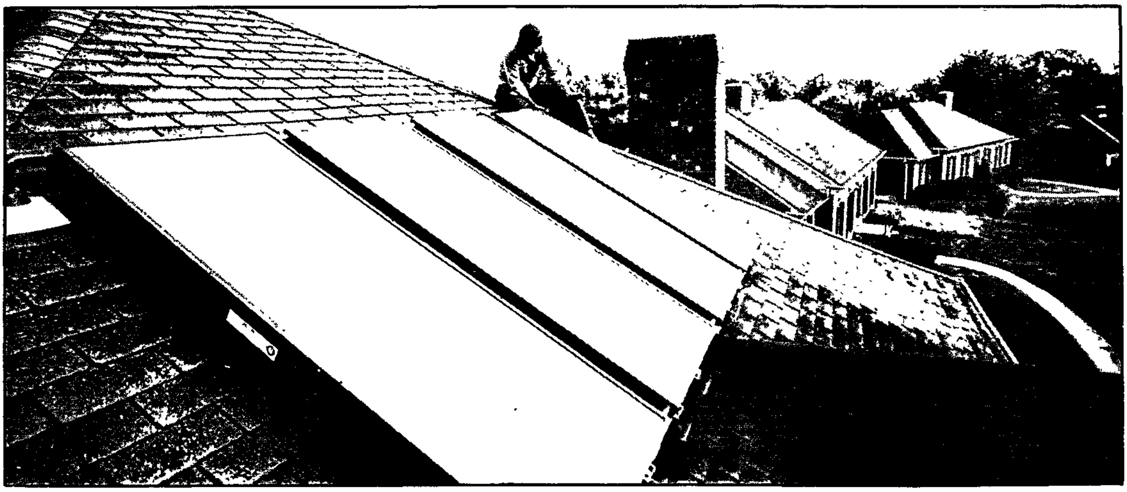


Courtesy Piedmont Natural Gas Co.

The PNG Conservation Company, which sells solar energy systems, is a division of Piedmont Natural Gas Co.

Utility Companies Expand Into New Markets

Utility companies, like other corporations, are increasingly diversifying—into solar products, home insulation, even cable television. But utilities, unlike other corporations, have a state-awarded monopoly franchise for their principal product. The N.C. Utilities Commission has a mixed record of monitoring the flow of capital between a regulated utility business and a nonregulated subsidiary venture.

by Ken Friedlein, Bill Finger, and Anne DeLaney

"The profits of the natural gas utility belong to the shareholders."

—John H. Maxheim, President and Chief Executive Officer, Piedmont Natural Gas Company

"The significant [regulatory] concern is for protecting the public interest as utilities pursue diversification."

—1982 Report of the Ad Hoc Committee on Utility Diversification, National Association of Regulatory Utility Commissioners

In October 1978, John Maxheim took over the presidency of the largest natural gas company in North Carolina. Piedmont Natural Gas (PNG) had just been through a rough time—laying off employees, offering less than adequate service, and paying a poor rate of return to its shareholders. Availability of gas supplies from the southwest had been part of the problem. Maxheim, who had been working to diversify United Cities Gas Company in Nashville, Tenn., wanted to avoid being dependent on a single product at his new corporate home.

Maxheim's diversification campaign began modestly, with an ad for PNG's home insulation business. Actually PNG hadn't sold any insulation yet, but that didn't deter Maxheim. Under the National Energy Policy and Conservation Act (PL 94-163), then about to be signed into law, public utilities not already engaged in the insulation business would not be allowed to get in. The ad qualified PNG, which is

Ken Friedlein is assistant business editor for The Charlotte Observer. *Bill Finger is editor of* North Carolina Insight. *Anne DeLaney, formerly an intern at the N.C. Center for Public Policy Research, is a free-lance writer.*

a public utility, to add insulation to its growing list of products.

Piedmont Natural Gas still hasn't sold much insulation, $258,000 worth in 1981. But in hedging his diversification bets, Maxheim signaled a new course for PNG's future. No longer was PNG merely a public utility serving 200,000 Carolinians. To accommodate its diversification, PNG created in 1980 a wholly owned subsidiary, PNG Energy Company, with six separate nonutility companies. The subsidiary's product lines included propane, coal, oil, solar installations, a cable television franchise, and satellite TV systems. Unlike PNG's main "product line"—its monopoly franchise to sell natural gas to residential, commercial, and industrial customers in 60 North and South Carolina communities—none of the PNG Energy Company ventures is subject to regulation by the N.C. Utilities Commission. By 1982, the total operating revenues from the company's nonregulated ventures had climbed to $14.4 million, about 5 percent of its total revenues of $315.8 million. Maxheim hopes that these nonregulated ventures can eventually account for 20 percent of PNG's profits.

"Natural gas distribution companies are entering a potentially very difficult period," said Maxheim. "The present [federal] level of deregulation will cause many of us to lose substantial markets. If we are to stay financially viable corporations, which can attract capital at reasonable rates and maintain our experienced and valuable work force, we must be allowed to enter nonregulated activities without the crippling stranglehold of utility regulation."

Some analysts contest whether gas companies face such a bleak picture. Indeed, Piedmont's own annual report points with pride to its growing number of customers. But Maxheim's major point sums up a growing controversy within utility circles throughout the country. To what extent should state utility commissions regulate the diversification of utility companies into subsidiary ventures?

Increased Diversification Poses Regulatory Challenge

In 1982, the National Association of Regulatory Utility Commissioners (NARUC) released its second major report in a decade on the importance of diversification. "Persuasive arguments can be made both in favor and in opposition to utility diversification," says the report. "Potential risks to monopoly ratepayers are associated with diversification by utilities. How significant are these risks? This determination ultimately *must be made by each state regulator*" (emphasis added).[1]

The "state regulator" in North Carolina is the Utilities Commission. Like most such regulators, the seven commissioners in North Carolina do not come to diversification cold (see page 5 for a biographical sketch of each). In fact, the first nonutility subsidiary in North Carolina predates the N.C. Utilities Commission, formed in 1941, by 31 years. In 1910, Duke Power Company organized the Mill-Power Supply Company to supply equipment to textile mills and other industries then converting to electricity. In recent years, however, the commissioners have had to deal with a growing number of ventures outside of the utility field.

Duke Power, for example, expanded into timber, mining, and other areas not generally regulated by the Utilities Commission. In 1969, Duke Power formed the Crescent Land & Timber Company (one of the largest land owners in the state, 270,000 acres); in the 1970s it formed the Eastover Mining Company and Eastover Land Company; in 1978, it formed Western Fuel Inc. to explore for uranium; in 1982, it formed Duke Power Overseas Finance in the Netherlands Antilles "to provide Duke Power with financial resources from outside the United States," as the company's 1982 annual report puts it; and since 1981, the company's marketing department has been expanding into such new services as providing statistical information to other companies.

The oil embargo of the early 1970s prompted many utilities to try to gain control over their energy sources. Hence, they diversified "vertically"—that is, within the energy field, from fuel source through means of distribution to home appliances. But, as they diversified, many utilities were going through a particularly difficult period for other reasons. Electrics (especially those committed to building nuclear plants) faced soaring construction costs and capital accumulation problems while gas companies coped with complex federal supply regulations. Meanwhile, a more conservation-conscious public began using less energy, and "alternative" energy sources hit the market (see "Alternative Energies for Future Needs," *N.C. Insight,* Winter 1980).

