



# State of Utah

DEPARTMENT OF COMMERCE  
Division of Public Utilities

APPROVED BY COMMISSIONERS

BRIAN T. STEWART *BTS 1/16/91*  
JAMES M. DYRNE *JMD 12/20/91*  
STEPHEN C. HEWLETT *SH 12/20/91*

Norman H. Bangertter  
Governor  
David L. Buhler  
Executive Director  
Frank Johnson  
Division Director

Heber M. Wells Building  
160 East 300 South/P.O. Box 45802  
Salt Lake City, Utah 84145-0802  
(801) 530-6651

## M E M O R A N D U M

Date: December 9, 1991

To: Utah Public Service Commission

From: Frank Johnson, Division Director *FJ*  
Wesley Huntsman, Manager, Management Analysis *Wesley*  
Ken Powell, Manager, Electric Utility Section *KP*  
Division Of Public Utilities (DPU)

Copies: Steven L. Walton, Director Economic Regulation  
Utah Power & Light (UP&L)

Subject: UP&L Transfer Pricing Policy pursuant to Docket No.  
87-035-27 order.

### Introduction

On October 24, 1991, the Division of Public Utilities (DPU) received a copy of the Company's proposed Transfer Pricing Policy and a cover memo to the Commission dated October 18, 1991 (See attachment # 1). The Transfer Pricing Policy had also been the subject of several data requests and discussions in the UP&L Rate Case No. 90-035-06.

### Recommendation

The Commission should approve the proposed Transfer Pricing Policy, but in so doing, it should specifically state that it is not preapproving costs incurred by Utah Power & Light through transactions with affiliates under the Policy.

Additionally, the Commission should require documentation and justification whenever qualitative factors are utilized to assert that affiliate transactions are in compliance with the Transfer Pricing Policy.

The policy should be used as a general statement of intent against which specific future transactions will be measured to determine whether affiliate transactions are in the public interest and result in reasonable costs and revenues.

## Details

During the PacifiCorp & UP&L merger case (Case No. 87-035-27), the Division expressed concerns about the pricing of goods and services provided by an affiliate to the merged company utility operations (See filed testimony of W. Huntsman, attachment # 2). During the merger proceedings, the Company indicated its intent to assure that affiliated transactions resulted in fair transactions and did not subsidize unregulated affiliates.

The Commission concurred with the Division's recommendations in the merger case and among the conditions stated for its merger approval was a requirement (No. 17) that: "The Merged Company shall adopt a transfer pricing policy regarding the pricing of goods and services and the transfer of assets and submit an application for the Commission's review and approval of such pricing policy."

Specifically regarding provisions of the proposed Transfer Pricing Policy, the Division is concerned that the wording to recognize the importance of qualitative factors in paragraph A of the Exchange of Goods and Services section does not specify the necessity for documenting and justifying the use of qualitative factors in relation to the specific quantitative pricing elements. In addition, The Division assumes that the rate of return included under the policy for goods and services provided by Electric Operations to affiliated Companies will be no lower than the Commission authorized rate of return, otherwise a subsidy would occur.

At the time the Division filed testimony in the rate case (Case No. 90-035-06) the Company's proposed Transfer Pricing Policy had not been finalized. Therefore, the Division testimony by witness W. Huntsman contained a general discussion regarding transfer pricing (See attachment # 3). In response to Division data request No. AI-10, the Company stated that: "The Company intends to engage in transactions which are mutually beneficial to electric customers and shareholders. In order to fully develop advantageous affiliate relationships, it is important to have the flexibility to develop prices which recognize the unique features of each transaction." (See attachment # 4)

Despite the apparent common interpretation of the general intent for affiliate transactions to avoid subsidization of unregulated affiliate operations and reasonable utility costs; the Company and the Division had different perspectives regarding specific charges for services provided by an affiliate in the rate case. Even though the revenue phase of the case has resulted in a stipulated settlement, it is clear that the parties did not agree on the appropriate costs which ratepayers should bear for Utility personnel usage of the Corporate aircraft operated by an unregulated affiliate. Therefore, it appears that specific case by case consideration of the reasonableness of affiliate charges under the Transfer Pricing Policy will be necessary.

