

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION INTO THE)	
DIVERSIFICATION OF RURAL ELECTRIC)	
COOPERATIVE CORPORATIONS INTO THE)	ADMINISTRATIVE
SATELLITE-DELIVERED TELEVISION)	CASE NO. 326
PROGRAMMING SERVICES)	

O R D E R

By Order entered December 28, 1988, the Commission initiated this investigation into the involvement of Rural Electric Cooperative Corporations ("RECCs") in the distribution and sale of satellite-delivered television programming services ("satellite-TV"). A primary focus of the investigation was to ascertain whether the RECCs were properly reporting and accounting for satellite-TV activities. Proper reporting and accounting are necessary to ensure that these activities are adequately disclosed and the risk of cross-subsidization of the satellite-TV business by the electric operations is minimized.

The investigation revealed that two different companies had been established to provide satellite-TV. Salt River RECC established a wholly-owned subsidiary, the Salt River Service Corporation, a/k/a Dish Wish TV. Green River Electric Corporation ("Green River"), Henderson-Union RECC, Jackson Purchase Electric Cooperative Corporation, South Kentucky RECC, Fox Creek RECC, and Grayson RECC, along with two non-jurisdictional utilities,

established Kentucky Telecommunications, Inc. ("KTI"). (The RECCs participating in KTI are hereinafter referred to as "KTI RECCs.")

On May 22, 1990, the Commission issued an Order containing a revised set of draft guidelines setting forth accounting and reporting requirements to be followed by any RECC offering satellite-TV. That Order also provided an opportunity for any party to request a hearing on the draft guidelines. On July 2, 1990, the KTI RECCs requested a hearing on three issues: whether the investment in KTI should be accounted for by use of the equity method of accounting; the effect of the equity method of accounting on capital credit allocations; and the Commission's ability to have open access to the books and records of KTI.

A hearing schedule was adopted and direct testimony was filed in prepared form by the KTI RECCs and the Commission Staff. Staff testimony was limited to the issue of the use of the equity method of accounting.

A public hearing was held on October 10, 1990. The KTI RECCs and the Attorney General's Office, Utility and Rate Intervention Division, participated in the hearing. Green River filed a brief on November 5, 1990; no other briefs were filed.

EQUITY METHOD OF ACCOUNTING

The Staff testified that KTI should be considered a subsidiary of the KTI RECCs and, therefore, the equity method of accounting should be used to record their investment in KTI. The Staff determined that KTI was a corporate joint venture and, according to the Uniform System of Accounts ("USoA") prescribed for Electric Borrowers of the Rural Electrification Administration

("REA"), KTI was a subsidiary of the investing RECCs. Accounting Principles Board ("APB") Opinion No. 18 defines a corporate joint venture as:

[A] corporation owned and operated by a small group of businesses (the "joint venturers") as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity which is a subsidiary of one of the "joint venturers" is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A minority public ownership, however, does not preclude a corporation from being a corporate joint venture.¹

KTI is a corporation established by a small group of RECCs to sell satellite-delivered television signals. The RECCs investing in KTI have executed a shareholders agreement which, along with the articles of incorporation and bylaws, assures the investors that they will be equal owners of KTI and enjoy equal representation on KTI's board of directors. Although the number of KTI shareholders steadily increased from two to eight since May 1988, this growth was not unexpected due to the nature of the new service being offered and the distinct service territories enjoyed by each RECC. However, the ownership will not be subject to frequent change. The stock of KTI is not publicly traded. Based

¹ APB Opinion No. 18, paragraph 3(d).

on these facts, the Staff determined that KTI fit the description of a corporate joint venture.

The KTI RECCs disagreed with Staff's determination that KTI was a corporate joint venture and therefore not a subsidiary of the investing RECCs. Green River cited four reasons why KTI was not a corporate joint venture: the KTI RECCs do not exercise joint control over KTI; the eight KTI RECCs do not constitute a small group of investors; the ownership of KTI has changed five times since it was organized in May 1988; and the Commission Staff was seeking disclosure of KTI financial information which could be secured without requiring the use of the equity method of accounting for the investment in KTI.

