicable and currently effective methods of allocation filed with the Commission."⁴⁸

The amount of capital to be used for determining compensation, however, should be "the amount of capital reasonably necessary for the performance of services or . . . work for . . . associate companies."⁴⁹ Once that has been determined, it should be multiplied by the appropriate rate of return and allocated according to work order under section 256.01-11.

In sum, both general expenses and compensation for capital should be allocated to each inter-affiliate transaction (*i.e.*, by work order) based on intra-system accounting methods filed with the Commission.

The FERC is not required in any way to follow the SEC cost accounting requirements under PUHCA in determining just and reasonable rates under the Natural Gas and Federal Power Acts.⁵⁰ Nevertheless, the FERC generally does follow the SEC practice of allowing an allocation of general expenses to affiliate transactions, on a pro rata basis. These allocations are proportion-

46. *Id.*

47. Final Rules, *Uniform System of Accounts for Mutual Service Companies and Subsidiary Service Companies, Public Utility Holding Company Act of 1935*, 44 Fed. Reg. 8,247, 8248 (1979).

48. 17 C.F.R. § 256.01-11 (1988).

49. 17 C.F.R. § 256.01-12 (1988).

50. See *Ohio Power Co.*, 39 F.E.R.C. ¶ 61,098, at 61,276-78.

ately the same as the ratio between the direct costs associated with the transactions and the utility's total direct costs during the test year.⁵¹ Significantly, the SEC has endorsed precisely the same principle of allocation.⁵² It is certain, therefore, that the FERC will allow some allocation of an unregulated subsidiary's general expenses to inter-affiliate transactions, and likely that it would permit allocations under methods previously approved by the SEC.

IV. GUIDELINES FOR UTILITY MANAGEMENT

The so-called "no-profits-to-affiliates" rule employed by the FERC is in fact a two-tiered market test based on factual circumstances to determine whether or not to allow prices paid to affiliates to be included in the rate base (or, sometimes, passed through dollar-for-dollar as costs). Operational or ownership control of an unregulated company by a jurisdictional company (or vice versa) is relevant to, though not dispositive of, this determination. Such control merely triggers a higher level of scrutiny by the FERC than it would otherwise apply.⁵³

In exercising its scrutiny, the FERC will look to operational control as the principal determinant of whether to allow payments to an affiliate to be included in the rate base. A useful definition of operational control is "a relationship which by its very nature and history precludes unhampered bargaining . . . sufficient to dominate the execution of the contracts in the face of united opposition."⁵⁴ In other words, operational control is control of the contract negotiation, and thus the pricing process. In determining whether such control exists, the FERC will consider whether the transaction in question was conducted at arm's length, in the atmosphere of a competitive market. According to applicable case law, competitive, sealed bidding is the best evidence of an arm's length transaction. A showing of competitive sealed bidding establishes that the control of an unregulated supplier by a regulated parent utility is innocuous to ratepayers, and therefore justifies the utility's recovery in rates of its payments to the affiliate supplier.

Awarding contracts to affiliates on the basis of competitive sealed bidding is the preferred strategy for utilities to ensure rate base inclusion or direct cost recovery of all payments made by the regulated company to the affiliates. Certain additional steps should be taken, however, to guarantee favorable rate treatment of inter-affiliate payments by the FERC. These include, but are not limited to: (1) minimizing and, if possible, eliminating any interlocking of directorates; (2) establishing at the affiliate a core of permanent, non-cyclical

51. See, e.g., *Florida Gas Transm'n Co.*, 31 F.P.C. 1402 (1964); *Pennsylvania Power & Light Co.*, 3 F.P.C. 89, 107 (1942); *Alabama Power Co.*, 2 F.P.C. 479, 483 (1941); *Alabama Power Co.*, 2 F.P.C. 432, 444 (1941).

52. *In re Corporation Serv., Inc.*, 1 S.E.C. 598, 602-03, File No. 37-3 (U.S. Gov't Printing Office) (July 31, 1936); *In re Penn-Western Serv. Corp.*, 1 S.E.C. 562, 564 File No. 37-1 (U.S. Gov't Printing Office) (July 13, 1936).

53. See, e.g., *Florida Gas Transm'n Co. v. FPC*, 362 F.2d 331 (5th Cir. 1966); *Colorado Interstate Gas Co.*, 6 F.E.R.C. ¶ 63,003, at 65,033 (1976); *Arkansas Louisiana Gas Co.*, 5 F.E.R.C. ¶ 63,012, at 65,121 (1978); *Distrigas Corp.*, 47 F.P.C. 752, 838 n.43 (1972).