*Attachment #1*

**UTAH POWER**  
**ONE UTAH CENTER**

**STEVEN L. WALTON, P.E.**  
Director  
Economic Regulation

201 SOUTH MAIN • SUITE 800 • SALT LAKE CITY, UTAH 84140-0008 • (801) 220-4051 • FAX (801) 220-2422

RECEIVED  
PUBLIC SERVICE COMMISSION  
OCT 18 11 03 AM '91

October 18, 1991

**PUBLIC SERVICE COMMISSION OF UTAH**  
Heber M. Wells Building  
160 East 300 South  
P.O. Box 45585  
Salt Lake City, UT 84145

**Re: Transfer Pricing Policy**


Gentlemen:

The Utah Commission order in Docket No. 87-035-27, approving the merger of Utah Power and PacifiCorp, required the merged company to adopt a transfer pricing policy regarding the pricing of goods and services and the transfer of assets between the electric utility divisions and their affiliates (Section III, L.8.B.17, pp. 98-99). Since the merger, the Company's transfer pricing policy has been reflected in the annual affiliated interest reports which have been submitted to the Commission for the years 1988, 1989 and 1990. The reports describe the basis for pricing all transactions with affiliated companies which took place during these calendar years.

However, in recent discussions, the Division of Public Utilities has indicated to the Company that a formal transfer pricing policy is desired. Therefore, the attached copy of PacifiCorp Electric Operations' transfer pricing policy for transactions involving affiliated companies is provided for your review.

Please contact me if you have any questions.

Sincerely,



Steven L. Walton

SLW/cw  
10:28

cc: Division of Public Utilities  
Committee of Consumer Services

# **TRANSFER PRICING POLICY**

## **GENERAL**

It is the policy of PacifiCorp Electric Operations (the "Company") to engage in transactions with affiliated companies when appropriate. In so doing, the Company will establish transfer prices which are both advantageous to electric customers and fair to affiliated companies. Special care will be taken to assure that the transactions are of an appropriate nature and do not have the appearance of self-dealing or cross-subsidization of nonutility operations by utility customers.

For the purpose of setting transfer prices, all affiliate transactions will be considered to fall into one of two categories -- transfers of assets and exchanges of goods and services. The term "transfer of assets", as used in this policy, refers to the disposition or acquisition of utility property for which cost recovery has been obtained from electric customers or for which future cost recovery will be sought. The issues to be considered in setting transfer prices are described below.

## **TRANSFERS OF ASSETS**

### **A. Transfers of Utility Assets to Affiliated Companies**

When it becomes necessary to dispose of utility assets, the interests of utility customers are protected by obtaining the highest possible price for those assets. Therefore, it is Company policy that if surplus utility assets are

transferred to affiliates, the transfer price will be the greater of fair market value or net depreciated book value. Fair market value is defined as the cost of comparable assets available from non-affiliated companies, determined in accordance with corporate procurement policies and procedures.

**B. Transfers of Affiliated Company Assets to the Utility**

When acquiring utility assets, the interest of utility customers are protected by obtaining the assets at the lowest possible price. Therefore, assets acquired by Electric Operations from affiliated companies will be transferred at the lesser of fair market value, as defined above, or the net depreciated book value on the records of the affiliated company.

***EXCHANGES OF GOODS AND SERVICES***

**A. Goods and Services Provided to the Utility by Affiliates**

In accordance with the Company's procurement policies and procedures, the market price shall be used to cost goods and services sold by an affiliated company to Electric Operations. Market price is defined as the lowest evaluated cost of comparable goods and services available from non-affiliated companies as determined by competitive bidding or justified otherwise as required by the Company's procurement policy. With respect to competitive bidding, it is understood that in determining the "lowest evaluated cost of comparable goods and services", factors such as technical expertise, performance capabilities, safety, convenience and minimization of related costs, etc. may be as or more important than lowest bid price.