Green River's opinion that the KTI RECCs do not exercise joint control over KTI is based on interpretations expressed in the current accounting literature. Green River cites three such interpretations:

Each venturer commonly participates in the overall management, and significant decisions commonly require the consent of each of the venturers (regardless of ownership percentage) so that no individual venturer has unilateral control.²

AcSEC [Accounting Standards Executive Committee of the American Institute of Certified Public Accountants] reached the advisory conclusion that joint venture should be defined very broadly to encompass all entities, regardless of legal form, that have certain characteristics - with the central distinguishing characteristic being joint control of major decisions.³

² Burton, Palmer and Kay. Handbook of Accounting and Auditing. Boston, MA: Warren, Gorham & Lamont, Inc., 1981, page 21-30.

³ Id., page 21-31.

A distinctive feature of a joint venture is that the relationship between the venturers is governed by an agreement (usually in writing) which establishes joint control. Decisions in all areas essential to the accomplishment of a joint venture require the consent of the venturers, as provided by the agreement; none of the individual venturers is in a position to unilaterally control the venture.⁴

Green River contends that the KTI RECCs do not have joint control of KTI, and that management decisions at KTI do not require the consent of all the RECCs. The Commission notes that while the cited accounting literature refers to the joint control of the venturers, joint control is not a part of the definition contained in APB Opinion No. 18. APB Opinion No. 18 states that a corporate joint venture usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Thus, APB Opinion No. 18 does not require unanimous consent of the venturers. Moreover, the accounting interpretations referred to by Green River do not establish the fact that KTI is not a corporate joint venture. The Commission therefore finds that APB Opinion No. 18 is controlling, rather than the interpretations contained in the cited accounting literature.

Green River contends that the eight investing RECCs do not constitute a "small group" as referenced in APB Opinion No. 18. Green River also contends that a small group is defined as five or fewer investors. This position is based on an interpretation

⁴ Canadian Institute of Chartered Accountants Handbook, Section 3055.

of APB Opinion No. 18 dealing with the "20 percent rule" for the general application of the equity method of accounting for investments. After a review of the accounting literature previously cited and APB Opinion No. 18, the Commission finds "small group" may include eight investors.

Noting that the ownership of a corporate joint venture seldom changes, Green River stated that the ownership of stock in KTI has changed five times since KTI was organized in May 1988. The Commission notes that the changes in stock ownership have resulted from the addition of new investors in a new business, rather than the routine withdrawal and addition of new investors as would be the case in a passive investment activity.

Finally, Green River contends that the Staff is seeking the disclosure of certain financial information concerning KTI operations by advocating the use of the equity method of accounting. Green River stated that the equity method should not be required to ensure disclosure, since the KTI financial statements received by Green River will be available to the Commission. In its brief Green River states, "If the Commission permits Green River to utilize the cost method, the Commission can always reconsider its decision if it does not obtain equivalent financial disclosures through the KTI financial statements or if the level of control by each KTI shareholder over KTI shifts significantly."⁵

⁵ Brief of Green River, page 12.

While the disclosure provided by an accounting method is an issue worth considering, the Commission believes that the selection of the appropriate accounting methodology should be dictated by the nature of the transactions involved. The Staff reviewed the USoA, APB Opinion No. 18, and the same accounting literature cited by Green River and determined that the investment in KTI should be accounted for using the equity method. The Commission has reviewed the record in this proceeding and notes that Green River has consistently opposed the disclosure of KTI financial information. The purpose of this proceeding was to establish guidelines and reporting requirements for the investment in satellite-TV activity during the early stages to minimize the potential for cross-subsidization. To allow Green River to use the cost method now and then have the Commission reconsider this decision later defeats the efforts in establishing these guidelines during the early stages of the development of KTI.

Green River also filed in the record an opinion letter it requested from REA concerning the accounting treatment for the investment in KTI. In this letter, the REA stated that the cost method of accounting should be used. However, the letter contains no explanations as to why the cost method is appropriate, nor does the USoA clearly support the REA's opinion.

