

# Are Regulators Allowing Returns on Equity Above the Real Cost of Equity?

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1. Context and Concepts
2. Five Utility Strategies
3. Regulatory Omissions
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## I. Context and Concepts

- A. *The purpose of utility finance:* To obtain from capital markets the mix of equity and debt capital that supports the utility's obligatory infrastructure at the lowest long-term cost to consumers.
- B. *The purpose of regulation:* To align private behavior with public interest, by setting standards for performance and compensating consistent with performance.
- C. *Utility profit:* three perspectives
  1. "Authorized return on equity"
    - a. In cost-based ratemaking, we set the utility's annual revenue requirement by applying a simple equation: Annual revenue requirement = expenses plus cost of capital.

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- (1) expense items: operating expenses, fuel, depreciation and taxes
  - (2) cost of capital items
    - (a) contractual interest rate x debt
    - (b) commission-authorized *return on equity* x equity
- b. The *authorized* return on equity is what the commission finds the utility is entitled to earn, if the utility operates prudently and if commission's projections for costs and sales are accurate.

"The return on equity in traditional regulation is a residual. That is, under normal regulation the return on equity or the profit a utility earns is what remains after all other operating expenses have been met (operating expenses, interest expenses, taxes, salaries, pension expense, etc.). Because both revenues and expenses may be more or less than anticipated, the residual—the rate of return on equity or profit to the firm—will vary or fluctuate. It is this variance or volatility of the return that makes utility common equity a more risky investment than utility debt...."<sup>2</sup>

## 2. "Real cost of equity"

- a. FERC's careful answer: "the rate of return required by investors to invest in a company - otherwise known as the capital attraction rate of return, or the market cost of equity capital."<sup>3</sup>
- b. U.S. Supreme Court: "[A] public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally

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<sup>2</sup> Testimony of Stephen G. Hill, *In Re Joint Application of Entergy Louisiana and ITC Holdings, et al.*, Louisiana Public Service Commission Docket No. U-32538 at pp. 30-31 (Apr. 10, 2013) (hereinafter, "Hill Testimony").

<sup>3</sup> *Coakley, et al. v. Bangor Hydro, et al.*, 147 FERC para. 61,234 at para. 14 (June 19, 2014).

being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties."<sup>4</sup>

**3. "Actual return on equity"**

This is the end-of-year figure on the utility's books indicating what actually was earned. The actual return on equity is a "residual": the money left over when all expenses are paid or booked.

4. ***Relationship among the three concepts:*** The ***authorized*** return on equity is supposed to track the real ***cost*** of equity. Whether the ***actual*** return on equity matches the ***authorized*** return on equity depends on how the utility and the economy actually perform over the year.

**D. Distinction between competitive markets and regulatory monopoly markets**

1. ***Competitive markets:*** Since the market sets prices, you make money by beating competitors
2. ***Regulated monopoly markets:*** Since the regulators set prices, you make money by persuading regulators.

**II. Five Utility Strategies for Persuading Regulators to Authorize Return on Equity Above the Real Cost of Equity**

**A. Move assets from state jurisdiction to FERC jurisdiction**

1. Cost-based rates for transmission (and sometimes, generation)
  - a. Higher base ROEs
  - b. Higher equity-debt ratio: 60-40 has been approved; whereas around 50-50 is more common. (*AUS Utility Reports*, Feb. 2013 stated that 47% equity was the average common equity ratio for electric utilities.)

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<sup>4</sup> *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679, 692-93 (1923).

c. Transmission "incentives" per Federal Power Act section 219<sup>5</sup>

2. Market-based rates for generation

**B. Use debt to fund equity: the magic of double leveraging**

**1. Double leveraging defined**

a. When a holding company purchases stock in the utility, the holding company is purchasing the utility's equity. If the holding company uses borrowed money (debt) to buy the equity, the holding company has leveraged its investment (just like someone who borrows money to buy a home or car). Since the utility also has debt (as all utilities do), we call the result double leveraging.

b. Double-leveraging is profitable because in the regulated utility setting, the cost of debt (the interest rate) is lower the authorized return on equity.