By the early 1980s, major business and utility publications were analyzing the key diversification issues before state regulators. A sampling of the titles suggests the scope of the articles: "Why Electric Utilities are Buying into Coal"; "The Coming Transformation in Electric Service: Entry into Cable Television"; "Can 'Advance Approval' Control Diversification?"; and "A High-Risk Era for the Utilities."[2] Many of the journals discussed the diversification strategies from the viewpoint of a utility

Subsidiaries

DUKE POWER COMPANY

Subsidiary Investments

(dollars in thousands)

	December 31 1982	1981
Property and investments—at cost		
Real estate, recreational and land development	$ 33,391	$ 32,057
Coal mining	56,545	89,457
Net current assets, principally investments, receivables and inventories	46,820	7,104
Total assets	136,756	128,618
Coal production commitments	(24,868)	(37,272)
Deferred income taxes	(36,458)	(36,365)
Total liabilities	(61,326)	(73,637)
Investments in and advances to subsidiaries	$ 75,430	$ 54,981

Crescent Land & Timber Corp.

Formed in 1969, this subsidiary manages approximately 270,000 acres of "non-utility" property consisting primarily of timber lands surrounding Duke Power's hydroelectric facilities, but also inclu...

Crescent has instituted new programs to search for other natural resources which may exist on its properties, including oil, gas and various minerals. Additional programs are under way to determine the best use for properties, which...

In 1982 Crescent harvested 32 million board feet of timber and 62,000 cords of pulpwood. Approximately 2 million new trees are being planted each ye... Since Duke ... tion ac...

From Duke Power's 1982 Annual Report

company. But, in the end, most brought the concern back to the regulatory table. As *Business Week* put it on February 23, 1981, "State regulators are becoming increasingly fearful that diversification will distract utility management's attention from its primary business."

Asked if he was "fearful" about the impact of diversification, N.C. Utilities Commissioner Edward B. Hipp responded that such uneasiness has surfaced more often in other states than in North Carolina. "We have the concern and always watch to be sure that nonutility costs are separated out in rate cases," says Hipp, who served on the NARUC committee that released the 1982 diversification report. "But we've never discouraged diversification because, number one, the statutes recognize the rights of utilities to engage in nonutility business. Number two, it's a fact of life and has been for a long time."

No specific enabling legislation exists for public utilities to engage in diversified activities, but a number of statutes recognize such corporate activity. "If any person conducting a public utility shall also conduct any enterprise not a public utility, such enterprise is not subject to the provisions of this Chapter," reads the N.C. statute that addresses the issue most directly.[3]

The "fact of life" that Commissioner Hipp has observed is becoming more prevalent with Duke Power, PNG, and other utilities. "We plan to expand our propane operation throughout our 26-county natural gas territory," says Jack Knox, vice-president for consumer affairs, Public Service Company of North Carolina. Carolina Power and Light (CP&L) now owns 100 percent of two coal mining operations.

Diversification by American corporations is, of course, nothing new. R.J. Reynolds Inc. bought Hawaiian Punch in 1963 and now, tucking Del Monte Corporation and Heublein Inc., among others, under its belt, has become a major American foods concern. Meanwhile, Spring Mills Inc. tried frozen foods, flopped, and returned to textiles. The managements of R.J. Reynolds and Spring Mills took calculated risks and lived with the results. Stock prices rose or fell, profits and losses were absorbed, and capital became more or less accessible to the parent company, depending upon the vagaries of the market and the successes of the diversification. But the utilities are not tobacco or textile companies.

Executives at PNG, Duke Power, and other utility companies begin their business day with a state-awarded franchise atop their desks. The state of North Carolina has granted these managers an unusual opportunity in a free enterprise economy: the opportunity to have a monopoly. In return for committing to provide telephone, gas, electric, and similar services, utility companies receive from the state the right to operate exclusively in a given territory and to charge rates that will cover expenses and return a profit to the companies' stockholders.

This franchise serves two purposes. First, consumers—denied a choice in utility suppliers—have some protection from pricing abuses by a utility monopoly. Second, the utility is allowed an opportunity to earn a "fair rate of return," or profit, which the company can use to reinvest in the business and pay dividends to shareholders. The allowed rate of return is set to make utility stock attractive to investors; thus the utility can raise capital and remain strong financially. As far as a utility's principal business is concerned, the state follows rigorous ratemaking procedures to balance the interests of both consumers and utility shareholders. (For more on the process of setting rates, "fair rate of return," etc., see sidebar by Hugh Wells on page 6.)

The state has not been so rigorous, however, in monitoring how a utility's expansion into a nonregulated business affects the ratepayers, the stockholders, and the nonregulated markets into which utilities are expanding. In considering diversification issues, state regulators seldom analyze closely such questions as these: Who is paying for a utility's expanding into, and operating, its nonutility businesses? Are the nonregulated ventures generating additional profits and enhancing the utility stocks, or are they draining resources and jeopardizing a utility's overall financial health?

Diversification poses difficult questions for state officials charged with regulating and monitoring utilities in North Carolina. The primary concern revolves around the potential for "cross subsidization" between regulated and nonregulated businesses. Financial jargon aside, "cross subsidization" boils down to this question: How and to what extent may dollars flow within a public utility's corporate structure? A "cross subsidy" refers to some type of financial support—i.e., "subsidy"—from one operation within the utility's corporate structure to another, usually from the regulated to the nonregulated venture.[4]

There are four primary ways in which a subsidy can pass from the regulated business to a nonregulated activity: improper cost allocation, inflated transfer prices, capitalization of a nonregulated venture, and below market pricing. These four terms, like "cross subsidization," would do admirably in competition for "Best Obtuse Jargon." But the admission price would be worth paying. In each case, the jargon translates into cold cash.

Cost Allocation: Whose Figures to Believe?

The costs of running a nonregulated venture should be borne by the customers of that activity, not by the ratepayers. For over a decade, the N.C. Utilities Commission has been unequivocal on that point. "It seems clear that under the statutory law of North Carolina, Duke [Power] has the corporate authority to engage in nonutility activities," the commission ruled in a 1971 rate case involving Duke Power Company and its subsidiary, Crescent Land & Timber. "[But] the ratepayers are not required to provide any return on this wholly unrelated investment. No service shall be rendered to Crescent Land & Timber Corporation by Duke employees without compensation from Crescent to Duke."[5]

Few argue with such a premise on allocating costs—in theory. But separating all the costs of nonregulated ventures from those of the regulated activity—on which utility rates are based—can be arbitrary at best and misleading at worst.

In 1981, Piedmont Natural Gas had a rate hearing before the Utilities Commission that raised a variety of questions regarding cost allocation. The Public Staff, which represents the public before the commission in rate hearings, hired a consulting firm to analyze PNG's subsidiary operations. Currin and Associates, the Raleigh-based firm that conducted the PNG study, provided the Public Staff with an 83-page report and testified before the commission during the hearing.

