

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION OF THE NEED)	
FOR AFFILIATE TRANSACTION RULES)	ADMINISTRATIVE
AND COST ALLOCATION)	CASE NO. 369
REQUIREMENTS FOR ALL)	
JURISDICTIONAL UTILITIES)	

O R D E R

By order dated September 3, 1998, the Commission issued draft guidelines addressing accounting requirements for cost allocations and affiliate transactions and a draft code of conduct. All parties were invited to submit comments on the draft guidelines and an informal conference was scheduled on March 19, 1999 to review the draft guidelines and the comments. After receipt of the comments, but prior to the informal conference, the draft guidelines on cost allocations were revised to reflect and incorporate many of the points raised in the comments. This first revised version of the draft cost allocation guidelines was then sent to all parties under cover of letter dated March 10, 1999. At that same time the parties were notified that discussion on the code of conduct was being suspended so the Commission could further consider the filed comments.

An informal conference was then held as scheduled on March 19, 1999 to discuss the first revised cost allocation guidelines. Based on the oral comments presented at the conference, as well as all the written comments that have been filed,

numerous changes have been made to these guidelines. These changes are intended to not only reflect the specific comments and positions of the parties of record, but also to achieve a degree of consistency with the cost allocation and affiliate transaction guidelines recently adopted by the National Association of Regulatory Utility Commissioners (NARUC).

The second revised version of the cost allocation and affiliate transaction guidelines is set forth in Appendix A to this Order. Also attached, as Appendix B hereto, is the first revised version of those guidelines with the changes reflected in the second revised version, and a summary of the parties major comments on the first revised version along with a brief discussion of the revisions being proposed to address the comments. Based on a review of the record and the appendices attached hereto, the Commission finds that the next step is to promulgate a regulation governing cost allocations and affiliate transactions. That regulation will be proposed to be in the form of the guidelines set forth in Appendix A and the process will commence as quickly as possible.

With respect to a code of conduct, the Commission will resume its investigation. A draft code of conduct was issued as an appendix to the Commission's September 3, 1998 Order. Comments were then filed by the parties. Based on a review of those comments, the Commission finds that a hearing should be held on January 14, 2000. The purpose of the hearing is to allow the parties to explain or supplement their previously filed comments and be subject to cross-examination on their comments. For the convenience of the parties, the draft code of conduct is attached hereto as Appendix C.

IT IS THEREFORE ORDERED that:

1. The draft guidelines on cost allocations and affiliate transactions as set forth in Appendix A shall be given further consideration in the process to promulgate a regulation.

2. A hearing on the attached draft code of conduct shall be held on January 20, 2000 at 9:00 a.m., E.D.T. in Hearing Room 1 of the Commission's offices at 730 Schenkel Lane, Frankfort, Kentucky. All parties that filed comments shall appear at the hearing to answer questions on their comments. Any party may appear to present new or supplemental comments.

Done at Frankfort, Kentucky, this 20th day of December, 1999.

By the Commission

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN ADMINISTRATIVE CASE NO. 369 DATED DECEMBER 20, 1999

SECOND REVISED COST ALLOCATION AND AFFILIATE TRANSACTION GUIDELINES

These guidelines shall apply to any utility that engages in any nonregulated activity or conducts any business with an affiliate. The purpose is to ensure that all appropriate costs, including common costs, of providing nonregulated services or products are allocated to the nonregulated activity and are not subsidized by the utility's ratepayers. The guidelines are also intended to preclude ratepayer subsidization of affiliated entities by ensuring that transactions between a regulated utility and its affiliates are conducted in a fair and consistent manner. To the extent, and so long as, a regulated utility is subject to federal rules and regulations that are in conflict with and preempt these guidelines, the federal requirements shall prevail unless the utility agrees to waive the preemption. Telecommunications utilities that are in compliance with cost allocation and affiliate transaction rules established by the Federal Communications Commission and this Commission, shall be deemed to be in compliance with these guidelines.

1. Definitions:

a. Affiliate is considered to be any party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with the utility. For purposes of these guidelines, a division or subsidiary is considered an affiliate.

b. Control is considered to be the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract, or otherwise.

c. Fully distributed cost is the sum of direct costs plus an appropriate share of indirect costs.

d. Net book value is the book cost, as defined by the uniform system of accounts, reduced by related provisions for accumulated depreciation, depletion, or amortization and adjusted for any unamortized plant acquisition adjustment related to the asset.

e. Prevailing market price is a generally accepted market value that can be substantiated by clearly comparable transactions, auction, or appraisal.

f. Subsidization is the recovery of costs from one class of customer or business unit that is attributable to another.

g. Cost allocation manual (CAM) is defined as an indexed compilation of a company's cost allocation policies and related procedures.

h. A regulated utility is an entity that is subject to the jurisdiction of a governmental rate-making body.

i. A nonregulated affiliate is an entity that is not subject to the jurisdiction of a governmental rate-making body.

2. Cost Allocation Methods. Regulated utilities that engage in any nonregulated activity must identify all costs of the nonregulated activity and assign those costs in accordance with the applicable uniform system of accounts (USoA). The fully distributed cost method should be utilized in allocating costs between regulated and nonregulated activities. This method requires the examination of all costs of an entity in relation to all the goods and services that are produced. All costs incurred directly or indirectly to produce a good or service must be recognized as a cost of that good or service. Costs are assigned either directly or using a logical basis for allocation. Costs that cannot be directly assigned or indirectly allocated must be included in the fully distributed cost calculation through a general or common allocation.

a. Direct Assignment. If only one service or product causes a cost to be incurred or benefits from a cost, that cost should be directly assigned to either regulated or nonregulated operations. Costs should be directly assigned to the greatest extent possible.

b. Indirect Assignment. If a cost is caused by or benefits both regulated and nonregulated activities and cannot be directly assigned, it should be allocated using a direct and logical measurement of cost causation if such a measurement exists.

c. Common Allocation. If a cost is common to both regulated and nonregulated activities and a direct measurement of cost causation is not apparent, an allocation formula should be used to distribute the cost in a reasonable manner that is equitable for both regulated and nonregulated operations. Revenues should not be used as a factor in the formula unless the utility can prove a direct cost causation with the revenues. Generally, revenue based allocations are not based on cost causation or utilization of resources.

d. Incidental Treatment. An incidental nonregulated service is exempt from these guidelines for purposes of cost allocation if the total revenue of all incidental activities does not exceed the lesser of one percent (1.0%) of total utility company revenue or \$1,000,000.

3. Development Requirements for Cost Allocation Manual. Each utility that engages in any nonregulated activity, other than activities that are incidental as defined above, shall develop a written cost allocation manual (CAM). The utility shall maintain and update its CAM as necessary to reflect current conditions and procedures. The CAM shall be available to representatives, agents, or staff of the Commission for review. Additionally, each utility shall keep a copy of its CAM open to public inspection in its offices and places of business in the same manner as the tariff.

a. Certification. Within 180 days of the effective date of the guidelines, the utility shall file with the Commission a statement, signed by an officer of the utility, certifying that a CAM has been developed and will be adopted by management effective with the beginning of the next calendar year.

b. Development of CAM by Industry Group. Industry groups or associations are encouraged to work together to develop a standardized CAM to be used by small companies in their industries.