(1) "[A]lleged 'double leveraging' occurs when a purchaser of stock uses debt to finance the purchase. In effect, the purchaser leverages the investment by using lower cost debt to obtain a higher return on equity."<sup>6</sup>

(2) "The theory's basic concept is that the true cost of a subsidiary's equity capital is the overall cost of the parent's capital. Accordingly, the cost of the subsidiary's equity should be computed as the weighted average of the parent's debt and equity costs. Otherwise, says the theory, shareholders of the parent receive not only the higher equity returns associated with the parent's equity, but an

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<sup>5</sup> FERC's main pronouncements are in *Promoting Transmission Investment through Pricing Reform*, 116 FERC ¶ 61,057 (July 20, 2006); *Promoting Transmission Investment Through Pricing Reform Policy Statement*, 141 F.E.R.C. ¶ 61,129 (Nov. 15, 2012) (hereinafter cited as "2012 Policy Statement"); and in the many cases applying the principles in those documents. See also Adam Pollock, *How Can FERC Improve the Transmission Incentive Policy? Ways to Improve Clarity, Transparency, and Performance* (National Regulatory Research Institute 2009).

<sup>6</sup> *Williams Natural Gas*, 80 FERC para. 61,158 (1997).

artificial (doubly leveraged) return on the subsidiary's equity."<sup>7</sup>

**2. Double bonus: Use double leveraging while moving assets to FERC**

- a. "[International Transmission Company's] business plan "unlocks" the profit potential in transmission by first (a) converting assets historically used for bundled state-jurisdictional service into assets used for unbundled FERC-jurisdictional service, then (b) providing that FERC-jurisdictional service through subsidiaries whose equity comes from debt incurred by the holding company.<sup>43</sup> ITC thus earns high FERC returns on equity financed with lower-cost debt. Without making a single change (or commitment) in transmission planning, maintenance, repairs or operations, ITC not only increases the market value of the assets it acquires (thus allowing it to pay a price for the assets that produces a gain for the selling company's shareholders); it also locks in an opportunity to earn the new higher FERC profits on future investments within the selling company's service area. (Those future investments are certain to occur, due to load growth, replacements and/or upgrades.) This latter profit opportunity comes not only from FERC's base return on equity and its capital structure policies (allowing a return on equity financed in part with holding company debt, with the return on equity applied to a 60-40 equity-debt ratio), but also from the "incentives" potentially available under FERC's Order No. 679."<sup>8</sup>

**3. Double leveraging imposes extra costs on ratepayers**

- a. The problem for utility customers arises because they are paying a high-cost return on equity that was funded with low-cost debt. Example from ITC's situation:
- (1) The utility subsidiary, after the acquisition would have an equity-debt ratio of 60-40.
  - (2) The subsidiary's equity would be funded by the holding company parent.

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<sup>7</sup> *Missouri Public Service Commission v. FERC*, 215 F.3d 1 (D.C. Cir. 2000).

<sup>8</sup> Direct Testimony of Scott Hempling, Mississippi Public Service Commission Docket No. 2012-UA-358 (June 20, 2013).

- (3) If we assume that subsidiary's equity is funded by the parent with equal amounts of equity and debt, then the utility subsidiary's 60 percent equity is actually made up of 30 percent equity and 30 percent debt.
- (4) In effect then, the subsidiary's capital structure is 30 percent equity and 70 percent (30 + 40) debt.
- b. An effective 30-70 ratio is less costly than an asserted 60-40 ratio, because the cost of debt is less than the cost of equity. (According to Stephen Hill, the cost of equity to ratepayers can be as much as 3 times the cost of debt (compare, for example a 9% cost of equity with a 5% cost of debt, then take into account that interest is tax deductible whereas equity return is taxed, which tax cost ratepayers pay along with the equity cost)).
- c. This logic shows that when a rate regulator accepts double leveraging, ratepayers pay more to ultimate equity holders than their actual cost of the equity invested in the utility. As FERC stated (summarizing) the customers' position in ITC's proposed acquisition of Entergy's transmission assets:

"Joint Customers state that they "do not find fault with [ITC Holdings'] financing strategy" because "the extremely low risk of the Commission-regulated, cost-of-service formula rate based transmission service can reasonably be financed with relatively low equity levels." However, Joint Customers argue that ITC Holdings attempt to perpetuate a myth that its transmission businesses are financed with 60 percent equity, when in fact, they are financed with approximately 30 percent equity, and that ITC Holdings continues to seek to have ratepayers charged an equity return on borrowed funds. Joint Customers argue that the Commission should require that the real sources of the funds used to finance the rate bases of the operating companies and their actual costs be used in the transmission formula rates of the operating companies."<sup>9</sup>

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<sup>9</sup> *ITC Holdings Corp., Entergy Corporation*, 143 F.E.R.C. para. 61,256 at para. 68 (2013) (footnotes omitted).