The Commission finds that KTI is a corporate joint venture, and as such, is a subsidiary of the investing RECCs. Based on the USoA, the investment in KTI should be recorded by the investing RECCs using the equity method of accounting, which was outlined in the draft guidelines issued May 22, 1990. Therefore, the

Commission will not modify the requirements of the draft guidelines concerning the use of the equity method of accounting.

CAPITAL CREDIT ALLOCATIONS

The KTI RECCs had sought a hearing on the issue of the effects the use of the equity method of accounting would have on the allocation of capital credits by the KTI RECCs. In its testimony filed on September 21, 1990, the Staff stated that it could see no reason why the RECCs should deviate from the terms of their respective bylaws just because the equity method was used to account for the investment in KTI. Green River did not address this issue in its brief. The Commission adopts the position of the Staff concerning the effect the use of the equity method would have on RECC capital credit allocations.

ACCESS TO KTI BOOKS AND RECORDS

Green River raised two objections to the provision in the draft guidelines for Commission access to the books and records of the satellite-TV subsidiaries. First, Green River argues that the Commission's authority is limited to the regulation of utilities, whereas KTI is not a jurisdictional utility. Second, Green River states that as one of the eight owners of KTI, Green River lacks the legal authority to grant the Commission open access to KTI's books and records.

The Commission finds no merit in Green River's arguments. KTI is a subsidiary of Green River. KTI has no employees. All KTI services and functions are performed by employees of Green River or one of the other KTI RECCs. Absent open access to KTI's books and records, the Commission would be severely restricted in

its ability to investigate Green River and the other KTI RECCs. Open access is essential to properly and fully monitor and review the operations of the KTI RECCs.

The request to modify the open access provision of the draft guidelines is rejected.

SUMMARY

After consideration of all matters of record, the evidence, and being otherwise sufficiently advised, the Commission finds that the draft guidelines appended to the Commission's May 22, 1990 Order should be adopted without change and should become effective on the date of this Order. Those guidelines are attached hereto as Appendix A. Since the guidelines require certain reporting requirements to be filed in conjunction with the Annual Reports, which are due no later than March 31, 1991, information related to the reporting requirements for 1990 may be filed within 90 days of the date of this Order, as a supplement to the Annual Report.


IT IS THEREFORE ORDERED that:


1. The guidelines set forth in Appendix A to this Order be and they hereby are adopted for use on and after the date of this Order.

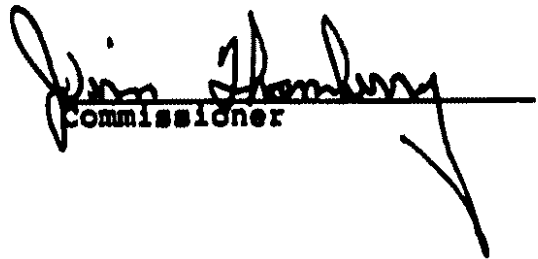
2. The information required by the guidelines in the reporting requirements to be submitted for calendar year 1990 shall be filed within 90 days of the date of this Order.

Done at Frankfort, Kentucky, this 18th day of March, 1991.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:


Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN ADMINISTRATIVE CASE NO. 326 DATED 3/18/91

GUIDELINES

The following guidelines have been developed to address accounting and reporting concerns of the Commission for those Rural Electric Cooperative Corporations ("RECCs") which have become involved in the distribution and sale of satellite-delivered television programming services ("satellite-TV").

REGULATORY CONCERNS

The Commission, in this proceeding, does not challenge the involvement of the RECCs in satellite-TV diversification. However, the Commission has certain concerns and objectives with regard to the protection of the RECCs' ratepayers. One of the primary concerns is the potential which will exist for cross-subsidization of nonutility operations by the regulated RECC. Cross-subsidization can occur through misallocation of common or joint costs, or through improper accounting treatments. The process of assuring that cross-subsidization does not occur will result in added regulatory oversight by the Commission and will require increased focus on cost identification by the RECCs.

