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General Regulatory Principles Concerning the Choice of Test Year and the Identification and Treatment of Non-Regulated Activities

R-3405-98

Testimony of

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on behalf of the
Regroupement National des
Conseils régionaux de l'environnement du Québec
(RNCREQ)

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April 9, 1999

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1. Purpose

The purpose of this testimony is to contribute to the Régie's deliberations concerning general principles for the setting and applying of transmission tariffs, in accordance with its decision D-88-98.

2. Introduction

Transmission pricing techniques serve a number of purposes. Among the most fundamental, of course, are (1) the verification and recovery of the costs of the transmission system and (2) the fairest and most efficient allocation of those costs among the users of the transmission grid. The second topic dominates the debate over transmission pricing in the U.S. and in many other countries where transmission systems, built and operated primarily to assure reliable service to monopoly franchise clientele, have recently taken on common carrier characteristics as a result of national policies in favor of competitive (and deregulated) generation markets. [1]

The questions retained for debate in this hearing suggest that the Régie is primarily concerned at this time with the first of these two questions. Thus, the principles proposed for debate in this inquiry will focus primarily on the revenue requirement for Hydro-Québec's transmission activities. Given that Quebec has not made a commitment to develop fully competitive electricity generation markets, this emphasis is understandable.

Nevertheless, when transmission tariffs are set, the equitable allocation of costs between Hydro-Québec's retail customers (who pay a bundled rate for electricity, including a transmission component) and wholesale customers (who purchase transmission services

[1] Transmission pricing also can affect a number of environmental and social issues, but these are not the subject of this report.

only) will have to be addressed, as will issues related to fairness among wholesale customers.

Of the five questions retained by the Régie for debate in this hearing (subsequently reduced to four), our comments are limited to principles 1 (the test year) and 5 (the identification and separation or regulated and non-regulated activities).

3. Use of a projected test year for setting electricity transmission tariffs

James Bonbright, one of the most respected commentators on utility regulation, has noted that public utility rates are designed:

> (1) to determine the types and amounts of service that the enterprise must undertake to render,
>
> (2) to enable the enterprise to pay operating expenses and to attract the capital needed to render this service, and
>
> (3) to encourage the management of the enterprise to meet the demand for service at the minimum cost.... [2]

A well-known U.S. regulatory text describes the purpose of the test year as follows:

> "In the first place, the commission's staff must audit the utility's books. For ratemaking purposes, only just and reasonable expenses are allowed; only used and useful property is permitted in the rate base. In the second place, the commission must have a basis for estimating future revenue requirements. This estimate is one of the most difficult problems in a rate case. A commission is setting rates for the future but it has only past experience (expenses, revenues, demand conditions) to use as a guide. "Philosophically, the strict [historical] test year assumes the past relationship among revenues, costs and net investment

[2] James Bonbright, with Albert Danielsen and David Kamerschen, Principles of Public Utility Rates, 2nd Ed., March, 1988.

> during the test year will continue into the future." (footnote omitted) To the extent that these relationships are not constant, the actual rate of return earned by a utility may be quite different from the rate allowed by the commission (footnote omitted)."[3]

Hydro-Québec urges that the Régie adopt a "projected test year", which the Company contrasts with "an annual normalized historical reference year" (Brief, p. 9). It argues that in the United States "there is a significant trend for the increasing use of this methodology" (Brief, page 10), and that the historic test year is "less and less appropriate for the management of modern companies" and "more tedious from an administrative point of view" (page 9). Hydro-Québec witness Dr. Mark Jaccard asserts that the projected test year "is a normal practice in North America" (Jaccard, p. 1).

Taken as a whole, these assertions paint an incorrect picture. A brief review of the test year issue as it evolved in the U.S. will clarify these points.