#### 4. FERC's response

"[T]he Commission's policy is to use the capital structure of the pipeline subsidiary when the pipeline is responsible for its own financing and issues its own debt." *Williams Natural Gas*, 80 FERC para. 61,158 (1997).

"[I]n choosing between the capital structure of the parent and the pipeline, the Commission will continue to look to whether the pipeline issues its own debt, but will also require a determination of whether the pipeline's equity ratio falls within the range of equity ratios of the proxy companies used in the DCF analysis...." *Id.*

"The rate of return to a pipeline should not depend on who owns the pipeline, nor on how that owner, whether a holding company or individual stockholders, financed its investment.... There is no reason why [the customers' proposal to ignore double leveraging] should not apply equally as well if the owner of the operating company is one wealthy individual or a group of individual investors. In the latter case, the Commission would have to inquire into the leverage used by the individual investors to finance their stock purchase in order to arrive at a reasonable rate of return." *Id.* at text accompanying n.22 (1997).

- a. FERC repeated this policy in its 2013 approval of ITC's proposed acquisition of Entergy's transmission assets. (The proposal died after the Mississippi Commission rejected it.)
- b. Norman Bay's response to Sen. Murkowski's Question 26, part of larger packet of responses to Senate Committee questions, dated June 4, 2014

"By eliminating the competition for capital between generation and transmission functions and thereby focusing only on transmission investment, the transco model responds more rapidly and precisely to market signals indicating when and where transmission investment is needed.' Additional transmission investment leads to improved electric reliability, improved access to power markets, and ultimately, reduced overall costs of delivering electric power. Second, the Commission has 'long recognized that the [transco] business model can bring significant benefits to the industry. Their for-profit nature

with a focus on the transmission business is ideally suited to bring about: 1) improved asset management including increased investment, 2) improved access to capital markets given a more focused business model than that of vertically-integrated utilities, 3) development of innovative services, and 4) additional independence from market participants.' Finally, a transco's financial model may lead to stronger credit ratings that attract a larger pool of investors. Those ratings produce immediate off-setting benefits in the form of cheaper debt."

c. Commentary on Mr. Bay's response

- (1) ***Competition for capital:*** In financial markets, there will always be competition for capital because capital is a scarce resource. The premise that there is a distinct, destructive competition for capital within a vertically integrated structure is unsupported. Capital from outside the company will flow into the company, whether vertically integrated or not, if the regulators authorize a return sufficient to attract capital. A prudently managed utility with an obligation to serve (including an obligation to build transmission) will seek that return, and a commission making lawful, public interest decisions will grant it. So if there is insufficient flow of capital to a particular utility obligation, the fault is either with the regulators for failing to approve sufficient rates, or with the utility management for failing to manage prudently so as to win sufficient confidence from capital markets. The "competition for capital" argument is only argument; it lacks both logic and facts.
- (2) ***Importance of transmission investment:*** As just explained, when transmission investment is a utility obligation, capital will flow if regulators and utility managers act appropriately. Capital flows to transmission investments now, as it has for a century, regardless of whether the investments are made by vertically integrated or transmission-only companies. Somehow vertically integrated utilities in the Southeast are managing to raise capital for nuclear plants far riskier than transmission.



- (3) ***Benefits of the Transco model:*** This is a *non sequitor*. Assuming, for purposes of argument, that the Transco model has benefits not available from vertical integration, those benefits do not depend on either double leveraging or a holding company structure. As Mr. Bay separately pointed out, holding companies and double leveraging exist in contexts other than Transcos; further, Transcos can exist without holding companies or double leveraging. In any event, the notion of a "more focused business model" is a double-edged sword. A transmission-only company makes money only through transmission; thus its profitability depends on persuading decision-makers to approve transmission. A traditional utility, in contrast, has an obligation to serve its customers at least-cost, taking into account all possible solutions to find the most cost-effective mix of generation, transmission, distribution, energy efficiency and demand response.