The Commission has reviewed the Uniform System of Accounts ("USoA") prescribed for electric borrowers of the Rural Electrification Administration ("REA") and agrees with the RECCs' position that no major modifications will be necessary to properly account for satellite-TV transactions. The following discussion expresses in greater detail the Commission's concerns and the conditions and

requirements necessary to ensure that the interests of the RECC ratepayers are protected. This discussion is not intended to be all inclusive.

PROTECTION OF UTILITY RESOURCES

Throughout this proceeding, two issues have been raised which impact the accounting treatments for satellite-TV transactions. First, several of the RECCs have indicated that certain satellite-TV costs incurred are minimal, and such costs should not be identified and recorded in the nonutility operation accounts, due to the immaterial nature of the cost. This position by these RECCs relates directly to the Commission's concern that the operations of nonutility activities should not be cross-subsidized by the utility ratepayers. In order to minimize the possibility that utility ratepayers cross-subsidize the satellite-TV operations, all costs must be properly identified, allocated, and recorded. The principle applies irrespective of the materiality of the cost. Nonutility operating costs should not be recorded as utility operating costs.

The second issue is the method to be utilized in accounting for the investment by the RECCs. Currently, there are two companies that have been organized to provide satellite-TV, Kentucky Telecommunications, Inc. ("KTI") and Salt River Service Corporation ("Dish Wish TV").

In order to determine the appropriate accounting treatment for the investment, the Commission has reviewed the definitions and requirements in the USoA. The USoA defines a subsidiary company as one which is controlled by the utility through

ownership of voting stock. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a company. This power can be exercised through intermediary companies, or by the investor, or in conjunction with or pursuant to an agreement. This power can be established by numerous direct or indirect means, including common directors and officers. Control is not defined as a specific percentage of ownership of the voting stock of the subsidiary. If a subsidiary relationship exists, the controlling utility must adjust the carrying amount of the investment to recognize the utility's share of the net earnings or net losses, as well as reduce the amount of the investment by the amount of dividends received from the subsidiary. The Commission notes that the accounting treatments outlined in the USoA are similar to those required by generally accepted accounting principles, more specifically, the "equity method" defined by Accounting Principles Board ("APB") Opinion No. 18. The Commission also notes that there is a significant difference between APB Opinion No. 18 and the USoA. While APB Opinion No. 18 requires application of the equity method when an investment in the voting stock is 20 percent or more, the USoA has no such restriction. Control is evaluated by a review of the relationship between the investor utility and the subsidiary.

Based on the review of the USoA, the Commission has determined that the investments in KTI and Dish Wish TV establish these companies as subsidiaries of their respective RECCs. Thus, all accounting transactions should be recorded in accordance with

the requirements of the USoA. In the case of Dish Wish TV, which is a wholly-owned subsidiary of Salt River RECC, this determination is clear. AS for KTI, the Commission has reviewed the articles of incorporation and bylaws of KTI in order to determine what degree of control exists between KTI and the investor RECCs. The investors in KTI are restricted to being either RECCs or Rural Telephone Cooperative Corporations, which in turn must be members of the National Rural Telecommunications Cooperative. The investor is allowed two seats on KTI's board of directors. These directors must be at all times either a full-time employee of the investor or a member of the investor's board of directors. Each investor makes the same amount of investment, is required to loan KTI the same amount of funds, and holds the same percentage of voting stock, currently at 12.5 percent. The Commission believes that the extent of control existing between the investor RECCs and KTI meets the definitions contained in the USoA, and therefore, the investment in KTI should be recorded as a subsidiary by the investor RECCs and they should comply with the requirements of the USoA.

Accounting Procedures and Controls

To account for the subsidiaries of RECCs, the USoA identifies a specific subaccount of Account No. 123, Investment in Associated Companies. This subaccount, Account No. 123.1, Investment of Subsidiary Companies, is where the initial investment in the subsidiary, interest accruals, loans to the subsidiary, and the amount of equity in the subsidiary's undistributed net earnings or net losses should be recorded. Because the REA has modified the USoA,

and Account No. 123.1 is required to be used for a different transaction, all RECCs which have diversified into satellite-TV should record the subsidiary transactions as Account No. 123.11, in accordance with current REA instructions.