4. Contents of Cost Allocation Manual. Each utility's CAM shall include the following information for Kentucky jurisdictional operations:

a. Affiliated Entities. A list of all regulated and nonregulated affiliates.

b. Assets, Goods, and Services. A list and description of the assets, goods, and services provided by the utility and its affiliates and identification of each as regulated or nonregulated.

c. Incidental Nonregulated Goods, Services, and Use of Assets. A list and description of nonregulated goods, services, and use of assets that qualify for incidental treatment in accordance with section 1.d. and 5.d. of these guidelines.

d. Allocation Methodology. For each USoA account and sub-account, identify whether the account contains costs attributable to regulated operations, nonregulated operations, and/or whether the costs are joint costs that cannot be directly identified. A description of the methodology used to apportion each of these categories must also be included. The allocation methodology shall be consistent with the principles identified in section one of these guidelines.

e. Affiliated Transactions. Descriptions of the nature of all transactions between the utility and its affiliates.

5. Affiliate Transaction Pricing.

a. Transactions Between the Regulated Utility and a Nonregulated Affiliate. The terms for transactions between the regulated utility and a nonregulated affiliate shall be in accordance with the following guidelines:

i. Goods, Services, and Use of Assets Provided by the Utility to a Nonregulated Affiliate. Goods, services, and use of assets provided to a nonregulated affiliate by the regulated utility pursuant to a tariff shall be at the tariffed rate. Nontariffed items shall be priced at the higher of the utility's fully distributed cost or prevailing market price.

ii. Goods, Services, and Use of Assets Provided by a Nonregulated Affiliate to the Utility. Goods, services, and use of assets provided to the regulated utility by a nonregulated affiliate shall be priced at the lower of the affiliate's fully distributed cost or prevailing market price.

iii. Assets Transferred from Utility to Affiliate. The transfer or sale of assets by the utility to a nonregulated affiliate shall be priced at the greater of the utility's net book value or prevailing market price.

iv. Assets Transferred from Affiliate to Utility. The transfer or sale of assets by a nonregulated affiliate to the regulated utility shall be priced at the lower of the affiliate's net book value or prevailing market price.

b. Transactions Between Regulated Affiliates. The terms for transactions between affiliated regulated utilities shall be in accordance with the following guidelines:

i. Goods and Services Transferred Between Regulated Affiliates. Goods and services provided by a regulated utility to an affiliated regulated utility shall be at fully distributed cost.

ii. Assets Transferred Between Regulated Affiliates. The transfer or sale of assets between regulated affiliates shall be at net book value.

c. Incidental Treatment for Affiliate Transaction Pricing. Affiliate transactions are exempt from these pricing guidelines if the total value of all affiliate transactions does not exceed the lesser of one percent (1.0%) of total utility company annual revenues or \$1,000,000.

d. Deviations from Affiliated Transaction Pricing Guidelines. The regulated utility may file a notice with the Commission of a request for a deviation from the affiliated transaction guidelines for a particular transaction or class of transactions. The utility shall have the burden of demonstrating that the deviation is appropriate and the result is just and reasonable. The Commission will grant the deviation upon a showing of good cause within 90 days of the date notice is received.

6. Demonstration of Compliance with Guidelines. In an application for base rates, the regulated utility must demonstrate compliance with the Commission's cost allocation and affiliate transaction guidelines.

a. Utility to Document Compliance. In any formal Commission proceeding at which cost allocation is at issue, the utility shall provide sufficient information to document that its cost allocation procedures and affiliate transaction pricing are consistent with these guidelines.

b. Utility to Provide Information. In any formal Commission proceeding at which cost allocation is at issue, the utility shall provide sufficient information for another party to perform a cost study in response to relevant data requests through the Commission's discovery process. The CAM shall be filed as part of the initial filing requirements in a proceeding involving an application for an adjustment in rates pursuant to KRS 278.190.

7. Access to Records. The Commission shall have access, including the right to perform or order a financial audit, to the books and records of a utility's affiliate to the extent necessary to ensure that transactions between the two entities comply with the requirements established herein.

8. Additional Filing Requirements. The Commission may require that the utility file periodic reports of information related to affiliate transactions when necessary to monitor compliance with these guidelines.

9. Prudence Review. Conformance with these guidelines shall not preclude the Commission from evaluating the prudence of any transaction, investment, or expense.

10. Waivers and Deviations. A utility may file an application for a waiver or deviation from any or all provisions of these guidelines. Any such application

shall demonstrate the basis of the utility's contention that it should be granted a waiver or deviation, including, if appropriate, documentation regarding the costs and benefits of compliance. For good cause shown, the Commission may grant a waiver or deviation if compliance is determined to be impracticable or unreasonable under the circumstances.

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN ADMINISTRATIVE CASE NO. 369 DATED DECEMBER 20, 1999.

SECOND REVISED COST ALLOCATION AND AFFILIATE TRANSACTION GUIDELINES

These guidelines shall apply to any utility that engages in any nonregulated activity or conducts any business with an affiliate. The purpose is to ensure that all appropriate costs, including common costs, of providing nonregulated services or products are allocated to the nonregulated activity and are not subsidized by the utility's ratepayers. The guidelines are also intended to preclude ratepayer subsidization of affiliated entities by ensuring that transactions between a regulated utility and its affiliates are conducted in a fair and consistent manner. To the extent, and so long as, a regulated utility is subject to federal rules and regulations that are in conflict with and preempt these guidelines, the federal requirements shall prevail unless the utility agrees to waive the preemption. Telecommunications utilities that are in compliance with cost allocation and affiliate transaction rules established by the Federal Communications Commission and this Commission, shall be deemed to be in compliance with these guidelines.

11. Definitions:

a. Affiliate is considered to be any party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with the utility. For purposes of these guidelines, a division or subsidiary is considered an affiliate.

b. Control is considered to be the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract, or otherwise.

c. Fully distributed cost is the sum of direct costs plus an appropriate share of indirect costs.

d. Net book value is the book cost, as defined by the uniform system of accounts, reduced by related provisions for accumulated depreciation, depletion, or amortization and adjusted for any unamortized plant acquisition adjustment related to the asset.

e. Prevailing market price is a generally accepted market value that can be substantiated by clearly comparable transactions, auction, or appraisal.

f. Subsidization is the recovery of costs from one class of customer or business unit that are attributable to another.

g. Cost allocation manual (CAM) is defined as an indexed compilation of a company's cost allocation policies and related procedures.

h. A regulated utility is an entity that is subject to the jurisdiction of a governmental rate-making body.

i. A non-regulated affiliate is an entity that is not subject to the jurisdiction of a governmental rate-making body.