Currin and Associates examined how PNG allocated costs in transportation (using the same vehicles for installing propane and gas), staff time (employees working for several PNG companies), insurance premiums, joint properties, and other areas. When an exact allocation could not be determined among the subsidiaries and the utility, PNG used a "common pool" approach. Overall, Currin and Associates gave PNG a clean bill of health, but they did discover some minor irregularities.

"The subsidiaries were not being charged rental for utility land which it utilizes in its operation," Currin found, for example. Ten PNG storage tanks in Charlotte had been assigned to the PNG Propane Company subsidiary. "The land on which these tanks are located remains on the books of the utility, and no rental fee is charged to PNG Propane."[6]

Currin felt that in its *common pool calculation* alone, PNG overallocated the natural gas business by $133,403. "It is difficult to find an all inclusive cost allocation method since Piedmont is engaged in subsidiary activities of widely differing natures," the Currin researchers concluded.[7] Currin did suggest, however, an improvement in the accounting procedures used in the common pool costs. "The Massachusetts Formula [an accounting system] used by Piedmont is acceptable, with the provision that the formula would be modified to an *end-of-period* level which is consistent with normal regulatory practice" (emphasis added).[8] PNG had used an *end-of-year* adjustment under the Massachusetts Formula rather than an *end-*

of-period adjustment. End-of-period, when customer rates for natural gas change, does not necessarily coincide with the end of either a calender year or a company's fiscal year.

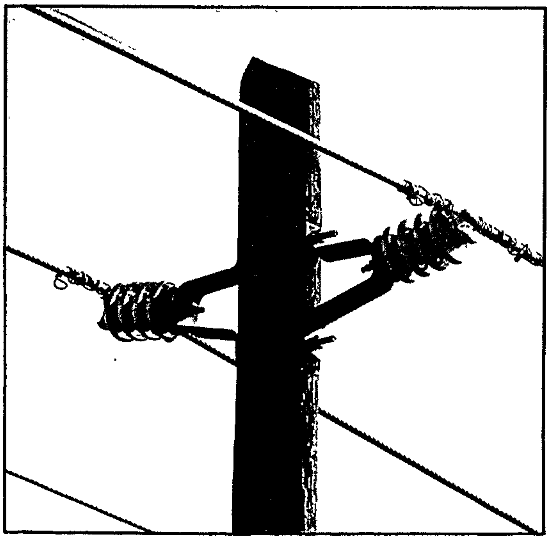
In determining cost allocations during the 1981 PNG rate hearing, the Utilities Commission treated cost allocation as "an art, not a science," as the 1982 NARUC report put it. The Utilities Commission ruled that PNG had overallocated some $467,000 in nonutility expenses to its utility operations.[9] If this amount had not been disallowed, residential customers, who buy about one-fourth of PNG's gas, would have "subsidized" PNG's nonutility operations with only 69 cents of an average yearly bill of $486. Similarly, commercial and industrial customers of PNG gas would have also "subsidized" PNG's nonutility ventures.

"In 1983, the company decided that the best way to handle allocation issues was to completely, physically separate all nonutility activities from the utility operation—separate office buildings, payrolls, computer operations, and billings—so that no question could be raised regarding the proper method of allocation," says PNG President Maxheim. "Actually, the propane dealers had recommended this in their intervention [in the 1981 rate case]."

As diversification increases, proper cost allocation by the utility can never be assumed. Given the scope of new product lines, the variations in acceptable accounting procedures, and the complexity of utility operations, only close scrutiny by the commission can ensure that the ratepaying public will not subsidize the stockholders of a utility company.

Inflated Transfer Prices—Buying from Yourself Isn't Always Cheaper

In the 1970s, Duke Power and CP&L decided to diversify "vertically"—that is, to expand into an area functionally related to its production of electricity. They wanted to secure reliable fuel supplies and theoretically to cut their operating expenses. Both Duke Power and CP&L bought substantial interests in coal mining operations, which would fuel their generating plants. "CP&L entered into coal mining not as a money-making venture but to ensure (at a time when national concern over future coal supplies was high) reliability of supply of good quality coal," says CP&L Board Chairman and President Sherwood Smith. "Use of the corporate subsidiary structure was a means of drawing on the services of an experienced coal mine developer [which invested with CP&L in the coal venture]." Entering into coal mining, says Smith, was "an integral part of the company's duty to serve."



Jackson Hill

In buying coal from its own subsidiaries, Duke Power and CP&L were engaged in "transfer pricing." These utilities had to decide on how high to price the transfer of goods and services from their subsidiaries to the parent operations. Both Duke Power and CP&L sought to recover from its ratepayers a transfer price for the coal *based on cost*. But utilities are regulated companies and thus must live with a transfer price approved by the N.C. Utilities Commission. The commission takes into consideration not only the costs to the parent company but also such factors as the going market rate.

The Utilities Commission has recently determined in several instances a fair transfer price between a utility and its subsidiary. In 1978, the commission denied Duke Power's request to charge its utility operation $55 per ton for coal purchased through the Peter White Coal Company. (Duke Power put up the capital to open this mine and purchased the coal on a cost plus management fee basis.) The commission permitted only $32 a ton, which approximated the market-level price. In 1982, the commission again cited Duke Power for charging its utility operations more than necessary for coal. The commission did not allow Duke Power to charge its customers the full cost of coal from its subsidiary, the Eastover Land Company, and accordingly reduced the company's rate increase request by $6.7 million.

"The evidence clearly shows that for the period January 1979 through May 1982," the commission found, "the prices Duke paid for coal purchased from Eastover were significantly greater than the prices Duke paid for slightly higher quality coal purchased from its nonaffiliated long-term contract suppliers."[10]

Duke Power, trying to recover what it was costing to mine its coal, wanted to pass as much of the costs as possible on to its electricity users, instead of to its stockholders. The Utilities Commission, with regulatory authority over the *electricity-producing part of the Duke Power conglomerate*, ruled otherwise. The transfer price allowed by the Utilities Commission in the end caused Duke Power to get out of the coal business. "The Company determined to sell these [coal] properties after the most recent rate order from the North Carolina Utilities Commission prohibited full recovery of the cost of coal from these mines," Duke Power explained in its 1982 annual report.[11]

Duke Power is not the only electric utility with coal troubles. In 1974, CP&L requested permission from the Utilities Commission to buy into coal. The commission gave CP&L a green light on buying 80 percent of the stock of two coal mining ventures known as "Leslie" and "McInnes." The Leslie mine was completed in 1979, and McInnes started producing in 1980. "After doing the adjustments in the Duke case, we decided to look at CP&L's coal activity more closely," says Bill Carter, director of accounting for the Public Staff. "This was the first year [1983] that we've gone in and examined it closely."