As Dr. Phillips notes above and as countless regulatory decisions affirm, the test year, to be a valid basis for the setting of future rates, must be well grounded in past experience. As we will explain later, most discussion of these issues in American regulatory practice dates to the 1970s and 80s. Thus, in 1972 the Maine Public Utilities Commission (PUC) stated the general view of almost all US commissions of that era when it described the test year as:

> "… a recent operating period during which revenue, expenses and plant requirements are generally in balance, in the sense that the relationship of revenues, expenses and plant in that year is generally representative of the recent past, and therefore likely to be representative of the near term future."[4]

In that decision, the Maine PUC rejected Central Maine Power's effort to update certain plant accounts to the end of the test period, stating:

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[3] Charles Phillips, Jr., The Regulation of Public Utilities, 1993, p. 196.

[4] Maine PUC, *Central Maine Power Company. Re Proposed Increase In Rates* (May 1972), p. 12.

> "Of course, the Company's future operations are expected to be at a different level from the test year. The Company's service requirements are growing, and its investment, revenues, and expenses will increase as it grows. But as long as revenues and costs remain in balance, that is, in the same relative position as in the test year, future costs will still be covered. As new customers and plant are added and additional costs to serve these additional customers are incurred, revenues from the new customers will also be added. Total costs will still be covered, as long as the percentage growth in revenues parallels the percentage growth in plant and expenses.....In application, the principle is one of matching the time and amount of the investment and expenses with the time and amount of the revenues produced by these investment and expenses, taking into account known changes that are extraordinary in nature."[5]

The use of the historic test year is thus based on the rebuttable presumption that the balance between revenues and costs (including capital costs and expenses) that held for the recent past will tend to hold for the immediate future. To the extent that the utility (or another interested party) believes otherwise, and therefore sees the need to modify rates in order to keep revenues in line with costs, the burden of proof is generally on that party to defend its proposed modifications to the historic relationships.

This approach is far easier to apply than an attempt to forecast the future account-by-account, as Hydro-Québec urges here. Furthermore, the historical test year is more easily applied and challenged by the Commission, its staff and the public than a projected test year built on hundreds of individual forecasts. With this latter approach, it is virtually impossible for staff and interveners to critically review each forecast. Exaggerations, therefore, may well go unchallenged.

Furthermore, regulatory history shows that the use of a historical test year does not disadvantage the utility. Indeed, the record prior to the 1970s (and again in the last decade) suggests that this method is as likely to produce overearnings as underrecovery

[5] Ibid.

unless the regulatory authorities are vigilant in requiring rate decreases when new revenues exceed new costs.[6]

The use of a projected test year, on the other hand, is more likely to produce overearnings, because the utility will understandably tend to make projections that insulate it from risk. To the extent that the use of the projected test year is accompanied by a variety of stabilization accounts and an annual reconciliation process, this danger can be mitigated. However, Hydro-Québec acknowledged in its responses to questions 9 and 10 of the RNCREQ that the absence of such a process would tend to result in overearnings if operating expenses declined, if a planned energy efficiency program were cancelled or if a major capital project which had been included in the projected test year were delayed.

Such reconciliation processes for routine differences between forecasts and actual experience are uncommon in the U.S., where there is a strong presumption against measures that have the effect of changing the price of electricity that has already been consumed. Furthermore, such processes tend to minimize the limited incentives for operating efficiency that traditional cost-of-service regulation provides.

Finally, Hydro-Québec has made clear in its responses to the Régie that it contests the need for such mechanisms as well as the legality of their use .[7] Thus, it would be inappropriate to adopt a projected test year on the assumption that it will be accompanied by reconciliation mechanisms.

[6] The 1970s, a period of high inflation, presented special challenges, described below.

[7] HQPR-11, doc. 2.1, R5.1.

Dealing with inflation

The historic test year came under considerable pressure during the times of high inflation in the 1970's. Many commissions, while continuing to use historic test years, allowed various "hybrids", such as a filing based on eight months actual and four months estimated data. Then the actual data for the last four months would be supplied during the early stages of the hearings.

As Dr. Phillips, writing in 1993, observed, "More recently, due largely to inflation, *a few commissions* have modified the traditional test year approach by using a forward-looking test year (either a partial or a full forecast) or by permitting pro forma expense and revenue adjustments." (emphasis added) (Phillips, *op. cit.*, at 196).