12. Cost Allocation Methods. Regulated utilities that engage in any nonregulated activity must identify all costs of the nonregulated activity and assign those costs in accordance with the applicable uniform system of accounts (USoA). The fully distributed cost method should be utilized in allocating costs between regulated and nonregulated activities. This method requires the examination of all costs of an entity in relation to all the goods and services that are produced. All costs incurred directly or indirectly to produce a good or service must be recognized as a cost of that good or service. Costs are assigned either directly or using a logical basis for allocation. Costs that cannot be directly assigned or indirectly allocated must be included in the fully distributed cost calculation through a general or common allocation.

a. Direct Assignment. If only one service or product causes a cost to be incurred or benefits from a cost, that cost should be directly assigned to either regulated or nonregulated operations. Costs should be directly assigned to the greatest extent possible.

b. Indirect Assignment. If a cost is caused by or benefits both regulated and nonregulated activities and cannot be directly assigned, it should be allocated using a direct and logical measurement of cost causation if such a measurement exists.

c. Common Allocation. If a cost is common to both regulated and nonregulated activities and a direct measurement of cost causation is not apparent, an allocation formula should be used to distribute the cost in a reasonable manner that is equitable for both regulated and nonregulated operations. Revenues should not be used as a factor in the formula unless the utility can prove a direct cost causation with the revenues. Generally, revenue based allocations are not based on cost causation or utilization of resources.

d. Incidental Treatment. An incidental nonregulated service **may be** exempt from these guidelines for purposes of cost allocation if the total revenue of all incidental activities do not exceed the lesser of one percent (1.0%) of total utility company revenue or \$1,000,000.

13. Development Requirements for Cost Allocation Manual. Each utility that engages in any nonregulated activity, other than activities that are incidental as defined above, shall develop a written cost allocation manual (CAM). The utility shall maintain and update its CAM as necessary to reflect current conditions and procedures. The CAM shall be available to representatives, agents, or staff of the Commission for review. Additionally, each utility shall keep a copy of its CAM open to public inspection in its offices and places of business in the same manner as the tariff.

a. Certification. Within 180 days of the effective date of the guidelines, the utility shall file with the Commission a statement, signed by an

officer of the utility, certifying that a CAM has been developed and will be adopted by management effective with the beginning of the next calendar year.

b. Development of CAM by Industry Group. Industry groups or associations are encouraged to work together to develop a standardized CAM to be used by small companies in their industries.

14. Contents of Cost Allocation Manual. Each utility's CAM shall include the following information for Kentucky jurisdictional operations:

a. Affiliated Entities. A list of all regulated and nonregulated affiliates.

b. Assets, Goods, and Services. A list and description of the assets, goods, and services provided by the utility and its affiliates and identification of each as regulated or nonregulated.

c. Incidental Nonregulated Goods, Services, and Use of Assets. A list and description of nonregulated goods, services, and use of assets that qualify for incidental treatment in accordance with section 1. d. and 5.d. of these guidelines.

d. Allocation Methodology. For each USoA account and sub-account, identify whether the account contains costs attributable to regulated operations, nonregulated operations, and/or whether the costs are joint costs that cannot be directly identified. A description of the methodology used to apportion each of these categories must also be included. The allocation methodology shall be consistent with the principles identified in section one of these guidelines.

e. Affiliated Transactions. Descriptions of the nature of all transactions between the utility and its affiliates.

15. Affiliate Transaction Pricing.

a. Transactions Between the Regulated Utility and a Nonregulated Affiliate. The terms for transactions between the regulated utility and a nonregulated affiliate shall be in accordance with the following guidelines:

i. Goods, Services, and Use of Assets Provided by the Utility to a Nonregulated Affiliate. Goods, services, and use of assets provided to a nonregulated affiliate by the regulated utility pursuant to a tariff shall be at the tariffed rate. Nontariffed items shall be priced at the higher of the utility's fully distributed cost or prevailing market price.

ii. Goods, Services, and Use of Assets Provided by a Nonregulated Affiliate to the Utility. Goods, services, and use of assets provided to the regulated utility by a nonregulated affiliate shall be priced at the lower of the affiliate's fully distributed cost or prevailing market price.

iii. Assets Transferred from Utility to Affiliate. The transfer or sale of assets by the utility to a nonregulated affiliate shall be priced at the greater of the utility's net book value or prevailing market price.

iv. Assets Transferred from Affiliate to Utility. The transfer or sale of assets by a nonregulated affiliate to the regulated utility shall be priced at the lower of the affiliate's net book value or prevailing market price.

b. Transactions Between Regulated Affiliates. The terms for transactions between affiliated regulated utilities shall be in accordance with the following guidelines:

i. Goods and Services Transferred Between Regulated Affiliates. Goods and services provided by a regulated utility to an affiliated regulated utility shall be at fully distributed cost.

ii. Assets Transferred Between Regulated Affiliates. The transfer or sale of assets between regulated affiliates shall be at net book value.

c. Incidental Treatment for Affiliate Transaction Pricing. Affiliate transactions are exempt from these pricing guidelines if the total value of all affiliate transactions does not exceed the lesser of one percent (1.0%) of total utility company annual revenues or \$1,000,000.

d. Deviations from Affiliated Transaction Pricing Guidelines. The regulated utility may file a notice with the Commission of a request for a deviation from the affiliated transaction guidelines for a particular transaction or class of transactions. The utility shall have the burden of demonstrating that the deviation is appropriate and the result is just and reasonable. The Commission may will grant the deviation upon a showing of good cause within 90 days of the date notice is received.

16. Demonstration of Compliance with Guidelines. In an application for base rates, the regulated utility must demonstrate compliance with the Commission's cost allocation and affiliate transaction guidelines.

a. Utility to Document Compliance. In any formal Commission proceeding at which cost allocation is at issue, the utility shall provide sufficient information to document that its cost allocation procedures and affiliate transaction pricing are consistent with these guidelines.

b. Utility to Provide Information. In any formal Commission proceeding at which cost allocation is at issue, the utility shall provide sufficient information for another party to perform a cost study in response to relevant data requests through the Commission's discovery process. The CAM shall be filed as part of the initial filing requirements in a proceeding involving an application for an adjustment in rates pursuant to KRS 278.190.

17. Access to Records. The Commission shall have access, including the right to perform or order a financial audit, to the books and records of a utility's affiliate to the extent necessary to ensure that transactions between the two entities comply with the requirements established herein. If necessary access to records to determine compliance is not provided, the costs attached to the affiliate transactions may be disallowed from rates.

18. Additional Filing Requirements. The Commission may require that the utility file periodic reports of information related to affiliate transactions when necessary to monitor compliance with these guidelines.

19. Prudence Review. Conformance with these guidelines shall not preclude the Commission from evaluating the prudence of any transaction, investment, or expense.

20. Waivers and Deviations. A utility may file an application for a waiver or deviation from any or all provisions of these guidelines. Any such application shall demonstrate the basis of the utility's contention that it should be granted a waiver or deviation, including, if appropriate, documentation regarding the costs and benefits of compliance. For good cause shown, the Commission may grant a waiver or deviation if compliance is determined to be impracticable or unreasonable under the circumstances.