After its investigation, the Public Staff argued that CP&L was recovering too much from the ratepayers for its coal costs. The commission agreed. "CP&L has mistakenly interpreted and applied prior orders of this commission which specified and directed the methodology to be used to compute the amounts charged to North Carolina retail ratepayers for coal purchased from CP&L's affiliated coal mines," the commission reported. "It is appropriate that such mistakes be corrected by this commission."[12] To correct the coal costs CP&L charged ratepayers from 1979 through April 1983, the commission reduced CP&L's 1983 rate request by $6.5 million.[13]

Transfer pricing will remain an important potential "subsidy" from ratepayers to stockholders as long as utilities buy part of their goods and services from a subsidiary. "The most familiar danger is backward [i.e., vertical] integration—of gas companies into gas production, electric companies into the coal business, telephone companies into equipment manufacture—along with artificially high transfer prices, as a means of effectively circumventing regulation and exploiting ratepayers," explained Alfred Kahn, representing 5 gas distribution companies and 15 electric utilities, to the National Association of Regulated Utilities Commission Ad-Hoc Diversification Committee. Kahn, a former New York Public Services Commissioner and economic adviser to President Jimmy Carter, went on to say that regulators generally have the tools they need to control improper transfer pricing. "Where the utility has integrated into a relatively competitive industry, this danger can be readily avoided. Commissions can apply a fair market price to test whether the utility is overcharging itself, and ultimately its ratepayers, for transferred products and services."[14]

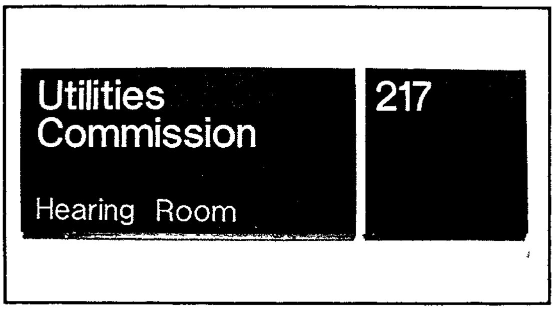
Capitalization of a Nonregulated Venture

"How will a utility finance the start-up of a new diversified venture or the acquisition of an existing company?" asks the NARUC diversification study. In a paragraph-length answer to its own question, the NARUC study summarizes this important issue:

"Utilities choosing to diversify must find ways to finance their new ventures. . . . Regulators may be concerned if utilities use their monopoly business credit or funds from the sale of utility securities [i.e., stocks and bonds] to raise capital for nonutility operations, particularly if the utility has large capital requirements of its own. This funding mechanism could be considered as an indirect subsidy from ratepayers. Nonutility financing may impair utility financing."[15]

Regulators in North Carolina generally think NARUC overstates the point in saying "this funding mechanism could be considered as an indirect subsidy from ratepayers." The N.C. statutes certainly give the commission ample power to address this type of subsidization: "No public utility shall pledge its faith, credit, moneys, or property for the benefit of any holder of its preferred or common stocks or bonds nor *for any other business interest with which it may be affiliated* . . . without first making application to the Commission and by order *obtain its permission so to do*" (emphasis added).[16]

In granting permission to expand, however, the commission has usually focused on cost allocation or transfer pricing concerns, not on sources of capital. In 1974, for example, the



Michael Matros

commission allowed CP&L to proceed with its plans to buy into the Leslie and McInnes coal mining ventures. But in its ruling, the commission concentrated on defining "fair market value" of the coal, the issue discussed above under transfer pricing. In giving CP&L the go-ahead, the commission hardly mentioned the capital issue, following a ~~longstanding~~ rule of thumb regarding company earnings.

"A utility is allowed to make a certain return on its franchise business," says Joe Smith, director of finance, statistics, and planning for the commission. "Normally, a company returns 60 to 70 percent of its earnings to its common stockholders, to keep them happy. About 25 to 30 percent are retained by the company and normally used for working capital. What the company does with that 25 to 30 percent is more or less their own business," says Smith.

A company might, for example, use those retained earnings to buy into a coal company, with the commission's blessing. "In effect, CP&L put in a small amount of equity—that is, retained earnings—and borrowed funds for the rest of the investment," remembers Smith. "Once it gets to retained earnings, it's the stockholders' money."

Robert Weiss, director of the economic division of the Public Staff, essentially agrees with Smith. "In a rate case, the commission sets a rate of return which it allows the utility to try to earn. The earnings by the utility then belong to the stockholders," Weiss says. "So there's no way the ratepayers can subsidize a utility's investing into a subsidiary if the rate of return is set correctly."

Before expanding into a new venture, utility companies have generally sought to have the commission clarify how the expansion will affect the rate base. The cost of products a utility purchases from a subsidiary includes a return on the capital invested in that subsidiary. The costs of these products are either included as expenses in the year purchased or are capitalized and included in the rate base, depending on the type of product. The larger the rate base, the larger the return the commission will grant the company, all other things being equal.

"Before a utility would expand, it would want the assurance that the commission would allow it to recover the cost later," explains Public Staff Director Robert Gruber. "If the commission has blessed the [subsidiary] transaction, the company feels sure it can recover the costs."

In a 1978 Duke Power request to invest in a uranium venture, the commission blessed the effort without raising significant questions about the Duke Power ratepayers subsidizing the company's stockholders. In a notable but hardly remembered dissent, however, then Commissioner Leigh Hammond, an economist and formerly a vice-chancellor at N.C. State University, did raise the issue of cross subsidization through capital sources.

"This [majority] decision takes the commission another step in the direction of forcing the customers of public utilities to assume risks and provide financing for activities that should be pursued by nonutility business firms, and supported by the venture capital market," began Hammond. Next he hammered at "one of the foundation stones of our enterprise economy," as he put it, the "risk and reward principle."[17]

"Apparently the Company (Duke) is unwilling to let its wholly owned subsidiary enter this exploration and mining venture without being tied back to the security of the utility operation. . . . Those individuals, or institutions, who *voluntarily* provided investment funds would reap the benefits from a successful venture or the risks of loss if the venture fails" (emphasis in original).

Hammond then got to the heart of the matter, even as he introduced the accounting subtleties involved. "More importantly, this decision approves an accounting provision that 'any exploration costs incurred in conjunction with this project which do not result in uranium concentrates being produced *will be charged off to electric operating expense* . . .' (emphasis added). This can mean nothing more than the customers of Duke Power Company will ultimately pay for any losses incurred by this venture. . . . This is a clever mechanism to provide a 'guarantee against loss' for a high risk nonutility subsidiary."

Duke Power officials complained about the commission's ruling for a quite different reason than did Commissioner Hammond. "It limited the return that the utility could earn [on the nonregulated uranium business] to whatever the regulated [business] return was," says Steve Griffith, senior vice-president and general counsel for Duke Power.

CP&L Chairman Smith makes the same point about his company's investment into coal. The commission limits shareholder earnings when the investment turns out well, he says. "This is imposing on stockholders a large risk in order to fulfill the duty to serve." If shareholders have to take a higher degree of risk, contends Smith, the utility may have a harder time raising capital, which can have a negative impact on rate levels and future service reliability.

While this issue has not attracted wide attention among N.C. regulators, it has a high profile in other states and in the national arena.

In 1982, U.S. Rep. Timothy Wirth (D-Col.), chairman of the House Subcommittee on Telecommunications, Consumer Protection, and Finance, held hearings on a rewrite of the Communications Act of 1934. This bill would have permitted American Telephone & Telegraph Co. to enter nonregulated data-processing businesses but only through subsidiaries *which raise their own capital.* If AT&T were to buy into a data-processing enterprise, said the bill, it must do so without using capital from the lucrative—but regulated—long-distance business. The bill, voted out of Wirth's sub-committee, faced strenuous objections from AT&T in full committee, where it died.