In addition, the USoA indicates that accounts receivable and accounts payable transactions with the satellite-TV subsidiaries should be recorded in Account No. 146, Accounts Receivable from Associated Companies, and Account No. 234, Accounts Payable to Associated Companies. Interest receivable generated from loans made to the satellite-TV subsidiaries should be treated as interest accruals and recorded in Account No. 123.11. The RECCs should develop any further subaccounts necessary for Account Nos. 146 and 234 to adequately track the transactions with the satellite-TV subsidiaries.

The USoA provides three accounts to track the revenues and expenses of these subsidiaries. Revenues, with the exception of interest income, are to be recorded in Account No. 417, Revenues from Nonutility Operations; expenses are to be recorded in Account No. 417.1, Expenses of Nonutility Operations. Interest income is to be recorded in Account No. 419, Interest and Dividend Income. The RECCs should develop any further subaccounts necessary to adequately track satellite-TV subsidiary transactions.

The USoA requires that the RECCs record their share of the undistributed net earnings or net losses in Account No. 418.1, Equity in Earnings of Subsidiary Companies, with a corresponding entry in Account No. 123.11. Further, the balance in Account No. 123.11 is reduced when dividends are declared by the subsidiary.

Therefore, the RECCs should record the undistributed net earnings or net losses of the subsidiaries in Account Nos. 418.1 and 123.11.

While the accounting system in the USoA is relatively straightforward, the separation of common or joint costs through allocation methodologies is more subjective in nature and will require greater scrutiny to ensure that cross-subsidization does not occur. It is within the cost allocation procedures that one of the greatest areas of potential misclassification of utility and nonutility costs exists. The RECCs must take great care to accurately and adequately allocate all common costs between their operations and those of the subsidiaries, even those costs which appear to be immaterial. The Commission is aware that there are several acceptable methodologies available for use by the RECCs to allocate these costs. It would not be appropriate for these guidelines to designate which specific methodologies are to be used. The needs and circumstances vary among the RECCs relative to the levels of involvement in satellite-TV. The RECCs have recognized that there is a need for cost allocation and have assured the Commission that allocation procedures are in effect. It will be the responsibility of the RECCs to justify the use and appropriateness of specific methodologies in general rate case proceedings before this Commission. The RECCs should maintain adequate supporting documentation of all allocated common or joint costs.

Cross-subsidization may also occur when assets are transferred to the subsidiaries or when purchases are made from affili-

ated companies. While satellite-TV currently is in its developmental stage and transactions like these have not been encountered, the RECCs should realize that such transactions are possibilities which can be reasonably anticipated. It will be the responsibility of the RECCs to ensure that all such transactions are accounted for at the appropriate price and that these transactions do not result in the cross-subsidization of the satellite-TV companies. The RECCs should maintain adequate supporting documentation for these transactions and be prepared to show during general rate case proceedings before this Commission that the transactions were reasonably priced.

Diversion of Management Talent

The Commission is aware that, under the present circumstances, some management personnel and employees of the RECCs are performing services for the satellite-TV subsidiaries. This situation has previously been addressed from an accounting standpoint. The Commission is also concerned that the utility operations of the RECCs could be neglected as a result of nonutility activities. The Commission will monitor the RECCs to ensure that utility operations do not suffer from involvement in satellite-TV or other nonutility activities.

Financial Resources

The Commission is aware that the RECCs have made loans to the satellite-TV subsidiaries. The Commission is concerned that the financial resources of the RECCs could be diminished in the assistance of the satellite-TV subsidiaries. It would not be appropriate for the RECCs to reduce services or delay necessary mainte-

nance and construction because financial resources had been loaned to the subsidiaries. REA limits the amount of investment and loans made to the satellite-TV subsidiaries to 15 percent of the total utility plant of the RECC. Currently, satellite-TV in Kentucky is in its developmental stage, requiring minimal investment and involvement by the RECCs or its subsidiaries. Thus, there have been no indications that the loans made to the subsidiaries have impaired the financial resources of the RECCs. However, the Commission will maintain an ongoing review of the financial condition of the RECCs in order to minimize such a risk.