As both Phillips and Bonbright note, regulators found numerous solutions other than projected test years to the problem of inflation. Bonbright (at p. 350) states a preference for "attrition allowances" as being more precise and easily adapted to the circumstances of individual utilities.[8] However, he is sharply critical of the idea that utilities and their investors are entitled to inflation adjustments at all:

> "Such an adjustment is selective, nonremedial, and unfair to others. Fixed securityholders are not safeguarded against inflation either. Common shareholders are not promised an inflation adjusted return — indeed no return is promised. Nonregulated shareholders are not given inflation-proof securities ..."[9]

In recent years, with low inflation, the debate over the appropriate test year has virtually faded away. Few U.S. commission decisions in the 1990s discuss the issue at all. Attrition is no longer a problem, so attrition allowances are no longer made. The automatic reconciliation clauses put in to cope with volatility in major items like fuel and

[8] An attrition allownce is normally an adjustment to the rate of return or the rate base to reflect a proven tendency of expenses and investment to outpace revenues. It is itself based on the historical year's data.

[9] Bonbright, *op. cit.*, at 350.

purchased power have proven to be a source of inefficiency and distorted incentives. Many have been repealed or modified. To the extent that Hydro-Québec is correct in stating that the historical test year is "less and less appropriate for the management of modern companies," it is because regulators are shifting to performance-based ratemaking, which reduces the importance of the test year concept. It is not because U.S. jurisdictions see any merit to projected test years.

Conclusion

In summary, the essence of the test year concept is substitution of an assumed balance among revenues, capital costs and expenses for an extensive forecasting exercise. Common sense and regulatory experience suggest that using historical data adjusted for known major changes is likely to be much easier and no less accurate than a complex effort to forecast all categories into the future.

If the Régie is concerned about the time between the test year and the rate year that would result, for example, from the use of 1998 as a test year for a rate case filed in 1999, to set rates effective in 2000, it might well contemplate the use of a "hybrid" test year, as mentioned earlier. With this approach, Hydro-Québec could file a rate case in April 1999 based on six months actual data (Sept. 98 to March 99) and six months projected data (April to August 1999). As the hearing progresses, actual data could be substituted for the projected data, such that, when a decision is made late in 1999, it could be based on a more recent 12 months of actual data. With this approach, modifications to the historic data could be limited to a manageable number of significant items, each of which could

then receive the appropriate regulatory scrutiny. The end result would still be a historic test year, but with the "lag" problem much reduced.[10]

The assertion that modern regulatory trends are toward future test years is not sustainable. Modern regulatory trends are, if anything, toward performance-based regulation that largely avoids the use of test years. As we suggested in our testimony concerning Hydro-Québec's supply tariff proposal, it would probably be premature to apply comprehensive performance-based ratemaking to Hydro-Québec without first carrying out cost-of-service regulation for several years, though in the long run this may well be desirable.

4. Implications of the decisions made in this proceeding for the risks assumed by Hydro-Québec, and therefore for the cost of capital.

While recognizing that this proceeding will not determine the cost of capital to be used in setting rates, it is important to emphasize that some of the principles sought by Hydro-Québec do have the potential to shift risks from the utility to the customers. If the Régie adopts these principles, it should consider a downward adjustment to the allowed rate of return to reflect this diminished risk. Two examples worth noting here are the projected test year (for reasons set forth in the discussion on inflation in the previous section) and the principle set forth in Section 2.3.3 of the Hydro-Québec brief that "the use of cost-of-service methodology by a regulated entity should grant it the express right to recover the cost of all investments which are useful and prudently acquired in order to provide the regulated service."

[10] This approach is in many ways similar to that used by SCGM to establish the base year for its projected test year. The difference is that, instead of using the gradually-updated current year *as the test year*, SCGM uses it in turn as the basis for a projected test year, one year later.