In the 1982 hearings before Wirth's subcommittee, AT&T Vice-President and Treasurer Virginia A. Dwyer made the position of regulated utilities crystal clear on this capitalization issue. "The requirement . . . that subsidiaries raise their own capital . . . makes no sense at all," said Dwyer. "If the company elects to invest earnings, which belong to shareowners, in new lines of business, it does so on behalf of shareowners. It is not a subsidy; it is simply a prudent investment decision. To assure fair competition [in nonregulated markets], AT&T needs the same flexibility as its competitors."

A competitor such as an IBM might note, however, that a competitor's flexibility doesn't include whatever profits were generated by AT&T's $30 billion in 1981, through federally regulated long-distance phone revenues. And if a major corporation, like an IBM, has some concern about such subsidization, what might a small-time businessman in North Carolina think about competition from a public utility?

Below-Market Pricing — The Competitive Edge

The three types of cross-subsidization discussed above — cost allocation, transfer pricing, and capitalization of a new venture — all affect whether ratepayers are somehow subsidizing a utility company's venture into a nonregulated area of business. A fourth type of cross-subsidization, "below-market pricing," affects primarily the companies already doing business in an area into which utilities diversify. When a utility company uses its capital assets, retained earnings, market credit, or sheer size to help it underprice the competition, it is engaging in "below-market pricing."

One group of N.C. businessmen worried about utility diversification are companies selling propane (i.e., liquefied petroleum gas). Propane dealers sell on the open market without regulation from the Utilities Commission. During a 1981 Piedmont Natural Gas rate hearing, propane dealers complained that PNG had an unfair advantage in expanding into their area of business. "Our complaints are not about competition per se, but about what we allege to be competition with a public utility which is subsidizing their nonregulated businesses with revenues from the ratepayers and assets of natural gas operations," said G. W. Rowden of the Durane Gas Company in Charlotte, which sells propane gas for home, industrial, and commercial use.

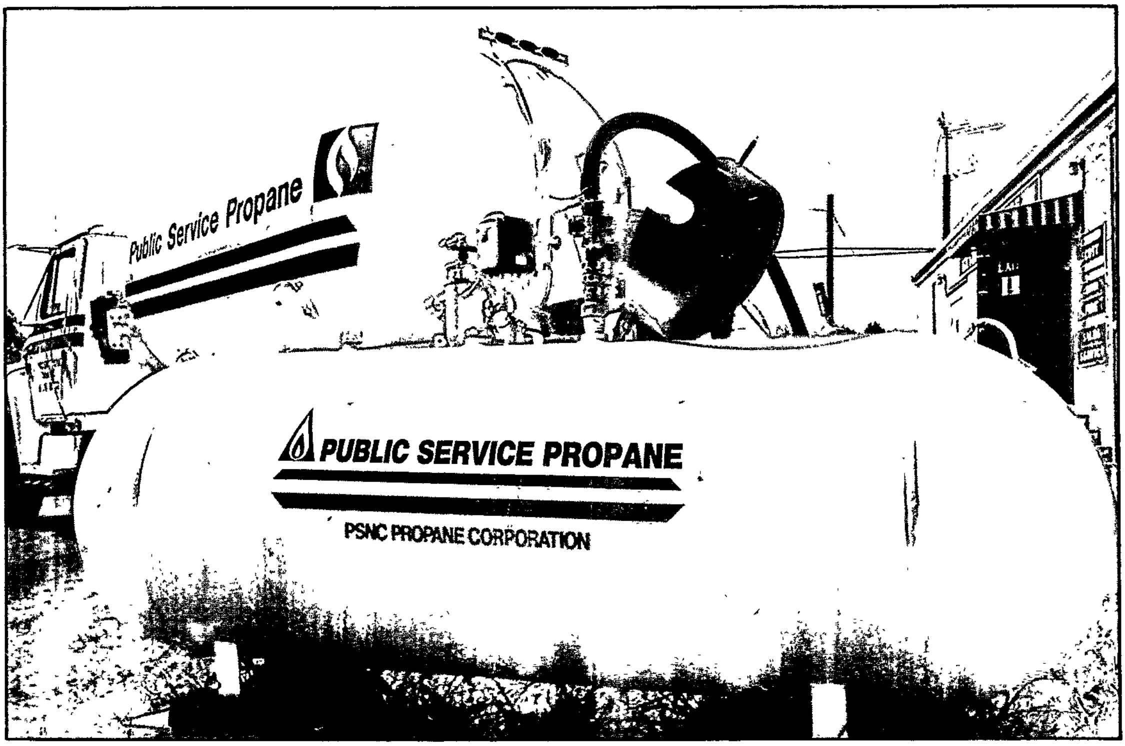
In a report to the Utilities Commission, PNG reported netting in its fiscal year 1980 about $11,300 on $952,000 in retail propane sales, a 1.2 percent return. Rowden of Durane Gas Company says he couldn't live on that kind of return. "You'd like to see 10 percent before taxes," he says. "That would leave at least 5 percent on sales after taxes." In 1980, PNG did hit 5.5 percent on its *natural gas sales* — its regulated business.

If a 1.2 percent return would slow a firm like Durane Gas Company, it did just the opposite to Piedmont Natural Gas. The company's 1981 annual report explains what happened: "Retail [propane] sales were up 252 percent, from $952,000 to $3.35 million, reflecting the aggressive marketing emphasis placed on this segment of the Company's activities."[18] People like G. W. Rowden of Durane Gas Company might ask the question: Where did PNG get the funds for an "aggressive marketing emphasis" if it made only $11,300 on its 1980 sales? The Utilities Commission does not require PNG to answer such a question.

"The propane dealers see a large company using its size and financial clout to get in their business," says Robert Fischbach, director of the Public Staff during the 1981 PNG rate hearing. "That's a fact of life — large companies doing that. I have a lot of sympathy for [the propane dealers'] position." But Fischbach didn't have enough sympathy to hire a firm like Currin and Associates to research possible evidence of below-market pricing (as he had to investigate cost allocation).

"Is the commission going to say, 'You can't involve yourself in nonutility questions'?" Fischbach asked rhetorically. "Those questions were raised [by the propane dealers] in Piedmont's rate case and the commission didn't bite."

The expansion of natural gas companies into the propane business continues to be a concern for small propane dealers. "Early this year [1983] we were visited by Mr. Robert T. Watkins, the marketing vice-president for Public Service, asking about buying part of our



Courtesy Public Service Co. of North Carolina

operation in Shelby," says Bruce E. Byers of North State Gas Service in Forest City, N.C. "They recently bought another propane company there and in Kings Mountain."

Charles E. Zeigler, chairman and president of Public Service Co. (PSNC), explained the PSNC hopes for propane in a May 1983 letter to his shareholders. "We have in place a nonutility retail marketing program to sell propane gas in areas adjacent to our natural gas mains in the central and western counties in North Carolina. . . . This should prove to be an attractive future profit center closely related to our utility expertise, operated by PSNC Propane Corporation, a wholly owned subsidiary."