COST ALLOCATION AND AFFILIATE TRANSACTION GUIDELINES

These guidelines shall apply to any utility that engages in any nonregulated activity or conducts any business with a nonregulated division, subsidiary, or affiliate. The purpose is to ensure that all appropriate costs, including common costs, of providing nonregulated services or products are allocated to the nonregulated activity and are not subsidized by the utility's ratepayers. The guidelines are also intended to preclude ratepayer subsidization of affiliated entities by ensuring that transactions between a regulated utility and its affiliates are conducted in a fair and consistent manner. To the extent, and so long as, a regulated utility is subject to federal rules and regulations that are in conflict with these guidelines, the federal requirements shall prevail.

The Kentucky Association of Electric Cooperatives (KAEC) suggests changing the first paragraph to say that the guidelines should ensure that transactions are allocated and recorded in a fair and consistent manner for rate-making purposes. The Union Light, Heat & Power Company (ULH&P) and Columbia Gas of Kentucky, Inc. (Columbia Gas) commented that the purposes of the guidelines can be achieved through management audits and base rate cases. Additionally, third parties can file complaints against utilities. ULH&P also points out that when it waived challenge to certain rate-making decisions based on federal preemption, it did that for rate-making purposes only so that waiving its right to challenge would not apply to these guidelines.

The Commission's jurisdiction over rates encompasses the function of rate-making as well as the function of record keeping. While cross-subsidization issues created by affiliate transactions are properly investigated in rate-making proceedings, the establishment of cost allocation guidelines is a recordkeeping/accounting issue within the scope of KRS 278.220. Proper recordkeeping/accounting rules are essential to ensure that a utility's financial reports accurately reflect its true financial condition and it is for this purpose that a Cost Allocation Manual (CAM) is designed. However, when a cost is properly allocated to a utility's regulated operations in accordance with a Cost Allocation Manual, the cost may or may not be properly included for rate-making purposes. The guidelines under consideration in this proceeding are not intended to resolve rate-making issues, but are limited to generic recordkeeping/accounting rules. Furthermore, the fact that the Commission has rate-making jurisdiction and audit authority does not negate the necessity of a cost allocation process that will appropriately assign costs on an ongoing basis for accounting purposes. A new provision has been added to section 6 requiring that the CAM be filed along with the initial filing requirements in applications for rate increases pursuant to KRS 278.190.

With regard to the extent of Commission jurisdiction Kentucky Power Company d/b/a American Electric Power Company (Kentucky Power) suggests

addition of language in the last sentence specifically referring to SEC and FERC to lessen the likelihood of litigation. GTE South Incorporated and GTE Wireless, Inc. request that the guidelines specifically exclude telecommunication utilities that are subject to FCC cost allocation rules. Columbia Gas commented that the guidelines should only apply to transactions between utilities and affiliates serving retail markets because transactions such as corporate support services, pipeline capacity, and commodity sales and supply are subject to adequate review through current law.

The guidelines have been modified to incorporate federal preemption and to clarify that the guidelines do not apply to the telecommunications industry that fall within the requirements of Part 64 of the FCC Regulations and the Kentucky Public Service Commission Order in Administrative Case No. 362. The Kentucky Association of Plumbing-Heating-Cooling Contractors, Inc., the Kentucky Propane Gas Association, Inc., and Modern Security Systems, Inc. (Commenters) suggested that language regarding federal preemption should be limited to areas that have been litigated and a decision is binding on the Commission. Such limiting language would unduly restrict the Commission's authority to determine the applicability of these guidelines in conjunction with federal rules and regulations. Since in most instances a binding legal decision does not exist, the suggested language would require the Commission to ignore clear principles of federal preemption, thereby precipitating unnecessary, costly litigation. The Commission will address issues of federal preemption on a case-by-case basis and there is no need to include the suggested language in the guidelines.

For the purposes of these guidelines, an affiliate is considered to be any party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with the utility. Control is considered to be the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract, or otherwise.

Kentucky-American Water Company (Kentucky-American) requests the definitions of affiliate and control be clarified to exclude entities where transactions with the jurisdictional utility are for regulated purposes. The Guidelines are intended to ensure that a utility's ratepayers are not subsidizing the operations of a nonregulated affiliate or subsidiary. Ratepayer subsidization can occur if the transactions between a utility and nonregulated affiliate are for regulated or nonregulated purposes. For this reason all transactions should be reviewed and no undue limitations should be placed upon the Commission.

Kentucky-American also requests that water utilities be addressed separately from gas and electric utilities that have many affiliate transactions. The number of transactions between a utility and affiliate is insufficient justification for Kentucky-American's requested segregation.

Berea College Water and Electric Utilities (Berea College Utilities) requests clarification of the term conducts any business with . According to Berea College Utilities, Sections 1 and 2 indicate they apply to utilities that provide nonregulated services, but the introduction also includes utilities that conduct business with affiliates. Berea College Utilities is concerned that the Guidelines could adversely impact its relations with other divisions of Berea College. The focus of the Guidelines is to eliminate ratepayer subsidization of nonregulated affiliates and if Berea College Utilities can show that this subsidization does not currently exist, then the Guidelines will not impact its transactions with affiliated divisions. However, if Berea College Utilities believes that any of the Guideline requirements are unduly burdensome, it has the option under Section 8 to request a waiver or deviation.

KAEC requests that the definition of control be revised to say that control must be by utility and majority ownership would be required to have control through ownership. The definition of control contained in the guidelines is virtually identical to that included in the Rural Utilities Service s (RUS) Uniform System of Accounts, which as borrowers from RUS, the members of KAEC are required to follow. In addition, the definition of control is the same as the Commission adopted in Administrative Case No. 326,¹ which dealt with cooperatives investing in satellite-delivered television programming services. Therefore, there is no reason for adopting the modification proposed by KAEC.

A new section 1. has been added to include definitions of some of the terms that are included in the guidelines.

1. Cost Allocation Methods. Regulated utilities that engage in any nonregulated activity must identify all costs of the nonregulated activity and report those costs in accordance with the applicable uniform system of accounts (USoA). The fully distributed cost method should be utilized in allocating costs between regulated and nonregulated activities. This method requires the examination of all costs of an entity in relation to all the goods and services that are produced. All costs incurred directly or indirectly to produce a good or service must be recognized as a cost of that good or service. Costs are assigned either directly or using a logical basis for allocation. Costs that cannot be directly assigned or indirectly allocated must be included in the fully distributed cost calculation through a general or common allocation.

Kentucky-American requested further definition of the term fully distributed cost method including specification of whether a rate of return is

¹ Administrative Case No. 326, An Investigation into the Diversification of Rural Electric Cooperative Corporations into the Satellite-Delivered Television Programming Services.

included. ULH&P and Columbia Gas asked for further definition of fully distributed cost method and fully distributed cost calculation and explanation of how these terms are distinguished from direct assignment, indirect assignment, and common allocation. A brief definition of fully distributed cost has been added to the guidelines. More detailed definition of these terms is not considered necessary or appropriate. It is not possible to specifically identify every element of cost especially since it can vary with the situation. However, if a return is an appropriate element of cost, then it should be allocated.