If the goods and services provided by an affiliate are not required to be competitively bid under the terms of the Company's procurement policies and procedures, the transaction will be priced at the affiliate's actual cost. Cost in this case may include a return on the affiliate's investment at a rate no greater than the utility's most recently authorized overall rate of return.

**B. Goods and Services Provided to Affiliates by the Utility**

Goods and services provided by Electric Operations to affiliated companies will be priced at a rate which covers all associated costs, including a return on investment.

WDH-04/06/88-3750W

1. cation to adopt and implement the proposed procurement  
2. policy.

3.Q. WHAT CONDITIONS DO YOU RECOMMEND TO ASSURE THAT  
4. PACIFICORP DOES NOT ALLOW AFFILIATED ENTITIES AN  
5. IMPROPER ADVANTAGE IN COMPETING FOR SUPPLY ARRANGE-  
6. MENTS WITH UTILITY DIVISIONS?

7.A. The Commission should require PacifiCorp to adopt  
8. and implement the procurement policies and procedures  
9. developed by UP&L, or as modified by PacifiCorp and  
10. approved by the Commission, in compliance with the  
11. provisions of the Third District Court Order.

12.

13. IV. PRICING AND PERFORMANCE ISSUES

14.Q. WHAT ARE THE DIVISIONS CONCERNS ABOUT THE THE PRICING  
15. OF GOODS AND SERVICES PROVIDED BY AN AFFILIATE TO THE  
16. UTILITY DIVISIONS OR VICE VERSA?

17.A. In a free market system, the price of a good or  
18. service is established by supply and demand. The  
19. seller may set a cost-based or a market-based price;  
20. and the buyer may use various market tests in reaching  
21. a purchasing decision. In any instance involving a  
22. less-than-arms-length transaction, the opportunity may  
23. exist for the natural forces affecting a buy-sell  
24. transaction to be manipulated. If an unregulated

1. entity stands to profit by the manipulation of the  
2. circumstances surrounding a buy-sell decision of the  
3. utility entity at the expense of utility ratepayers  
4. then regulatory restrictions appear warranted.

5.Q. WERE RECOMMENDATIONS MADE IN THE MOUNTAIN BELL  
6. AFFILIATE TRANSACTIONS REPORT TO ADDRESS THE QUESTION  
7. OF APPROPRIATE PRICES FOR GOODS AND SERVICES?

8.A. Yes, The consultant recommended a control  
9. process for transactions between the utility and  
10. unregulated affiliates which included:

11. (1) Performing market tests and developing specific  
12. criteria for validating the product specifi-  
13. cations, quality, and price of a good or service  
14. available from an affiliate. To determine if the  
15. price is reasonable, the utility buyer may employ  
16. techniques such as industry standards or bench-  
17. marks, estimates of internal costs for providing  
18. the services, or market prices of comparable  
19. goods or services. If performance criteria are  
20. so restricted that only the affiliate can  
21. qualify, then that entity should be subject to  
22. Commission regulation.

23. (2) Providing for systematic conflict resolution.  
24. Specific procedures for escalating unresolved



1. issues between buyers and sellers in the organi-  
2. zation, and procedures for negotiation.
3. (3) Providing management reporting procedures to  
4. provide performance reports and present the  
5. results of buying activities within PacifiCorp.
6. (4) Establishing policies and procedures to ensure  
7. that the interentity transfer of goods and ser-  
8. vices within the PacifiCorp organization conforms  
9. with regulatory rules.
- 10.Q. HAS PACIFICORP RECOGNIZED THE NEED FOR A CONSISTENT  
11. POLICY REGARDING THE PRICE OF GOODS AND SERVICES AMONG  
12. ITS AFFILIATES SUBSEQUENT TO THE MERGER?
- 13.A. Yes. In response to the Divisions data request  
14. number 9 section C, PacifiCorp briefly summarized  
15. Pacific Power's current transfer pricing policy. That  
16. response stated in part:
17. "Pacific Power uses the lower of  
18. cost, or market, as the transfer  
19. price for goods and services sold by  
20. an affiliate to the utility. Such  
21. costs include a return on the affi-  
22. liate's investment (attributable to  
23. utility sales) no greater than the  
24. most recently authorized utility rate

1. of return."