***Caution:*** There is real public interest value in making transmission ownership and control independent of generation, such as preventing discrimination. But those arguments do not need double-leveraging. Mr. Bay has bootstrapped double leveraging onto Transco benefits, just because Transcos benefit from double leveraging. As for the possibility that Transcos can provide more innovative services, there is no proof. Innovation depends on company culture and regulatory expectations, which can vary with human nature; it does not necessarily vary with corporate form.

- (4) ***Financial model leads to stronger credit ratings:*** This is an obscure way of stating the obvious: The more money regulators force ratepayers to pay, the happier are the creditors. That fact of life also is independent of double leveraging and holding company form.

## **5. Leveraging, whether or not double leveraging, is risky**

- a. ITC itself stated, in its filings with the Securities and Exchange Commission:

"[ITC's] substantial indebtedness can have several important consequences, including, but not limited to, the

following: If future cash flows are insufficient, ITC may not be able to make principal or interest payments on its debt obligations, which could result in the occurrence of an event of default under one or more of those debt instruments....A substantial portion of the dividends and payments in lieu of taxes ITC receives from its regulated operating subsidiaries will be dedicated to the payment of interest on its indebtedness, thereby reducing the funds available for working capital expenditures and the payment of dividends on its common stock....ITC's ability to secure additional financing prior to or after existing [debt] facilities mature, if needed, and in connection with the merger may be substantially restricted by the existing level of ITC's indebtedness and the restrictions contained in ITC's debt instruments. ITC's substantial indebtedness could place it at a competitive disadvantage and make it more vulnerable to general adverse economic conditions."<sup>10</sup>

- b. Ironically, a 60-40 equity ratio implies financial strength; that is what ratepayers should be getting, given their high rate payments. But as the quotes about leveraging's risks make clear, they are not getting that benefit. Double leveraging makes the company weaker.

**C. Seek supranormal returns to perform obligatory tasks**

1. The purpose of rate regulation is to provide compensation for performance. The typical "incentive" proposal fails this test.
2. Utility incentive proposals usually amount to an increase, in some form, in the dollars that would be produced by the traditional revenue requirements formula. (As Peter Bradford famously said, "regulation is incentive regulation.") This increase in compensation is not matched by an increase in performance, but the performance obligation is rarely defined. The proposal is for a supranormal return without any commitment to supranormal performance. (This can only happen in a regulated, monopoly market. In a competitive market, sellers have no choice but to match returns with performance-or-lose customers.)
3. Example: One prudent transmission practice is to build transmission when necessary. A second prudent transmission practice is to use the best

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<sup>10</sup> ITC's SEC Form S-4 Registration Statement at p.64 (Dec. 3, 2012).

available technology. A third prudent transmission practice is, where transmission ownership induces anticompetitive behavior, to turn ownership over to a third party—selected because it is the party most likely to create benefits for consumers (as opposed to that third party willing to pay the most to the seller). Prudent utility practice deserves normal rates of return, not extra cash. Yet FERC grants extra money for each of these actions. (It is true that Federal Power Act Section 219 requires FERC to grant "incentives," but the statute grants FERC sufficient discretion that it need not require ratepayers to pay extra for actions the utilities should be doing anyway—especially where the state commissions are sufficient alert to require those actions.)

#### **D. Shift normal business risks to ratepayers**

##### **1. Risk of bad luck**

- a. "Prudent actions can produce uneconomic outcomes. A new pipeline overruns its budget, due to unpredicted and unavoidable siting disputes. A new power plant ends up with excess capacity, because customer demand falls below reasonable forecasts. A trusted fuel supplier goes bankrupt, forcing the utility to buy high-cost substitutes on the spot market. A gas company's financial hedges become unnecessary (expensively so), because fuel prices drop. An experimental power plant technology fails, forcing the utility to abandon construction. When prudence combines with disappointment, who bears the extra cost—shareholders or customers?"<sup>11</sup>
- b. Regulators have no constitutional obligation to impose the cost of bad luck on the customers.<sup>12</sup> Note, though, that state statutes could grant shareholders protection than the Constitution does. Putting business risk on the customer separates decisional authority from decisional accountability. It relieves utilities of normal business risk, undermining a culture of conservatism and care within the company.