These guidelines are intended to present basic principles to be used by the utilities that are subject to the guidelines. The guidelines are not intended to be a detailed instruction manual. Section 1. and subsections a., b., and c. provide adequate basic guidance for the allocation of costs. The concept of fully distributed cost is not a new one. The basic concept is the same as that used in the telecommunications industry where it is referred to as the attributable cost method. It is also the same concept referred to as the fully allocated cost basis in the Guidelines for Cost Allocations and Affiliate Transactions adopted by the National Association of Regulatory Utility Commissioners (NARUC).

a. Direct Assignment. If only one service or product causes a cost to be incurred or benefits from a cost, that cost should be directly assigned to either regulated or nonregulated operations. Costs should be directly assigned to the greatest extent possible.

b. Indirect Assignment. If a cost is caused by or benefits both regulated and nonregulated activities and cannot be directly assigned, it should be allocated using a direct and logical measurement of cost causation if such a measurement exists.

c. Common Allocation. If a cost is common to both regulated and nonregulated activities and a direct measurement of cost causation is not apparent, an allocation formula should be used to distribute the cost in a reasonable manner that is equitable for both regulated and nonregulated operations. Revenues should not be used as a factor in the formula unless the utility can prove a direct cost causation with the revenues. Generally, revenue based allocations are not based on cost causation or utilization of resources.

d. Incidental Treatment. An incidental nonregulated service may be treated as regulated for purposes of cost allocation if the total revenue of all incidental activities does not exceed the lesser of one percent (1.0%) of total utility company revenue or \$1,000,000 and the service is an outgrowth of the utility's regulated operations performed by utility personnel with utility facilities.

There were a number of suggestions regarding the threshold for incidental treatment. Louisville Gas and Electric Company and Kentucky Utilities Company (LG&E/KU) said the \$1,000,000 limit is too low for a typical utility company doing business in the Commonwealth. They suggested the Commission

establish classes of utilities based on revenues and set a threshold for each class. Western Kentucky Gas (Western) suggested a threshold of 5 percent. KAEC suggested that for utilities with total revenue greater than \$10 million, nonregulated services should be considered incidental if their revenue does not exceed \$1,000,000. Kentucky Power requests that the \$1,000,000 threshold be removed because it is arbitrary and imposes a greater administrative burden on the larger utility with no corresponding benefit to the ratepayer. The threshold of the lesser of one percent or \$1,000,000 will be retained. The larger utilities are the primary opponents of the \$1,000,000 threshold, however, with their advanced accounting systems, the allocation process should not be too burdensome. Although the materiality concerns of some respondents are recognized, accurate financial information regarding a utility's operating results for regulated and nonregulated operations is considered to be equally important and the one percent or \$1,000,000 threshold is considered to be a reasonable compromise.

Columbia Gas argued that nonregulated services should not have to be provided by utility personnel with utility facilities in order to qualify for incidental treatment. This requirement has been removed from the second revised guidelines.

2. Filing Requirements for Cost Allocation Manual. Each utility that engages in any nonregulated activity, other than activities that are incidental as defined above, shall develop a written cost allocation manual (CAM). The utility shall maintain and update its CAM as necessary to reflect current conditions and procedures. The CAM shall be available to representatives, agents, or staff of the Commission for review.
rate-making

Kentucky-American and Kentucky Power argued in support of the revised draft guidelines that deleted the requirement for each utility to file its CAM with the Commission. Kentucky Power urged against the suggestion made during the informal conference that the CAM be filed with the tariff. Kentucky Power contended this would give the impression the CAM had been approved since a filed tariff is approved unless rejected by the Commission. They also argued that the constant updates required to keep the CAM current would impose unnecessary administrative burdens on the Commission Staff and the utility. In statements made during the informal conference and in written comments, the Commenters contended that to be effective the CAMs must be filed with the Commission. They argued that, due to resource and budget constraints, the Commission could not aggressively audit the CAMs; therefore, public access to the CAMs is essential to ensure fair, just, and reasonable rates. The guidelines will not be altered to require that CAMs be filed with the Commission; however, a provision has been added to require that each utility make its CAM available for public inspection in the same manner that it is required to have its tariff available for public inspection.

Western states a CAM that has no impact for rate-making purposes has little or no value to the Commission or the utility. One purpose of a CAM is to remove from the rate-making process nonregulated activities of a utility; therefore, the CAMs will have an impact on rate-making.

During the informal conference, one participant asked whether CAMs would have to undergo review in a rate proceeding if filed with the Commission for approval or disapproval. The CAMs will not be filed with the Commission. The CAMs would be subject to review in any proceeding before the Commission in which cost allocation is at issue.

ULH&P requests that the utility be entitled to request confidential protection of information resulting from discovery of the CAM. It is expected that the CAMs will be developed in such a manner that confidential treatment should not be necessary. The CAMs will not contain numbers or specific details of transactions but should only contain descriptions and methodologies. However, any requests for confidential protection will be considered on a case-by-case basis.

During the informal conference, one participant questioned whether the filing of CAMs would be just another layer of regulation added to the management audit process. As explained during the informal conference, the provision for periodic management audits applies only to major utilities; however, the cost allocation guidelines will apply to any utility engaging in nonregulated activity. While CAMs may be another function of the Commission, the intent and purpose are very different from those of a management audit.

KAEC suggested that the title of this section be changed to Development Requirements for Cost Allocation Manual since the revised draft guidelines no longer require that CAMs be filed with the Commission. This change has been made.

a. Certification. Within 180 days of the effective date of the guidelines, the utility shall file with the Commission a statement, signed by an officer of the utility, certifying that a CAM has been developed and adopted by management.

Delta Natural Gas Company, Inc. (Delta) suggests that the phrase and adopted by management be deleted as unnecessary. It is important that management agrees with the contents and mechanics of the CAM since it will be used in the development of rate proceedings and preparation of financial reports. The only way the Commission will know if management stands behind the CAM is by having management make such a certification. The adopted by management phrase will provide this certification.

Western wants one year to develop a CAM and wants its implementation to coincide with the beginning of the next year's fiscal year. UHL&P and Columbia Gas requested 270 days to develop the initial CAM. Given the existence of company cost allocation procedures in the electric and gas industries and the existence of CAMs in the telephone industry, 180 days to develop a CAM should be adequate. Should this not be the case, an individual company can request an extension of time. It is reasonable that a CAM should not be put into effect until it can impact a company's operations for a full year; therefore, the guidelines have been modified to reflect this provision.

b. Filings by Industry Group. Industry groups or associations are encouraged to work together to develop a standardized CAM to be used by small companies in their industries.

KAEC suggested that since the Commission had eliminated the filing requirement for the CAM, the title for this paragraph should be changed to Development of Cost Allocation Manual by Industry Group. This change has been made.