The PSNC & PNG propane operations appear to be a serious threat to the 200-odd small propane businesses in North Carolina. However, neither the Public Staff nor the Utilities Commission appears to be willing to address this result of diversification. "If a utility engages in a nonutility operation and hurts another business, that operation is not in our jurisdiction," says Public Staff Director Gruber. "That's an antitrust issue, for the Attorney General's office or for the Antitrust Division of the U.S. Department of Justice."

While the antitrust issues may fall outside the Utility Commission's traditional jurisdiction, the policy questions raised by the expansion of utility companies into related but nonregulated ventures fall well within the historical concern of the commission. For example, most gas and electric companies are moving into various conservation and "alternative" energy business areas, from the home insulation business to the solar hot water heater trade. In a 1979 rate ruling, the commission encouraged the electric utilities to help create a new nonprofit N.C. Alternative Energy Corporation (see "Alternative Energy Corporation," *N.C. Insight*, Winter, 1980).

David Aylward, chief counsel and staff director for the U.S. House of Representatives Subcommittee on Telecommunications, Consumer Protection, and Finance, sees advantages to allowing utilities to get into nonutility operations that are closely related to the utility function. Successful diversification efforts, for example, could improve the overall financial health of the utility company. But he also sees a danger.

"Allowing a natural gas utility to insulate homes makes an awful lot of sense, but it immediately raises questions about competitors in the home insulation business," said Aylward in a telephone interview. "Will we have a net economic and social loss? A utility may have a willingness to live with very low profits in the nonregulated areas in the short term in order to use one monopoly [i.e., natural gas] to create another [i.e., home insulation]. *The cost in the long-term is loss of competition in the nonregulated area*" (emphasis added).

Diversification and the New Corporate Structure

While the N.C. statutes give the Utilities Commission substantial power in regulating utility companies, the statutory tools are not as strong as in some states. Under Virginia law, for example, a utility company may engage in activities beyond its franchise only "so far as it may be related to or incidental to its stated business as a public service company," explains Lewis Minter, general counsel to the State Corporation Commission of Virginia, which regulates utilities. "But this statute may be moot," Minter continues. "A utility can circumvent the entire thing by creating a holding company, which is exactly what VEPCO did."[19]

Early in 1982, Virginia Electric and Power Company (VEPCO) created a new corporate structure, a holding company called Dominion Resources Inc. The utility company became only one of several planned subsidiaries. This corporate shift affects North Carolina too, since VEPCO serves northeastern North Carolina.

"They're trying to split up the utility into separate components," says Minter. "Under our existing law, they can set up a holding company, but don't have to come to us. They can create subsidiaries 'til hell freezes over. We're very concerned about cross-subsidization in diversification ventures. We're reviewing this new structure right now to determine up front whether these subsidiaries are in the public interest and how best to control the proposed affiliate arrangements and necessary raising of capital."

VEPCO is proposing to put one or more generating plants into a separate subsidiary which would sell its electricity to VEPCO. "If you have a separate generating company with its capacity sold under contract to VEPCO, then it can have a more favorable capital structure than VEPCO could have," contends Everard Munsey, executive director for public policy for VEPCO. "It would have an increased proportion of debt, resulting in lower total costs. You get more leveraged capital structure and it's cheaper for the ratepayers."

"That's the VEPCO argument," counters Minter, "but we're not ready to buy it." This specific subsidiary arrangement will have to be

---

Recommendations on Utility Diversification

From the National Association of Regulatory Utility Commissioners

Below are excerpts from the recommendations chapter of the 1982 Report of the Ad Hoc Committee on Utility Diversification, *published by the National Association of Regulatory Utility Commissioners (NARUC). These recommendations address a broad spectrum of diversification issues and provide a national context for the specific recommendations made in the accompanying article. Among the 10 members of the NARUC committee that compiled these recommendations were N.C. Utilities Commissioner Edward B. Hipp and former N.C. Commissioner John Winters Sr. To obtain a copy of the full NARUC report, send a check for $15.00 to NARUC, Publications Department, P.O. Box 684, Washington, D.C. 20044. These excerpts are reprinted with NARUC's permission.*

These recommendations represent a synthesis of the committee's varied views and concerns about utility diversification. The subject is an important one for regulatory commissioners even if no utility within a jurisdiction is presently planning to diversify. In jurisdictions where utilities have announced diversification plans, the issue has quickly become controversial, often involving state legislators. It is very difficult to develop a carefully considered policy when the subject of the policy is part of a highly visible controversy. If a utility wants to pursue diversification activities in a timely fashion, it will not appreciate experiencing "regulatory lag" as regulators grapple with the issues raised.

1. While diversification may complicate the already complex and crowded regulatory agenda, efforts to establish satisfactory rules during the early stages will likely pay off by reducing the need to spend time in the future, avoiding future arguments, and possibly averting legal challenges.

2. The burden should be on the utility to show that diversification is consistent with the public interest and that ratepayers will be protected from unreasonable risk and from involuntarily subsidizing diversified (nonutility) activity.

3. Regulators should review their statutory and administrative powers regarding control of the following aspects of utility diversification: (a) affiliated interest relationships; (b) transactions between the utility and any affiliates; (c)

approved by the Virginia State Corporation Commission (SCC) and by the Federal Energy Regulatory Commission (FERC). If the Virginia SCC and FERC approve the VEPCO proposal, the subsidiary composed of generating plants could sell electricity at wholesale rates to its holding company, as regulated by FERC. The holding company would in turn distribute the electricity to the customers.

"My hunch," says Minter, "is that VEPCO is hoping the deregulation fever in Washington would allow them to charge its electric distribution company anything that FERC would approve as a wholesale rate for the electricity."

VEPCO spokesman Munsey insists that "regulation by FERC is incidental."

Gruber, of the N.C. Public Staff, however, shares the Minter hunch. "If FERC regulated the rates instead of the commission, the rates would probably be much higher. FERC is not as vulnerable to ratepayers. People don't go to FERC hearings in Washington like they do to Utilities Commission hearings here."

If Dominion Resources, the holding company of which VEPCO is one subsidiary, gets approval for breaking down its utility franchise into separate components, this new holding company could utilize the transfer pricing technique discussed above *within the franchise portion of its business.* The transfer pricing questions raised above involved a utility company purchasing goods or services from a *non-franchise subsidiary* (i.e., Duke Power or CP&L buying its subsidiary's coal). A separate electric generating subsidiary, in its contract to supply electricity (regulated by FERC), might charge rates higher than the Virginia SCC would allow — just as Duke and CP&L assessed their ratepayers more for the cost of its subsidiaries' coal than the N.C. Utilities Commission eventually allowed.

The Virginia commission is reviewing the VEPCO proposal carefully and expects to issue a decision in 1984. VEPCO's Munsey says that separate subsidiaries will make it easier — not more difficult — to allocate costs correctly to different operations and to prevent cross subsidization. But Minter worries about the impact of FERC taking over some of the regulatory authority and the overall effect of the proposed arrangement on the public interest.

---

accounting procedures; (d) dividend payments; (e) transfer pricing; (f) common cost allocation; (g) holding company formation; (h) conditions on the establishment of a holding company; and (i) periodic review of the impact of diversification on the utility and its ratepayers.