54. *Florida Gas Transm'n Co. v. FERC*, 31 F.P.C. 1402, 1408 (1964).

employees, particularly at the middle-management level; and (3) maximizing the affiliate's dealings with non-affiliates, within its budgetary and operational constraints, and within the countervailing "functional relationship" requirement of section 11 of the PUHCA that the majority of the affiliate's business comes from affiliates. Taking these measures will tend to preserve and enhance the appearance of a subsidiary as an independent business entity pursuing commercial objectives outside its own corporate family, as opposed to a captive company. This appearance is likely to moderate the FERC scrutiny by preventing any "red flags" from materializing. Should the FERC decide to question inter-affiliate transactions, evidence of these factors could cumulatively establish the absence of genuine control, even if such transactions were not at arm's length.

V. POLICY CONSIDERATIONS

The energy crisis has made it necessary for electric utilities to be far more cost conscious than perhaps they once were. The crisis has also precipitated an expansion of natural gas markets and enhanced the economics of vertically integrating natural gas pipelines and distribution companies. For both reasons, regulators have come to scrutinize utilities' investment decisions and expenditures far more closely than before, focusing now on prudence and anticompetitive effect, respectively, as well as cost of service.⁵⁵ These considerations tend to counsel a strict interpretation of the no-profits-to-affiliates rule as barring any profit from inter-affiliate transactions *per se*.

On the other hand, economic revelations of recent years have dictated a relaxed enforcement of the national antitrust policy. Contrary to earlier belief, fierce competition in atomized markets of the sort contemplated by classical price theory does not always, or even usually, yield the lowest price to consumers; more often, the economies of scale flowing from large, integrated corporations produce lower costs, hence lower prices.⁵⁶ Furthermore, the demand for gas and electricity is more elastic than once believed, so even natural monopolies have a significant market-derived incentive to keep rates reasonably low. These realizations seem to call for a more liberal application of the rule as a "rule of reason," commensurate with the FERC's application of it.

Given these competing realities of the current economy, ratemaking agencies are in need of an appropriate mechanism for striking a balance between a very strict and a very lenient application of the no-profits-to-affiliates rule. It is insufficient to simply require, as a condition of rate recovery, that all revenues accruing to an unregulated affiliate from a regulated one result from an arm's length transaction. Under this market comparison approach, the *post hoc* criteria of an "arm's length transaction" are as mallea-

55. *See, e.g.*, *Duquesne Light Co. v. Barasch*, 109 S. Ct. 609 (1989); *Niagara Mohawk Power Corp. v. Public Serv. Comm'n*, 69 N.Y.2d 365, 507 N.E.2d 287, 514 N.Y.S.2d 364 (1987).

56. *See, e.g.*, *Business Elec. Corp. v. Sharp Elec. Corp.*, 485 U.S. 717 (1988); *Murphy v. Business Cards Tomorrow, Inc.*, 854 F.2d 1202 (9th Cir. 1988).

ble and nebulous⁵⁷ as those of "excessive profits." The best solution, therefore, would be a dynamic mechanism ensuring that inter-affiliate sales originate as actual arm's length transactions, rather than merely ensuring that prices produced by such sales are consistent with arm's length criteria. One such solution would be mandatory competitive bidding on any transaction in which an unregulated utility affiliate seeks to engage. This requirement would encourage genuine market efficiency in utility management. Moreover, by effectively taking the control of inter-affiliate transactions out of the hands of the utility holding company and leaving it to the free market, the requirement would firmly proscribe any utility from unduly skewing major investment and expenditure decisions to the advantage of its shareholders.⁵⁸

57. See, e.g., *FERC Captive Coal Rule Seen Lacking Market and Quality Definitions*, ELECTRICAL WEEK 9 (Oct. 19, 1981).

58. A thoughtful note has proposed mandatory competitive bidding where a captive mining subsidiary seeks to supply coal to its parent utility:

Unfortunately, current methods used to regulate transfer prices are neither accurate nor efficient. A market price comparison system yields inconclusive results. Coal market conditions keep it from accurately identifying a market price for coal sold under long-term contracts. At the same time, cost-based methods of transfer price determination do not encourage efficient management of mines. The results may be inefficient mining operations, inflated coal prices, and windfall profits to utility shareholders.

Note, *Using Market Bidding to Regulate the Transfer Price of Utility-Affiliate Coal*, 36 STAN. L. REV. 1215, 1241 (1984).