ULH&P and Columbia Gas commented that encouraging industry groups or associations to develop a standardized CAM should be extended to all utilities, not just small ones. ULH&P further stated that the Edison Electric Institute (EEI) and NARUC were working to prepare a standardized CAM which could suffice or be the basis for a collaborative CAM. Commission Staff is unaware of any work in process by EEI to develop a standardized CAM. However, Staff is aware that EEI provided input in the development of NARUC's Guidelines for Cost Allocations and Affiliate Transactions (NARUC Guidelines) adopted July 21, 1999. It should be noted that the NARUC Guidelines are not a CAM, but serve as a framework for the development of policies and procedures for cost allocations and affiliated transactions.

Because of the organizational complexity of the larger utilities, it was assumed that it would be easier for the small utilities to come together and develop standardized CAMs. No opposition has been expressed to utilities like ULH&P and Columbia Gas working with their counterparts in the industry to develop a standardized CAM. However, the resulting CAM must be in conformity with the standards included in the Commission's guidelines.

3. Contents of Cost Allocation Manual. Each utility's CAM shall include the following information for Kentucky jurisdictional operations:

a. Utility Divisions. A list of all regulated and nonregulated divisions within the utility.

b. Affiliated Entities. A list of all regulated and nonregulated subsidiaries and affiliates.

c. Services and Goods Provided. A list of the services and goods provided by the utility and its subsidiaries and identification of each as regulated or nonregulated.

LG&E/KU contend that this section should contain a clarification that the Commission has jurisdiction over a utility company's subsidiaries only to the extent that they are engaged in jurisdictional activities. Further, LG&E/KU took exception to being required to identify the goods and services provided by its non-jurisdictional subsidiaries. LG&E/KU noted that this requirement was not present in the LG&E Energy Corporate Policies and Guidelines for Intercompany Transactions (Corporate Policies) approved by the Commission in Case No. 97-300,² and they question the benefit of this requirement. LG&E/KU argue that the reporting of transactions between themselves and their affiliates under the Corporate Policies provides the Commission with sufficient information to determine the nature and extent of any cross-subsidization.

In its September 12, 1997 Order in Case No. 97-300, the Commission continued for the post-merger LG&E Energy a requirement established in Case No. 89-374³: The Commission will have access, as necessary in the exercise of its statutory duties, to the books and records of LG&E Energy and its other affiliates and subsidiaries as the books and records may be related to transactions with LG&E and KU (emphasis added). It should be clear that this relationship could go beyond the simple involvement of an LG&E Energy subsidiary in jurisdictional activities. Concerning the reliance of LG&E and KU on the LG&E Energy Corporate Policies, as the Commission recently noted in Case No. 99-056,⁴ the LG&E Energy Corporate Policies consist of five double-spaced pages that describe the basic concepts to be followed in transactions between KU, LG&E, and LG&E Energy affiliates. The Corporate Policies do not address the specific actions required by LG&E Energy affiliates to implement these basic concepts. The development of a CAM, along with requirements for its contents, constitutes a specific action that goes beyond the basic concepts contained in LG&E Energy's Corporate Policies. If LG&E, KU, or any other utility believes the requirement of a list and description of the services and goods provided by the

² Case No. 97-300, Joint Application of Louisville Gas and Electric Company and Kentucky Utilities Company for Approval of Merger, final Order dated September 12, 1997.

³ Case No. 89-374, Application of Louisville Gas and Electric Company for an Order Approving an Agreement and Plan of Exchange and to Carry Out Certain Transactions in Connection Therewith.

⁴ Case No. 99-056, The Application of Louisville Gas and Electric Company and Kentucky Utilities Company for a Certificate of Public Convenience and Necessity for the Acquisition of Two 164 Megawatt Combustion Turbines, final Order dated July 23, 1999.

utility and its subsidiaries and an identification of each as regulated or nonregulated is unduly burdensome, that utility does have the option under Section 8 to request a waiver or deviation.

d. Incidental Nonregulated Services and Goods. A list of nonregulated services and goods that qualify for incidental treatment in accordance with section 1. d. of these guidelines.

e. Allocation Methodology. For each USoA account and sub-account, identify whether the account contains costs attributable to regulated operations, nonregulated operations, and/or whether the costs are joint costs that cannot be directly identified. A description of the methodology used to apportion each of these categories must also be included. The allocation methodology shall be consistent with the principles identified in section one of these guidelines.

Kentucky Power considers reliance on the USoA for this section to be burdensome and unnecessary and stated that most utilities base their indirect cost allocations on the nature of the activity performed rather than the USoA account where the cost is recorded. It pointed out that more than one allocation method may be associated with the same account depending on the number of activities associated with the account. Kentucky Power suggested that the CAM be required to contain written agreements, an organization chart of the affiliated companies, accounting bulletins, procedure and work order manuals, and other documents that provide information on how costs are allocated between regulated and nonregulated services or products. All financial reporting required by the Commission of jurisdictional utilities is based on the USoA. Requiring cost allocation information based on the USoA is, therefore, consistent with other Commission practices and ensures that information is provided in a format that is concise and readily understandable. The USoA information can be provided in a brief chart format that refers to existing accounting bulletins or procedure manuals for more detailed descriptions of specific methodology.

During the informal conference, one participant suggested that the CAM be required to contain a matrix identifying cost pools associated with each account and the bases used to apportion each cost pool as required by the FCC cost allocation rules. The current requirements of the guidelines should solicit sufficient information while allowing the utilities some latitude regarding format and terminology.

f. Affiliated Transactions. Descriptions of the nature of all transactions between the utility and a nonregulated division, subsidiary, or affiliate.

g.
h.

4. Affiliate Transaction Pricing. The terms for transactions between the regulated utility and a nonregulated division, subsidiary, or affiliate shall be in accordance with the following guidelines:

a. Goods and Services Transferred from Utility to Affiliate. Goods and services provided to a nonregulated division, subsidiary, or affiliate by the regulated utility pursuant to a tariff shall be at the tariffed rate. Nontariffed items shall be priced at the utility's fully distributed cost.

b. Goods and Services Transferred from Affiliate to Utility. Goods and services provided to the regulated utility by a nonregulated division, subsidiary, or affiliate shall be priced at the affiliate's fully distributed cost.

Kentucky-American, LG&E/KU, Kentucky Power, ULH&P, KAEC, Western, Columbia Gas and Delta filed individual comments rejecting the required use of fully distributed cost and asymmetrical pricing for transactions between utilities and affiliated entities. In general, the respondents favored either market-based pricing or a more flexible pricing rule, stating that the competitive bidding process should provide sufficient protection against potential subsidization and that rules guarding such transactions could be fashioned so as to benefit both the market and the ratepayers.

Kentucky-American, KAEC and Kentucky Power noted that the Commission has the authority to undertake a review of affiliate transactions during the course of a rate proceeding at which time justification for the affiliate transactions could be efficiently reviewed and ratepayers could be adequately protected.