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<sup>11</sup> Quoted from Scott Hempling, *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction* at Chapter 6.D (American Bar Association 2013).

<sup>12</sup> See *Duquesne Power & Light v. Barasch*, 488 U.S. 299 (1989) (rejecting utility's view that the Constitution requires recovery of prudent investment, regardless of the investment's usefulness).

## 2. Risk of business shrinkage

- a. Customers are seeking and finding alternatives to the traditional utility. I have long argued that these customers have to pay off the past: the utility's costs, not yet recovered, prudently incurred to meet the historic obligation to serve.
- b. But future investment is another story. If large numbers of customers find alternatives to the traditional utilities, those utilities will be smaller. This happens to any business whose former customers substitute self-supply for purchases. It happens to bakeries when people bake their own bread and groceries when people grow their own tomatoes. In the utility context, this shrinkage, if handled carefully, will reduce costs for all. It may be sad news for utility shareholders who bought stock betting on constant growth. But that's not regulation's concern. In regulation, we care about compensating the utility fairly for its investment but we don't cover shareholder bets.<sup>13</sup>

### E. Reduce business risks without reducing authorized return equity

1. In utility ratemaking, the annual revenue requirement is based, in large part, on projected costs. A key shareholder risk is that actual costs will exceed projected costs. To reduce this risk, utilities are proposing, and commissions are approving a, mix of devices. They include riders, cost trackers, surcharges, pre-approvals and decoupling. The most risk-reducing of these devices is the formula rate.

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<sup>13</sup> See *Market Street Railway Co. v. Railroad Commission of California*, 324 U.S. 548, 554, 557, 567 (1945), showing no constitutional sympathy for a company whose services are no longer needed:

[I]f there were no public regulation at all, this appellant would be a particularly ailing unit of a generally sick industry. The problem of reconciling the patrons' needs and the investors' rights in an enterprise that has passed its zenith of opportunity and usefulness, whose investment already is impaired by economic forces, and whose earning possibilities are already invaded by competition from other forms of transportation, is quite a different problem. . . .

The due process clause has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces.

2. A formula rate, in its most advanced form, combines the features of all the other devices. Its main purpose is to convert return on equity from a residual into a guarantee. As Stephen G. Hill has explained:

"The return on equity in traditional regulation is a residual. That is, under normal regulation the return on equity or the profit a utility earns is what remains after all other operating expenses have been met (operating expenses, interest expenses, taxes, salaries, pension expense, etc.). Because both revenues and expenses may be more or less than anticipated, the residual—the rate of return on equity or profit to the firm—will vary or fluctuate. It is this variance or volatility of the return that makes utility common equity a more risky investment than utility debt. With a debt instrument, the monetary stream to the [debt] investor is known with certainty. Normally, with a common equity investment, the residual return to the investor is volatile—under FERC's formula rate, it is not."

"The FERC formula rate allows the utility's return on equity to be collected in rates like an expense and [at the end of the year] trued up so that the earned return will always equal the allowed return. The FERC formula rate of return on equity, therefore, will not vary and is, in effect, a guaranteed return that the utility will earn with certainty."<sup>14</sup>

3. If a commission approves a risk-reducing device, but does not commensurately reduce the risk-related return on equity, the utility will overearn. FERC has recognized this point, at least conceptually, as Hill points out: ". . . FERC has recognized that a formula rate structure in which the return on common equity is recovered with no variance substantially reduces risk and calls for a much lower return on equity than is normally allowed under traditional regulation." *Id.*

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<sup>14</sup> Testimony of Stephen G. Hill, *In Re Joint Application of Entergy Louisiana and ITC Holdings, et al.*, Louisiana Public Service Commission Docket No. U-32538 at pp. 30-31 (Apr. 10, 2013).