The current debate over the recovery of so-called stranded investment in the U.S. is occurring precisely because U.S. utilities do not have any such "express right". Many feel that they should, and that, when the advent of competition has made it impossible to recover those costs in the open market, they have an absolute right to be reimbursed for the capital costs they have not been able to recover through rates. However, most states do not recognize this "right". Those, like California, that have created such a right in the context of their restructuring process have made a corresponding downward adjustment to the utility's return on equity, reflecting the diminished investment risk.

To the extent that the Régie determines that Hydro-Québec has a "right" to full recovery of all prudently incurred costs, the appropriate cost of equity capital (return on equity) will be significantly lower than that of an unregulated corporation whose capital is at risk when it cannot compete effectively.

Furthermore, if Hydro-Québec has an "express right" to recover the cost of all investments which are useful and prudently acquired, then consumers are entitled to any appreciation in asset values above original cost. Once the customers take on the unequivocal obligation to compensate the utilities for unexpected declines in the market value of assets, it is beyond dispute that they are entitled to the gains in value as well.[11] This principle is documented in the writings even of the leading electric utility witnesses in the U.S. For example, Dr. Alfred Kahn, author of *The Economics of Regulation* wrote recently:

> "On the other hand, to the extent the unregulated operations make use of facilities the costs of which have been recovered by depreciation charges to purchasers of the regulated services — or, more generally, that the companies realize capital gains by selling for more than net book value assets that have been included in rate base — there is a sense in which that differential really "belongs" to the purchasers of the regulated services, so long as their commissions have operated consistently on an original cost or prudent investment basis for determining

[11] Given the historical evolution of the Hydro-Québec system, Québec consumers arguably have an entitlement to the full market value of these assets and of the energy they produce regardless of the disposition of the "express right" issue.

> allowable revenues. This proposition is the corollary of the entitlement of the utility companies to recovery of their stranded costs."[12]

Dr. Kenneth Gordon, a former chair of the Maine and Massachusetts Commissions speaking for the Edison Electric Institute, the U.S. utility trade association, makes the same point:

> "I do agree that when the utility is the seller of a service or an asset to an affiliate, and the market value of the regulated asset is higher than the book value, then the utility should, in fact, receive the market value of the asset. Otherwise, the unregulated affiliate (and thus the utility's shareholders) is receiving a financial reward through a discount on that asset, while that financial reward should more properly accrue to those who bore the risk of the investment. In a regulatory setting based on consistent costing principles, this is simply the flip side of the utility's right to be paid full book value (by ratepayers) when the market value of assets is below the book value, the so-called stranded cost problem."[13]

As utilities seek ways to employ their regulated assets in unregulated ventures, this principle takes on considerable importance.

5. Identification and separation of regulated and non-regulated activities

The criteria for separating regulated from non-regulated activities are very important for several purposes:

(1) to ensure that utility customers are not asked to pay costs that should be charged to competitive activities;

(2) to ensure that utilities are not overcharged for goods and services provided to them by their competitive affiliates;

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[12] Alfred Kahn, *Letting Go: Deregulating the Process of Deregulation or: Temptation of the Kleptocrats and the Political Economy of Regulatory Disingenuousness*, (MSU Public Utilities Papers, 1998), pp. 83-84.

[13] Testimony of Kenneth Gordon on behalf of the Edison Electric Institute, Illinois Commerce Commission Docket Nos. 9800013 and 98-0035 (March 11, 1998), p. 10.

(3) to ensure that the customers of the regulated utility obtain the full value of assets acquired on their behalf, paid for from their rates, and for which they collectively assumed the risk;

(4) to ensure that access to regulated monopoly facilities is not manipulated in ways designed to give the utility's non-regulated activities an unfair advantage over other competitors;

(5) to ensure that the non-regulated activities in no way compromise the utility's ability to provide satisfactory electric service.

The mixing of regulated and unregulated activities in a single, vertically integrated monopoly has been a source of endless controversy in the U.S. The tendency to exploit monopoly customers for the benefit of the competitive activities is pervasive[14], and will almost inevitably be pushed as far as the law allows by a company seeking to maximize profit. The most significant example in U.S. history was the former American Telephone & Telegraph Company (AT&T), whose history of anticompetitive conduct brought on several antitrust suits, the last one resulting in its break-up in 1984 in order to separate monopoly from competitive activities. In the electric industry, divestiture of generation, the creation of independent system operators (ISOs) for transmission, and the requirement of separate subsidiaries (with regulatory approval of standards of conduct governing the relationship of the subsidiary to the monopoly) are among the measures used to prevent abuse of customers and/or competitors.