In consideration of the comments and after further review of the issue, Commission Staff believes the asymmetric pricing standards for pricing the transfer of goods and services between the utility and the affiliate are preferable to the fully distributed cost approach. The asymmetric pricing standard is an essential tool that should minimize the opportunity for cross-subsidization and predatory pricing. The guidelines include a deviation provision that affords utilities the opportunity to request different treatment if the situation so merits. This pricing methodology, with the allowance for deviations, should not serve as a disincentive for affiliate transactions.

The Commission's rate-making authority will aid in assuring that the affiliate transaction pricing guidelines are followed; however, it cannot substitute for the ongoing requirement that transactions between affiliates be priced in a manner that avoids cross-subsidization. Moreover, many utilities may not undergo a rate review for many years, which would render the rate-making process a useless tool in monitoring affiliate transactions.

c. Assets Transferred from Utility to Affiliate. The transfer or sale of assets by the utility to a nonregulated division, subsidiary, or

affiliate shall be priced at the greater of the utility's cost or fair market value.

d. Assets Transferred from Affiliate to Utility. The transfer or sale of assets by a nonregulated division, subsidiary, or affiliate to the regulated utility shall be priced at the lower of the affiliate's cost or fair market value.

LG&E/KU and Western stated that ratepayers are being adequately protected, and are many times better off, as long as the utility recovers the incremental costs associated with such transactions.

Under the guidelines the preferred method of establishing the cost based price of assets, goods, and services transferred between utilities and affiliates is fully distributed cost. Recognizing that there may be instances when other costing methodology achieves a more favorable result, the provision for deviations from the standard rules exists.

Columbia Gas and ULH&P requested that transactions between affiliated public utilities be exempted from the guidelines.

In further consideration of this issue it has been determined that an additional section should be added to the guidelines to specify the pricing of transactions between regulated utility affiliates. The preferred method of pricing these transactions is fully distributed cost in that this approach will assure that the utility ratepayers are not harmed by the transaction. As with other provisions of the guidelines, if the transaction would be more beneficial if priced under another methodology, a deviation from the standard may be requested.

ULH&P recommended that one-time single event transactions be excluded from the CAM requirements. This issue has been addressed in the section dealing with incidental treatment. If the utility has transactions or activities in dollar amounts that exceed the thresholds, the transaction must be accounted for in accordance with the guidelines.

e. Deviations from Affiliated Transaction Pricing Guidelines. The regulated utility may file an application with the Commission requesting a deviation from the affiliated transaction guidelines for a particular transaction or class of transactions. The utility shall have the burden of demonstrating that the requested pricing is more appropriate and the result is just and reasonable. The Commission may grant the deviation if it is determined to be in the public interest.

A provision has been added to apply the incidental treatment standard to the affiliate transaction pricing. Companies that are engaged in only insignificant levels of affiliate transactions should not be subject to the pricing guidelines; however, these transactions are subject to scrutiny in rate cases or other

proceedings if there is any indication that cross subsidization is occurring through the transfer of assets, goods, and services between the utility and its affiliates.

5. Demonstration of Compliance with Guidelines. In an application for base rates, the regulated utility must demonstrate compliance with the Commission's cost allocation and affiliate transaction guidelines.

a. Utility to Document Compliance. In any formal Commission proceeding at which cost allocation is at issue, the utility shall provide sufficient information to document that its cost allocation procedures and affiliate transaction pricing are consistent with these guidelines. If the Commission deems the evidence provided by the utility to be insufficient or finds there is good cause or evidence to indicate the utility has not complied with these guidelines, the utility may be required to perform a cost study.

LG&E/KU suggest that the utilities need some sense of what would be considered sufficient and what would be insufficient with regard to demonstrating compliance. ULH&P and Columbia Gas object to the requirement to demonstrate compliance because it creates a need to prove a negative. Delta states that the requirement for a cost study should be removed. They claim that a cost study should only be performed if competent evidence standing alone establishes that the utility has improperly allocated costs. The last sentence of Section 5. a. has been deleted. If cost allocation is at issue in a proceeding before the Commission, the burden of proof in justifying the allocations made by the utility will rest with the utility. This is consistent with standard Commission practice; therefore, no further change or more detailed explanation within the guidelines is considered necessary.

b. Utility to Provide Information. The utility shall provide sufficient information for another party to perform a cost study in response to relevant data requests through the Commission's discovery process.

As stated previously, a provision has been added to this section to require that the CAM be filed as a part of the initial filing requirements in rate case proceedings.

LG&E/KU suggests that clarifying language be added to this subsection to make sure that the cost study will only be provided to another party during the course of a formal rate case. It is agreed that language clarifying that this information will only be available through a formal Commission proceeding at which cost allocation is an issue is necessary. This section has been amended.

6. Access to Records. The Commission shall have access, including the right to perform or order a financial audit, to the books and records of a utility's subsidiary or affiliate company to the extent necessary to ensure that transactions between the two entities comply with the

requirements established herein. If necessary access to records to determine compliance is not provided, the costs attached to the affiliate transactions may be disallowed from rates.

Kentucky-American and KAEC questioned the Commission's statutory authority to require access, including the right to audit the books and records of a nonregulated subsidiary or affiliate. Since, the purpose of the audit would be to determine compliance with the CAM that is developed by the utility, Kentucky-American claims that it is unclear why there is a need, or whether there is jurisdictional authority to audit an affiliate. KAEC states that the Commission does not have the statutory authority to require access to the books or records of a nonregulated entity. According to KAEC out-of-state and nonregulated business partners of co-ops have indicated they will not participate in business arrangements where the regulator has access to their books and records.

The utility has the burden of proof to show that its rates are based on fair, just, and reasonable costs. As part of that proof, the utility must present evidence that its ratepayers are not subsidizing the operations of nonregulated subsidiaries or affiliates. Therefore, the issue is not the Commission's jurisdictional authority to require access to the books or records of nonregulated entities, but rather the utility's burden of proof regarding the reasonableness of its affiliate transactions.

The Guidelines for Cost Allocations and Affiliate Transactions adopted by NARUC states that Regulators should have complete access to affiliate records, consistent with state statutes, to ensure that the regulator has access to all relevant information necessary to evaluate whether subsidization exists. Giving the Commission complete access to the financial books and records of nonregulated affiliates or subsidiaries would meet the utility's evidentiary burden of proving ratepayer subsidization does not exist. If access is denied or limited, the Commission would be unable to determine if the costs of the nonregulated subsidiary or affiliate are fair, just, and reasonable and therefore, the only alternative available would be to deny the utility the ability to recover those costs.

Western and ULH&P requested language be changed to specify that the guidelines will not require periodic audits and that an audit would only occur when there is sufficient evidence that a utility is not properly allocating costs. The intent of the Guidelines is not to require annual or periodic audits of nonregulated affiliates and the language in the guidelines does not infer that audits would be required on a regular basis. In certain circumstances more frequent audits might be required to ensure a utility is complying with its CAM. Therefore, it would be imprudent to include language that might limit authority to require audits of nonregulated affiliates.