2.Q. WHAT PRECAUTIONS DO YOU RECOMMEND TO ASSURE THAT THE  
3. UTILITY MAKES APPROPRIATE SUPPLY DECISIONS WHEN  
4. AFFILIATED ENTITIES ARE INVOLVED?

5.A. The Commission should require PacifiCorp to  
6. adopt the transfer pricing policy expressed in  
7. response to the Division's request, and implement a  
8. control process for transactions between utility  
9. divisions and unregulated affiliates.

10.

11. V. ASSET TRANSFERS & RETENTION OF INTEGRAL

12. UTILITY FUNCTIONS

13.Q. DO YOU HAVE ANY INDICATION THAT PACIFICORP INTENDS  
14. TO DIVEST ANY UTILITY ACTIVITIES OR FUNCTIONS?

15.A. No, however, there are opportunities for such  
16. transfers to occur. For instance, PacifiCorp has  
17. consistently indicated that it has no intention of  
18. placing the UP&L coal mining operations under its  
19. NERCO affiliate. However, if substantial benefit  
20. could be derived by NERCO developing UP&L coal  
21. reserves currently included in rate base as plant  
22. held for future use, the Company may well reconsider  
23. such action. Another example would be the plant  
24. maintenance function. At the present time UP&L

1. maintains employees and hires contractors to perform  
2. required maintenance on its power plants. PP&L on  
3. the other hand has entered a service contract with  
4. NESCO, an affiliated company, to perform required  
5. power plant maintenance. In addition, experience  
6. in the telecommunications industry suggests that  
7. restrictions are necessary to assure that integral  
8. functions are not reorganized into independent  
9. profit centers for the benefit of stockholders at  
10. the possible detriment of ratepayers.
- 11.Q. HAS THE COMPANY IN ANY WAY INDICATED THE CONDITIONS  
12. UNDER WHICH IT WOULD CONSIDER TRANSFERRING A UTILITY  
13. FUNCTION TO AN AFFILIATE OR INDEPENDENT ENTITY?
- 14.A. Yes, in testimony before FERC, Mr. Fredric D.  
15. Reed testified that:
16. "Prudent management would dictate  
17. that if we can obtain services more  
18. cost effectively from others, we should  
19. do so."
- 20.Q. WHAT CONDITIONS SHOULD THE COMMISSION IMPOSE TO ASSURE  
21. THAT RATEPAYERS ARE NOT HARMED BY DIVESTITURE OF  
22. INTEGRAL UTILITY FUNCTIONS?
- 23.A. The Commission should require Pacificorp to  
24. document and report the analysis performed to

WDH-04/06/88-3750W

1. determine that divestiture of an integral utility  
2. function is a cost effective management decision.

3.Q. ARE YOU CONCERNED ABOUT THE LIKELIHOOD OF ASSET  
4. TRANSFERS BETWEEN THE UTILITY AND UNREGULATED  
5. AFFILIATED ENTITIES WITHIN THE PACIFICORP ORGANIZATION?

6.A. Yes, undoubtedly a certain amount of reor-  
7. ganization will be necessary to complete the merger of  
8. the two corporations. One can only suppose that it  
9. will be necessary for management to transfer a certain  
10. amount of assets in the process. The transfer of any  
11. appreciated assets from the Utah Division to any  
12. affiliated entity at book value would deprive Utah  
13. ratepayers of the appreciation on the utility invest-  
14. ment on that property. The price of any asset trans-  
15. ferred to the Utah Division would be of as much con-  
16. cern to regulators.

17.Q. HAS PACIFICORP RECOGNIZED THE NEED FOR A CONSISTENT  
18. POLICY REGARDING THE TRANSFER OF ASSETS AMONG AFFILI-  
19. ATES SUBSEQUENT TO THE MERGER?