Since retail power supply within Québec will apparently continue to be regulated for the foreseeable future, some of these concerns are not relevant here. Nevertheless, to the

[14] See, for example, Mohammad Harrunuzzaman and Kenneth Costello, *State Commission Regulation of Self-Dealing Power Transactions*, National Regulatory Research Institute, 1996, and Robert Burns, Peter Nagler, Kaye Pfister and Stephen Henderson, *Regulating Electric Utilities with Subsidiaries*, National Regulatory Research Institute, 1986. The latter contains an extensive further bibliography at pp. 301-312.

extent that Hydro-Québec or its affiliates engage in the marketing of power generated in Québec to purchasers not covered by its obligation to serve, appropriate separation criteria will be needed to protect against affiliate abuse.

However, the Régie has indicated that the discussion about the criteria for the identification and separation of regulated and non-regulated activities in this hearing applies *only* to the setting of transmission rates (D-99-34, p. 4). Therefore, it is not necessary to address these issues at this time.

The issue of the identification and separation of non-regulated from regulated activities *with respect to transmission* remains a relatively minor one. In response to the RNCREQ's request for examples of non-regulated activities carried out by Hydro-Québec's transmission division TransÉnergie, Hydro-Québec was only able to mention a single example, that of consulting services offered internationally.[15] Elsewhere, it has also referred to the example of renting transformers. Neither of these activities seem of sufficient importance to justify a generic hearing of this nature. In the absence of further indications of a problem that requires resolution at this stage, **it would be advisable for the Régie to refrain from establishing broad principles in the abstract and instead address this question as necessary in the transmission rate case itself.** In the future, it may well wish to undertake a generic inquiry tailored expressly for that purpose, which would address concerns related not only to transmission but also to generation and distribution.

It should also be noted from the outset that the criteria proposed by Hydro-Québec apparently were not conceived to apply solely to transmission. Thus, with respect to its

[15] HQPR-11, doc. 7.1, R24. Significant questions may also arise with respect to the use in competitive ventures of telecommunications assets built to serve the transmission system, although Hydro-Québec has made no mention of this in its evidence. Nevertheless, this question can probably be addressed within the transmission rate case.

fifth proposed criterion ("The interests of regulated customers"), Hydro-Québec wrote, in response to a question from the ROEE:

> « Hydro-Québec propose ici un critère à vocation générale plutôt qu'uniquement rattaché au service de transport … »

Furthermore, much of the discussion of these concepts in the report by Mr. Baladi (HQPR-9) is framed specifically in terms of the generation and marketing of electricity.

Defining the issues

Hydro-Québec's evidence fails to present a clear definition of the expressions "regulated activity" and "non-regulated activity". According to Mr. Baladi, a regulated activity is equivalent to a "core utility service", defined as follows:

> "A *regulated activity means the transmission or distribution of electric power* or natural gas, and services necessary to perform those activities, for which the utility is granted by the government or the regulatory authority the exclusive rights to provide these services throughout a designated service territory. Services necessary to perform transmission or distribution functions include billing and meter reading."[16] (emphasis added)

This definition is unsatisfactory for a number of reasons. First, in limiting regulated activities *by definition* to the transmission and distribution of electricity or natural gas, it fails to take into account the possibility that other activities, such as for example the generation, supply or export of electricity, may be regulated by virtue of legislative provisions and/or economic reasons. Furthermore, neither billing nor meter reading are necessarily monopoly services. They can be performed by distributors or, in the case of billing, by credit card companies. They are in the process of being deregulated in both Pennsylvania and California. While they are certainly regulated in Québec at present, they cannot be defined as regulated as a result of any immutable economic principle.

[16] HQPR-9, p. 6.