Western requests that the audits of nonregulated affiliates be limited to the utility's compliance with its CAM. The Guideline states that the audits will be

required, to ensure that transactions between the two entities comply with the requirements established herein. Therefore the existing language is deemed sufficient.

ULH&P requested a language modification to clarify that the cost of the audit would be borne by the Commission and not the utility. The requested language modification is not necessary because the issue of cost recovery should be made on a case-by-case basis and not rigidly established in the guidelines.

7. Additional Filing Requirements. The Commission may require that the utility file periodic reports of information related to affiliate transactions when necessary to monitor compliance with these guidelines.

ULH&P has requested that the Commission clarify the type of information that would be required under this section. ULH&P further requested that the Commission state that informational filings under the Public Utility Holding Company Act would satisfy this section, and that periodic be defined to mean annual or no more frequently than annual. Similar concerns were raised by a participant at the March 19, 1999 informal conference.

Commission Staff is unable to accept ULH&P's suggested changes. At this time, it is not known what specific information will be required in conjunction with this monitoring role. It is highly likely that any requested information will vary from utility to utility. As ULH&P is aware from the decision in Case No. 94-104,⁵ the Commission has always indicated its willingness to accept reports filed with the SEC if those reports satisfied the informational requirements of the Commission. Likewise, it would be imprudent to define periodic to mean annual or no more frequently than annual. The circumstances surrounding the need for additional information will result in the appropriate definition of periodic on a case-by-case basis.

8. Prudence Review. Conformance with these guidelines shall not preclude the Commission from evaluating the prudence of any transaction, investment, or expense.

KAEC suggests adding language clarifying that prudence reviews be limited to rate-making purposes. At this time, it is not clear that a prudence review would be for anything but rate-making purposes. However, as noted by Kentucky-American, the intent of these rules is not to limit the Commission's authority in these matters, so this modification will not be made.

⁵ Case No. 94-104, Application of the Cincinnati Gas & Electric Company and Cinergy Corp. for Approval of the Acquisition of Control of The Union Light, Heat & Power Company by Cinergy Corp., final Order dated May 13, 1994.

Western attempts to use this section to bolster its arguments that as the Commission already has the authority to address affiliate transactions, no further guidelines are necessary. This argument seems to suggest that Commission regulations are the instruments which give it authority, somewhat circular reasoning at best. It is state law, primarily KRS Chapter 278, as enacted by the state legislature, that provides the Commission with its authority. Commission regulations are intended to help it implement the provisions of KRS Chapter 278, as provided by KRS 278.040(3), which states:

The commission may adopt, in keeping with KRS Chapter 13A, reasonable regulations to implement the provisions of KRS Chapter 278 and investigate the methods and practices of utilities to require them to conform to the laws of this state, and to all reasonable rules, regulations and orders of the commission not contrary to law.

The need for Section 8 is amply illustrated by Delta's comments, who believes that this section is unnecessary, because if the utility complies with the CAM, no further review is necessary. The intent of the proposed cost allocation and affiliate transaction regulations is not to determine if a particular transaction is prudent, but to provide guidelines on the appropriate accounting treatment for that activity. For example, there are numerous instances where transactions are appropriately accounted for, but are disallowed for rate-making purposes, such as charitable contributions or marketing expenses. The intent of Section 8 is to clarify that the cost allocation and affiliate transaction rules do not limit the Commission's authority to investigate the appropriateness of any particular transaction.

9. Waivers and Deviations. A utility may file an application for a waiver or deviation from any or all provisions of these guidelines. Any such application shall demonstrate the basis of the utility's contention that it should be granted a waiver or deviation, including, if appropriate, documentation regarding the costs and benefits of compliance. For good cause shown, the Commission may grant a waiver or deviation if compliance is determined to be impracticable or unreasonable under the circumstances.

Western stated that any waiver provision should allow for an automatic waiver if all of the affiliated transactions are incidental as defined in Section 1(d). Based on the modifications that have been made to Section 1(d), and the addition of a new provision in Section 5(d), incidental affiliated transactions are exempt from the CAM requirements and, therefore, no waiver would be required.

APPENDIX C

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN ADMINISTRATIVE CASE NO. 369 DATED DECEMBER 20, 1999

CODE OF CONDUCT FOR UTILITIES

WITH NONREGULATED ACTIVITIES OR AFFILIATES

A code of conduct governs a public utility company's activities relative to the sharing of information, databases and resources between its employees or affiliates involved in the marketing or provision of nonregulated services and its employees or affiliates involved in the provision of regulated services. An affiliate is defined as a person that directly, or indirectly through one or more intermediaries, controls, is controlled by or is under common control with the utility. Control is considered to be the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract, or otherwise. These guidelines shall apply to any utility that engages in any nonregulated activity or conducts any business with a nonregulated division, subsidiary, or affiliate.

1. A utility and its affiliates must be separate corporate entities and maintain separate books and records. Any utility that engages in nonregulated activities directly rather than through an affiliate shall separately account for all investments, revenues, and expenses in accordance with its filed cost allocation manual.

2. A utility may not provide advertising space in its billing envelope to its affiliates or for its nonregulated activities unless it offers the same to competing service

providers on the same terms it provides to its affiliate. This rule applies to competitive services only.

3. A utility may not attempt to persuade customers to do business with its affiliates by offering rebates or discounts.

4. A utility may not solicit business on behalf of its affiliate or for its nonregulated activities or speak or give the appearance of speaking on behalf of its affiliate.

5. A utility may carry out any promotion, advertising sales, marketing or research and development with its affiliate or for its nonregulated activities subject to cost allocation guidelines.

6. All electric company employees engaged in the merchant function shall abide by all standards promulgated by applicable Federal Energy Regulatory Commission orders and regulations.

7. No utility employee shall share any customer information with its affiliate unless such information is readily publicly available or is simultaneously made publicly available.

8. All dealings between a utility and its affiliate shall be at Arms length.≡ Arms length is defined as the standard of conduct under which unrelated parties, each party acting in its own best interest, would negotiate and carry out a particular transaction.

9. A utility may not share marketing and business plans or market research with an affiliate.

10. Employees transferring from the utility to an affiliate may not take with them competitively sensitive information or material of any kind.

11. Where a utility offers a nonregulated service, marketing employees shall not have access to customer information provided to order takers.

12. Utilities may not provide any type of preferential treatment to its affiliates to the detriment of a competitor.

13. If a utility receives a request for a recommendation from a customer seeking a specific service which is offered by the utility's affiliate, or by the utility itself, the utility must provide the customer with the names of several competing suppliers of that service, if it mentions its own affiliate or that it provides the service.

14. The utility name or logo shall not be used by an affiliate unless a disclaimer is used. The form, content and appearance of the disclaimer shall be pre-approved by the Commission.

15. A utility shall not provide credit support for its affiliates.

16. Utilities shall inform the Commission of all new nonregulated activities on a time-concurrent basis.

17. Start-up costs associated with the formation of an affiliate shall be borne by stockholders.

18. The Commission may require that the utility and its affiliates file periodic reports of information related to affiliate transactions when necessary to monitor compliance with these guidelines.