20.A. Yes. In response to the Divisions data request  
21. number 9 section C, PacifiCorp briefly summarized  
22. Pacific Power's current transfer pricing policy. That  
23. response stated:

24. "When an electric utility

1. transfers property to an affiliate,  
2. Pacific Power believes the utility  
3. should be reimbursed at the property's  
4. market value in cases where the pro-  
5. perty is to be used in ventures not  
6. involving the electric utility.

7. In cases where the property will  
8. be used to provide service to the  
9. electric utility, the reimbursement  
10. should equal the original cost  
11. depreciated value of the property."

12.Q. HAS THE COMMISSION ADOPTED RULES REGARDING THE RE-  
13. QUIRED REPORTING OF TRANSFERS OR SALES OF ASSETS BY  
14. PUBLIC UTILITIES.

15.A. Yes; the Commission has currently adopted what is  
16. generally known as "Rule 95"; however, those rules are  
17. outdated. The Commission has requested Division and  
18. Utility comments on proposed new rule "A67-05-95" in  
19. Case No. 85-999-18. The Division proposal for this  
20. rule was filed with the Commission on May 20, 1987  
21. (See Exhibit No. \_\_\_\_\_ (DPU-2.4). Disposition of the  
22. proposed rule is currently pending before the  
23. Commission.

24.Q. WHAT PRECAUTIONS DO YOU RECOMMEND TO ASSURE THAT THE

1. UTILITY MAKES APPROPRIATE ASSET SALES AND TRANSFER  
2. DECISIONS WHEN AFFILIATED ENTITIES ARE INVOLVED?

3.A. The Commission should require PacifiCorp to adopt  
4. the asset transfer pricing policy expressed in  
5. response to the Division's request. In addition, the  
6. Commission should require PacifiCorp to provide  
7. notification and reporting consistent with the Divi-  
8. sion's proposal regarding "Rule A67-05-95"; unless  
9. modified by Commission Order.

10.

11. VI. RECORDS AND DOCUMENTATION

- 12.Q. WHAT AUTHORITY DOES THE COMMISSION HAVE TO REQUIRE  
13. REPORTS AND DOCUMENTATION FOR AFFILIATED INTEREST  
14. TRANSACTIONS AND TRANSACTIONS WHICH RESULT IN COSTS  
15. ALLOCATED TO THE UTILITY OPERATIONS?

16.A. The Commission has authority to prescribe the  
17. forms of accounts, records, and memoranda to be kept  
18. by public utilities, which in its judgment may be  
19. necessary to carry out any provision of the statutes  
20. pertaining to utility regulation (UCC 54-4-23).

- 21.Q. IS PACIFICORP CURRENTLY REQUIRED TO REPORT THE  
22. TRANSACTIONS BETWEEN UTILITY AND UNREGULATED  
23. AFFILIATED ENTITIES TO UTILITY REGULATORS?

24.A. Yes. PacifiCorp is currently required to make an

1 Q. Have you reviewed the corporate organization of  
2 PacifiCorp, including Electric Operations?

3 A. Yes, I have reviewed the changing organiza-  
4 tional structure of PacifiCorp as provided to the  
5 Commission in annual Affiliated Interest Reports  
6 since the merger was approved. In addition I  
7 reviewed the officer and director relationships  
8 between the different PacifiCorp affiliates. A  
9 summary showing the officers and directors for each  
10 of the major PacifiCorp organizations is attached  
11 as Exhibit No. DPU 3.2.

12 This analysis disclosed interlocking  
13 directorates and evidence of control within most  
14 the PacifiCorp organizations, which indicates that  
15 transactions between these entities would be less  
16 than arms-length. Therefore, those PacifiCorp  
17 organizational entities would be appropriately  
18 considered "affiliated companies" under the  
19 definition previously stated.

20

21 MERGER ORDER COMPLIANCE

22 Q. Did you evaluate whether or not PacifiCorp has  
23 complied with the conditions of approval imposed by  
24 the Commission for the PacifiCorp and UP&L merger?