4. Regulators should consider establishing a policy wherein any utility wishing to diversify is required to prepare and present the following:

a. a statement of purpose including a showing that the diversification will be consistent with the public interest;

b. a statement of the goals of the diversification including the types of nonutility activity contemplated and the time frames expected for various stages of diversification (perhaps measured by extent of involvement);

c. a description of the corporate organization plan by which diversification will be accomplished including a showing of the impact on the utility's corporate and financial structure;

d. a description of the proportion of the total business of the holding company that will be represented by the utility using, for example, a proportion of total assets, sales, revenues or other relevant measure;

e. a methodology for allocating common costs and setting prices for affiliate transactions; and

f. a plan of review that will trigger periodic regulatory review of the impact of diversification on the utility and that will allow amendments to the original application as plans and circumstances change.

5. While state commissions should not regulate nonutility subsidiaries, they must have the power, after finding a problem in the utility, to pursue that problem into the books and records of the holding company and its subsidiaries. This power and the preceding policy may have a deterring effect on diversification, but they are necessary for the protection of the utility ratepayers. However, truly proprietary information should be subject to a mechanism to assure protection of proprietary interests.

6. Regulators should not divert diversified earnings from shareholders to subsidize rates, except as ratepayers may deserve a share of those earnings to the extent that ratepayers are put at substantial or identifiable additional risk.

7. It is inappropriate for regulators to approve in advance specific acquisitions or other business ventures so long as they are within the general framework of the application approved by the commission. However, regulators should be aware of differences between diversification activities which are related versus those which are unrelated to traditional utility operations. In addition, regulators may want to give special attention to those cases where affiliate transactions will occur between the utility and the nonutility operations of the diversified business.

Conclusion and Recommendations

As federal policy continues to tilt towards deregulation, utilities will quite naturally attempt to find good business opportunities in the new legal structures open to them. Consequently, the regulatory issues involved in diversification become all the more important. After the deregulation dust settles in the telecommunications area (see article on page 28), local telephone companies—not to mention AT&T—might well take a page or two from the diversification book now being written by gas and electric companies around the country.

John Naisbitt, in his best seller *Megatrends*, views the diversification trend among the nation's utilities as part of a general corporate effort to find new directions. "Companies, like people, find it difficult to change, mainly because people run companies," writes Naisbitt. "Utilities, so often under highly regulated mandates, have been in the business of winning rate cases; now they must reexamine what business they are in as the industry is deregulated and decentralized."

Naisbitt then moves directly to the point. "As in so many other industries, diversification is the early direction: Utilities are increasingly involved in real estate, fish hatcheries, insurance, oil drilling, coal mining, pipelines, and barge transport. So far, it is not very significant, partly because they don't know how state regulatory agencies are going to respond."[20]

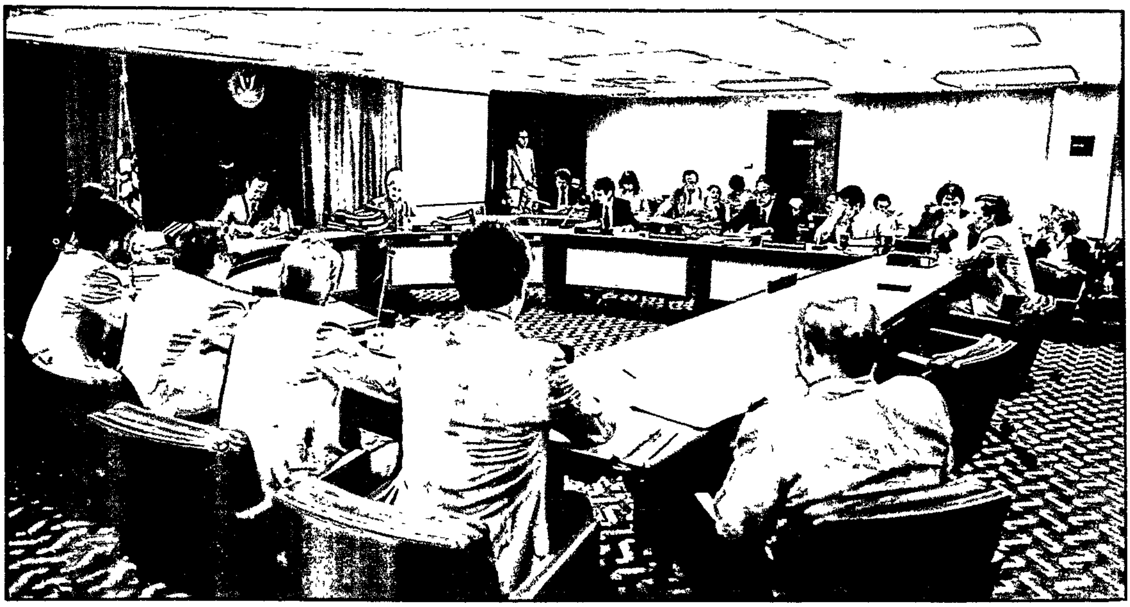
Thus far, much of the diversification in North Carolina has been into utility-related areas — coal, propane, uranium, insulation, and solar water heaters. In addition, the scope of diversification has been small in North Carolina compared to that in many states. Even Piedmont Natural Gas, one of the most aggressive diversifiers, only grossed 5 percent of total sales from products other than natural gas.

Nevertheless, utility companies in North Carolina have moved into ventures not related to the supply of the utility service. Piedmont Natural Gas, for example, recently created PNG Communications Company division, which operates a franchised cable service for a 700-home residential community in York County, S.C. "In 1982, the communications division also entered the Satellite Master Antenna Television (SMATV) business of providing localized cable service to apartment and condominium developments using on-site, satellite dish antenna systems," PNG said in its 1982 annual report.[21] "At year end, the division was actively operating seven SMATV projects with over 1,000 subscribers in the Charlotte, N.C., metropolitan area."

State officials, despite clear national trends towards increased diversification, have—with few exceptions, such as former Commissioner Hammond's dissent quoted above—considered diversification issues secondary in the complex regulatory process. Commissioner Hipp seems to summarize the commission's approach in calling diversification a "fact of life."

On November 23, 1983, the most recent meeting of the legislature's Utility Review Committee, attention focused on telephone deregulation issues. Near the end of the meeting, the question of diversification came up, prompted

A meeting of the Federal Energy Regulatory Commission (FERC).



Courtesy Federal Energy Regulatory Commission by a letter to Speaker of the House Liston Ramsey (D-Madison). A propane gas proprietor had complained to the Speaker that a natural gas company was using its utility logo in advertising its nonregulated propane business.

Steve Rose, staff counsel for the Utility Review Committee, reported that the N.C. statutes recognize that such nonregulated ventures are "not subject to the provisions of this Chapter" (see footnote 3). No further discussion ensued about the logo. Nor did the legislators weigh whether the statute should be construed as *sanctioning such action*, or merely recognizing that it exists. No one questioned whether the statute should be amended. Rep. J. P. Huskins (D-Iredell), co-chairman of the committee, did instruct Rose to write the propane distributor and invite suggestions from him on whether the law should be amended.

Like the commission and the legislative committee, the Public Staff seems to downplay the issue. "We would be concerned if the utilities got into any ventures that are losing money because that would have an impact on the overall company performance," says Director Gruber. "If the ventures were large, I think we could be involved. But I don't foresee that happening."