Similarly, Mr. Baladi proposes the following *definition* for non-regulated activities:

> "An activity provided on a competitive basis (such as the selling or marketing of electricity, or related services) by any unit or division within a utility, or its parent, or its affiliates engaged [sic], inside or outside of its exclusive service territory, even if the activity is related to a certain extent to the provision of the utility's primary monopoly function."[17]

In fact, the notion of a "regulated" activity is not a single concept, but is composed of several elements.

The following table shows, for a few simple examples, that there is in fact a complex continuum between "purely regulated" and "purely non-regulated" activities.

	provision of transmission service to regulated customers	export of electricity	rental of power transformers	foreign consulting by utility employees	foreign consulting by employees of a non-regulated subsidiary
approval required for sale?	N	Y	N	N	N
approval required for acquistion of inputs?	Y	Y	N	N	N
price set by regulator?	Y	N	N	N	N
cost allocation subject to regulatory approval?	Y	Y	Y	Y	N
revenues applied to costs of a regulated product or service?	Y	Y	Y	Y	N

The point of this exercise is not to definitively determine the degree of regulatory oversight required for a given activity, but simply to show that there are many parameters defining the continuum from "regulated" to "non-regulated". Rather than adopt definitions and principles that may well prove problematic at this early stage, without having had the opportunity to observe their implications in a real regulatory situation, it may well be preferable for the Régie to address these issues on a case-by-case basis —

[17] HQPR-11, doc. 7, R59.a.

especially since the real consequences for transmission pricing appear to be of such limited scope and magnitude.

Identification criteria

The written evidence produced by Hydro-Québec is somewhat ambiguous as to the precise criteria that it seeks to have adopted by the Régie for the identification of regulated and non-regulated activities. Hydro-Québec's proposal seems to consist simply of identifying the five elements listed as subheadings to section 2.5.2.1 of its brief as criteria to be considered. While some of these "criteria" are self-evident, Hydro-Québec provides no guidance as to how they are to be interpreted when they don't all point in the same direction. As such, they are sufficiently vague as to be of little use in making actual determinations with respect to individual activities, which in any case will have to be determined on a case-by-case basis.

In addition, Hydro-Québec's assertion that the existence of a competitive market for a given activity confers upon it, a priori, non-regulated status (brief, section 2.5.2.1.4) requires additional comment. According to Hydro-Québec, a competitive market exists whenever there is more than one potential supplier for a given product or service (HQPR-11, doc. 7, R31). Mr. Baladi also considers that "an activity which is currently *or potentially* economically provided by suppliers other than the public service utility should be non-regulated" (HQPR-9, p. 6, emphasis added).

To the extent that an activity otherwise requires regulatory control in the setting of prices, the existence of multiple suppliers can only justify the removal of this control when the market for the product is sufficiently vigorous that competitive pressures eliminate the possibility of monopoly rents. There is a vast literature on the degree of market power that is compatible with an unregulated market, which we need not go into here, given that the present debate is limited to transmission. However, it goes without saying that the

need to regulate does not vanish when a second player joins the market. The notion that a public utility enjoying a de facto monopoly should be relieved of all regulation simply because the activity could *potentially* be economically provided by other suppliers should not be taken seriously. Before conferring non-regulated status on such an activity, a regulator would want to be sure that the market structure ensured long-term customer choice.

Separation criteria

With respect to the separation of regulated and non-regulated activities, Hydro-Québec's evidence provides a taxonomy of the various options, without providing any actual criteria for determining which structure is most appropriate in a given situation.

While the utility will of course propose the arrangement that suits it best, it is up to the regulator to determine whether or not that proposed arrangement provides adequate protection to regulated consumers and, more generally, is in the public interest.

Hydro-Québec's evidence suggests that it expects to carry out a number of non-regulated operations through a process of administrative separation within the existing company (Brief, p. 22). While this practice has precedent in U.S. experience, it is an on-going source of regulatory difficulty. The more widely accepted practice is that when a utility is permitted to participate in a competitive line of business, it may only do so through a separate subsidiary. Indeed, most regulators would be unwilling to deregulate a utility's competitive activity if it were being conducted within the structure of the monopoly utility itself.