1 A. Yes. In general the Division believes that  
2 PacifiCorp is meeting the requirements of the  
3 merger order dated September 28, 1988 in Case No.  
4 87-035-27. The Division has monitored PacifiCorp's  
5 efforts to comply with the specific stated  
6 conditions in the order. It appears that the  
7 Company has complied with all stated conditions  
8 with the exception of condition No 17 on page 98 of  
9 that order which stated:

10 "The Merged Company shall adopt a  
11 transfer pricing policy regarding the  
12 pricing of goods and services and the  
13 transfer of assets and submit an  
14 application for the Commission's review  
15 and approval of such pricing policy."  
16

17 In the merger case referenced above, I  
18 testified on behalf of the Division regarding the  
19 transfer pricing policy issue. I recommended that  
20 the Commission require adoption of a transfer  
21 pricing policy regarding the price of goods,  
22 services and assets transferred between the utility  
23 and unregulated affiliates (my testimony at pages  
24 23 to 30, See Exhibit No DPU 3.3)

25 The Company notified the Division recently  
26 that a transfer pricing policy had been formulated  
27 and would be filed with the Commission in the very  
28 near future. However, at the time of our audit for



1           this rate case, no transfer pricing policy had been  
2           adopted by PacifiCorp management or submitted for  
3           Commission approval. The lack of such a policy  
4           made the determination of reasonable utility costs  
5           associated with the Electric Operations use of  
6           corporate aircraft more difficult. I will discuss  
7           corporate aircraft costs later in my testimony.

8    **Q. Do you still believe it is necessary for the**  
9           **Commission to require PacifiCorp to adopt a**  
10           **transfer pricing policy and obtain Commission**  
11           **approval for such a policy?**

12    **A.**           Yes. Until such a policy is formulated and  
13           approved by the Commission, utility managers may  
14           acquire goods and services on the basis of what is  
15           good for the PacifiCorp organization rather than  
16           what is best for utility ratepayers. Once such a  
17           policy has been discussed and its reasonableness  
18           decided, the associated costs will be more easily  
19           handled in rate cases.

20

21                   **INTERCOMPANY AFFILIATE TRANSACTIONS**

22    **Q. What was the total dollar amount of affiliated**  
23           **transactions within the PacifiCorp family during**  
24           **recent years?**

**UTAH POWER & LIGHT COMPANY RESPONSE  
TO THE DIVISION OF PUBLIC UTILITIES  
FIRST DATA REQUEST # AI  
Dated August 20, 1991**

**By: D. Douglas Larson**

**PSCU Docket No. 90-035-06**

**Request No. AI-10**

Please provide a copy of the transfer pricing policy adopted by PacifiCorp in accordance with condition 17 of the Commission's Order (Page 98-99) in Case No 87-035-27 approving the merger. Also, why were the Company's actions regarding this requirement not contained in the December 7, 1990 report to the Division regarding merger related commitments.

**Response No. AI-10**

PacifiCorp has delayed its response to the transfer pricing policy requirement in order to better gauge the nature and magnitude of post-merger utility/affiliate relationships. Based on this experience, the Company believes that a formal, all-encompassing transfer pricing policy is not desirable.

The Company believes that the diversity of its nonutility operations makes it impractical to design a policy which can be uniformly applied to every utility-affiliate transaction to produce optimal pricing decisions for electric customers. The Company intends to engage in transactions which are mutually beneficial to electric customers and shareholders. In order to fully develop advantageous affiliate relationships, it is important to have the flexibility to develop prices which recognize the unique features of each transaction.

All transactions between Electric Operations and affiliated companies are reported to the Commission in the Company's annual affiliated interest report. This report describes the basis for determining the prices for transactions with each affiliate. Where applicable, it also includes the margin of charges over costs, the rate of return on assets, and the basis for valuing transfers of assets. The Company believes that the extensive disclosure of actual data contained in the affiliated interest report represents compliance with the Commission's transfer pricing requirement and provides an effective safeguard for the interests of its electric customers.