The Commission is also concerned about the impact the RECCs' involvement in satellite-TV subsidiaries will have on future capital credit assignment and rotation. It is not clear at this time what impact profits or losses from the nonutility subsidiaries will have upon the capital credit assignments. The Commission has reviewed the bylaws of the RECCs during this investigation and notes that several RECCs' bylaws contain restrictions concerning the assignment of capital credits. This situation reinforces the need for the RECCs to utilize adequate and appropriate accounting and allocation methods to minimize the risk of the nonutility activity benefiting at the expense of the RECCs' ratepayers.

ACCESS TO SUBSIDIARY BOOKS AND RECORDS

In the establishment of necessary regulatory safeguards for utility diversification, the Commission is convinced that open access to all books, records, and personnel of the subsidiaries is an important and indispensable requirement. It is essential that the Commission have the ability to monitor and review the opera-

tions of the RECC through access to the books and records of its nonutility subsidiaries. In addition, during formal proceedings, it may be necessary for the Commission to review the operations of the unregulated subsidiaries to effectively monitor the relationship between the RECC and its subsidiary. Thus, the Commission shall have access to the books and records of the satellite-TV subsidiaries.

REPORTING REQUIREMENTS

In order for the Commission to effectively monitor the activities of the RECCs and the satellite-TV subsidiaries and to ensure ratepayer protection, certain additional reports shall be required of the RECCs.

Annual Reports

The Commission is aware that the REA has instructed its borrowers who have majority-ownership in a subsidiary to prepare consolidated financial statements in accordance with the requirements of the Financial Accounting Standards Board's Statement of Financial Accounting Standards ("SFAS") No. 94. These consolidated financial statements must also contain supplementary schedules presenting a balance sheet, income statement, and a statement of cash flows for each majority-owned subsidiary. While SFAS No. 94 requires consolidation of majority-owned subsidiaries, REA has instructed its borrowers to prepare the REA Form 7 on an unconsolidated basis.

Under SFAS No. 94, majority-ownership is indicated when one company has a majority voting interest, either directly or indirectly, of over 50 percent of the outstanding voting shares of

another company. Therefore, Salt River RECC will have to prepare consolidated financial statements due to its 100 percent ownership of Dish Wish TV. A copy of the consolidated financial statements should be submitted along with the annual report filed with the Commission. The RECCs that invested in KTI will not be required to prepare consolidated financial statements. However, this determination does not excuse those RECCs from accounting for the investment in accordance with the requirements of the USOA. The RECCs investing in KTI should prepare their annual reports as usual, but these reports should be supplemented with financial schedules disclosing KTI activities which are included in the account balances shown on the balance sheet and income statement of the annual report. This requirement will also apply to those RECCs that, while not investors in KTI, provide satellite-TV to their members through KTI.

In addition, each RECC involved with satellite-TV should furnish the following information on an annual basis:

1. Copies of any and all contracts or agreements executed between the RECC and the satellite-TV company. After the initial filing of these documents, only reference to the document will be required, as long as the terms have not been changed. Any change in a contract or agreement will require that a copy of the new document be filed, indicating the previous one it replaces.

2. A general description of the cost allocation methodologies the RECC has established and implemented to ensure the proper accounting of common or joint costs between the RECC and the satellite-TV company. After the initial filing of these descrip-

tions, reference to the descriptions will be permitted, unless there have been revisions or additions. New cost allocation methodologies or revisions to existing methods should be disclosed in the year the change was made.

3. A copy of the RECCs' latest annual audit report, including any special reports on RECC internal controls.

General Rate Case Filings

As part of the RECCs' application in a general rate case, the RECC will provide updates on any contract or agreement relating to satellite-TV involvement in force during the test period. In addition, the RECC will provide explanations supporting the use of the particular cost allocation methodologies implemented to ensure the proper assignment of common joint costs. The explanations should include any documentation which supports the use of a particular allocation methodology.