As long as all of the transactions between the Company's regulated and its unregulated operations take place within Hydro-Québec, these transactions will be very difficult to scrutinize. There will not be posted tariffs or contracts for the supply of water heaters or

access to the fiber optic network (to take just two examples) from the utility to a separate entity that is actually providing these services. Consequently, there will not be easy scrutiny of whether such transactions are priced to cover their costs and whether competitors have access to the same services on comparable terms. By contrast, when a utility divests its competitive businesses or transfers them to its unregulated subsidiary, regulators have the opportunity to verify that such transactions have taken place at prices that comply with the applicable regulatory standards.

Hydro-Québec's evidence further suggests that such transfers should be made at original cost less depreciation (Baladi, HQPR-9, p. 18). Such terms would result in the transfer of the residual value of fully depreciated productive assets from the regulated clientele to the shareholders. This contradicts the positions of Kahn and Gordon, quoted earlier, whereby the financial reward should accrue to those who bore the risk of the investment.

In fact, earlier in his report, Mr. Baladi pointed out that transfer pricing can be undertaken at actual costs or at market value. He correctly indicated that some U.S. jurisdictions apply "asymmetric pricing principles", whereby a transfer from the utility to the affiliate is recorded at "the greater of book cost or market value" (p. 14). In our view, if any principle is to be retained at this stage, it should be this one.

Together with a requirement that such services be provided through a separate subsidiary, many states and the U.S. Federal Energy Regulatory Commission require that transactions between the monopoly utility and the competitive affiliate be governed by "Standards of Conduct" approved by the regulatory commission. Such standards govern pricing policies, access to monopoly facilities and information and use of the name of the monopoly by its competitive affiliate.

These standards are typically somewhat relaxed when the competitive business has nothing to do with energy. However, recent experience with the use of electric utility

backbone fiber optic networks in Massachusetts show the type of controversy that can arise even when the competitive business is not electricity. In Massachusetts, Boston Edison (an electric utility) entered into a joint venture with a telecommunications company. It transferred its backbone fiber network to the joint venture at cost, even though the market value was considerably higher. This conveyed a considerable competitive advantage to the communications venture over its competitors, at the expense of the electric customers, who lost the benefit of the increased market value of these installations over and above the depreciated cost of the facilities. The Massachusetts Department of Telecommunications and Energy has been investigating this matter for the last year.[18] We mention it here just to illustrate the complexities that accompany the mixing of monopoly and competitive activities.

Conclusion

The evidence provided by Hydro-Québec with respect to this fifth principle (the identification and separation of regulated and non-regulated activities) is unsubstantiated and ambiguous.

The evidence is focussed far more on the treatment of marketing and supply — **which are specifically excluded from the scope of this hearing** — than on transmission, despite the Régie's decision (D-99-34) that its conclusions on this issue will apply *only* to transmission.

Furthermore, Hydro-Québec's evidence fails to recognize the importance of taking market power and the existence of competitive conditions into account in determining whether or not an activity should be non-regulated. It inappropriately attributes the choice of separation criteria to the utility, ignoring the key role that must be played by the regulator in this decision.

[18] Docket DTE 97-95.

Finally, it assumes that transfers from a utility to a non-regulated subsidiary should be made at book value, even if the consequences are profoundly prejudicial to customers' interests. Modern U.S. regulatory practice favors so-called "asymmetric pricing", whereby a transfer from the regulated utility to the affiliate is made at the **greater** of book or market value, and a transfer in the opposite direction is made a the **lower** of these two values.

The issues relating to the identification and separation of non-regulated from regulated activities *with respect to transmission* are relatively uncomplicated, and can be dealt with as they arise in the transmission rate hearing itself. Under these circumstances, it would be advisable for the Régie to refrain from establishing broad principles at this time. In the future, it may well wish to undertake a generic inquiry tailored expressly for that purpose, which would address concerns related not only to transmission but also to generation and distribution.