### III. Regulatory Omissions

#### A. Accept aspirations rather than compel commitments.

Example from FERC's decision approving ITC's acquisition of Entergy's transmission:

"Although Applicants have acknowledged that the Proposed Transaction will have an effect on rates due to the use of an actual capital structure targeting 60 percent equity and 40 percent debt, agree with Applicants' conclusion that those effects are offset by the benefits of independent transmission company ownership over the Entergy transmission facilities. As Applicants note, the Proposed Transaction will benefit customers in the Entergy footprint and bring an independent transmission company to a region that has not experienced the benefits of independent transmission ownership. We agree with Applicants that transferring Entergy's transmission facilities to ITC Holdings will strengthen the Entergy Operating Companies' focus on generation and distribution. Further, we note that the benefits discussed below are over and above any benefits that will result from Entergy's integration into MISO. In other words, these benefits are due to ownership of Entergy's transmission assets by an independent transmission company, and are benefits that are not attributable to Entergy's integration into MISO."<sup>15</sup>

#### B. Accept, uncritically, the view that bigger is better.

Concerning ITC's proposed acquisition of Entergy's transmission:

"ITC is an acquisition company. Its business model is to leverage and acquire. (*See* ITC's S-4: "ITC is highly leveraged and will assume and incur substantial additional leverage in connection with the merger, which may have an adverse effect on ITC's business and the value of ITC common stock.") With each leveraged acquisition, it pays premiums based on the assumption that transmission will be (a) relatively free of competition and (b) well-compensated under FERC ratemaking. But its ratings advantage could reverse itself under plausible changes in those

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<sup>15</sup> *ITC Holdings Corp., Entergy Corporation*, 143 F.E.R.C. para. 61,256 at para. 124 (2013) (footnotes omitted).

assumptions. Transmission's monopoly role could be disrupted by new technologies like storage and other "non-transmission alternatives," which FERC's Order 1000 seeks to encourage. The high compensation levels could come down, as FERC is signaling in its 2012 Policy Statement on Transmission Pricing. ... And there could be more challenges to the prudence of transmission investments, as FERC is signaling in its May 2013 Order requiring revisions to formula rates for MISO and all its transmission owners, including ITC."<sup>16</sup>

#### **IV. Regulatory Solutions**

##### **A. Context: Repeal of the Public Utility Holding Company Act of 1935.**

PUHCA 1935 imposed conservatism on utility holding companies by limiting the amount of nonutility businesses, by requiring financing to match the requirements of utility service, by preventing utilities from using ratepayers to finance non-utility businesses, by reviewing in advance and limiting interaffiliate financial transactions (including limiting double leveraging), and by limiting geographic expansion. All these financially conservative limits are now gone. States have to replace those regulatory protections with visions and standards.

##### **B. Regulators should establish a vision for corporate structure,** by addressing each possible utility action, and determining whether to prohibit it, permit it without review, or subject it to reviews and conditions. See attached table.

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<sup>16</sup> Direct Testimony of Scott Hempling, Mississippi Public Service Commission Docket No. 2012-UA-358 (June 20, 2013).

**Corporate Restructuring by Public Utilities: How Should Regulators Prepare and Respond?**

Corporate Event	Prohibition?	Regulatory Action	
		Reviews, Limits and Conditions?	Permission w/o Review?
1. Utility merger with another utility			
a. operationally integrated			
b. not operationally integrated			
2. Utility acquisition of nonutility			
a. for utility purpose			
b. not for utility purpose			
3. Nonutility acquisition of utility			
a. acquirer has operational relationship to utility			
b. acquirer has no operational relationship to utility			
4. Interaffiliate transactions			
a. goods and services: sale to utility			
b. goods and services: sale by utility to nonutility			
c. financing: loan or guarantee to utility			
d. financing: loan or guarantee from utility to nonutility			
5. Issuance of debt or equity			
a. at the holding company level, for utility purposes			
b. at the holding company level, for nonutility purposes			
c. at the utility level, for utility purposes			
d. at the utility level, for nonutility purposes			
e. at the nonutility level, for utility purposes			
f. at the nonutility level, for nonutility purposes			
6. Divestiture or spin-off			
a. of utility assets serving your state			
b. of utility assets serving other states			
c. of nonutility assets or businesses			
7. Use of utility assets for non-utility business			
a. utility assets in your state			
b. utility assets in other states			