Utility company executives, particularly within the electrics, also question the extent to which diversification poses a problem in North Carolina. "It is good to prepare for future developments, but the prospect for *major* diversification in the electric industry is small in terms of capital employed and revenues," says CP&L Chairman Smith.

Small or large in scope, the regulatory issues outlined above could well become more prevalent as deregulation trends in Washington tend to dovetail with diversification trends within the utility business. Most pro-business analysts argue that diversification is definitely a good trend, likening it to an individual investor with a diversified portfolio. Other analysts, ranging from the NARUC report to Robert Gruber, think it can work either way.

"We're concerned over whether the ratepayer is subsidizing a nonutility operation and whether the nonutility venture can pay its own way," says Gruber. "If it can, it can contribute to the overall health of the utility, and we favor it. If it has a negative impact on the taxpayer, then we have problems with it."

But how does Gruber know whether diversification has a negative impact on the ratepayer? The commission and Public Staff have fragmentary and inconsistent information about the diversification process. For example, Piedmont Natural Gas did not release publicly how much home insulation it sold in 1982. Did that part of the PNG overall operation lose money? Did the utility portion of PNG have to subsidize its home insulation business through some internal financing techniques? In some cases the Utilities Commission, after finding evidence of cross subsidization, has reduced rate increases appropriately. These instances have occurred sporadically, however. The potential problems in the four types of cross subsidization and in the new corporate structures discussed above lead to five recommendations. These should be viewed in the broader context of the NARUC recommendations (see sidebar on pages 22-23).

1. **The Utilities Commission should establish a consistent policy on cost-allocation and transfer-pricing issues.** The commission has demonstrated an ongoing concern for these two issues. Where specific, in-depth investigations have been undertaken, the commission has usually reduced rate increases. In 1981, the Public Staff hired Currin and Associates to examine cost allocation in a Piedmont Natural Gas rate case. But no similar investigation has been done since. Similarly, after discovering problems with Duke Power's coal prices, the Public Staff took a close look at CP&L's coal prices. In 1983, when the Public Staff "examined it closely," as Public Staff accounting director Bill Carter puts it, the commission adjusted CP&L's rate increase for coal priced above market levels from 1979 through 1983.

What prompts such steps as hiring Currin and Associates or choosing in a particular year to examine an issue "closely"? Neither the commission nor the Public Staff appears to have a consistent policy to trigger such action.

One method of determining the relative importance of these two cross subsidization issues in relationship to the myriad of other issues involved in a rate case would be for the commission to establish a "threshold" measurement. For example, the commission could establish a rule that when a company *either* has invested two percent of its total assets in, *or* has received five percent of its total revenues from, subsidiary ventures, *then* the Public Staff and the commission *must* conduct an in-depth review of cost-allocation and transfer-pricing issues.[22] The commission has the statutory authority to establish such a policy.

2. **The Utilities Commission and Public Staff should undertake a review of present and future staffing requirements in light of the growing trend of utility diversification into nonutility activities.** Currin and Associates made this exact recommendation—verbatim—in

"We're concerned over whether the ratepayer is subsidizing a nonutility operation and whether the nonutility operation is paying its own way."

—Robert Gruber, Executive Director
N.C. Utilities Commission Public Staff

1981. But the commission and the legislature have taken little notice. In 1983, the commission and Public Staff have essentially the same size staff as they did in 1981. Given the current legislative concern over a tight budget, adding positions exclusively for diversification concerns may be difficult. As an alternative, the commission and Public Staff should consider assigning persons within each section (natural gas, electric, accounting, etc.) to devote some portion of their time to monitoring cross subsidization issues on a systematic basis.

3. **The Utilities Commission should review and approve the sources of capital that a utility proposes to use in expanding into a nonregulated venture.** Currently, a utility must obtain commission approval *to expand* into a subsidiary venture but it is *not required* to gain approval for *how it expands.* The Utilities Commission regards the retained earnings of the utility as belonging to the stockholders and thus takes no responsibility for how the utility uses these retained earnings. But the retained earnings of the utility inevitably are tied back into the utility operation, especially in the complex world of high finance. Commissioner Hammond expressed the rationale behind this recommendation best in his dissent to the commission approval of the 1978 Duke Power request to expand into the uranium business. "This market system should be able to perform without requiring utility customers to 'involuntarily' provide the investment funds and assume the risks of exploration and mining operations."[23]

4. **The Utilities Commission should require utility companies to submit profit and loss statements to the commission for all nonutility businesses.** Unless the commission knows the quality of a utility's performance in its nonutility businesses, the commission will have great difficulty in determining to what extent a subsidiary's business might affect the utility operation. Inevitably, management concern will be spread across the spectrum of operations of a utility. Likewise, one could assume that the financial resources of the utility might be called upon to bolster a sagging nonutility effort, or perhaps to undergird a start-up operation. Without the profit and loss statements, the commission will not be able to make the best determination of what rates it should allow the utility to charge.

5. **The Utilities Commission and the General Assembly should monitor in a more formal fashion the structure of utility companies and the relationship of their structures to diversification.** The N.C. statutes do not appear to provide any means of addressing the "holding company" structure now being pursued by VEPCO. If new corporate structures allow a utility company to skirt the degree of oversight of nonregulated ventures that now exists, that corporate restructuring must be addressed in its early stages. Examining this process may require a statutory change or it may simply require a formal, ongoing effort by the Utilities Commission to issue rules and regulations regarding diversification issues *before* the new corporate structure takes hold (see NARUC recommendations, Nos. 1, 3, and 4.)

Utility companies, like much of corporate America, will continue to diversify into various markets. As utility companies are generally structured in this country — i.e., as publicly owned corporations — diversification is not necessarily good or bad. Hence, this article does not pass judgment on whether diversification is a positive or negative trend. This article instead attempts to underscore the urgency of recognizing — and monitoring — how diversification affects ratepayers, utility stockholders, business competitors, and the general public.

Utilities have a state-awarded franchise to serve all ratepayers in a given geographical area. Hence, the state regulates this activity. Utility companies also operate businesses in the free enterprise sector of the economy. The N.C. Utilities Commission cannot and should not regulate the diversified activities to the same extent that it regulates the utility franchise. The commission should, however, as former Commissioner Hammond puts it, "forever keep the diversified activities separate from the utility business."□

FOOTNOTES

[1]"1982 Report of the Ad Hoc Committee on Utility Diversification," National Association of Regulatory Utility Commissioners, October 11, 1982, p. 8.

[2]See "Why Electric Utilities are Buying into Coal" by James Cannon, *Business and Society Review*, Winter 1980-81, pp. 53-59; "The Coming Transformation in Electric Service: Entry into Cable Television" by Steven R. Rivkin and Virginia S. Carson, *Public Utilities Fortnightly*, February 4, 1982, pp. 21-27; "Can 'Advance Approval' Control Diversification?" by Louis Iwler, *Electrical World*, June 1982, pp. 25-27; "A High Risk Era for the Utilities," *Business Week*, February 23, 1981, pp. 76-86; and many other such articles, especially in *Public Utilities Fortnightly* and *Electrical World*. The report cited in footnote 1 includes a very helpful bibliography.

[3]NCGS 62-3(23)d. See also NCGS 62-51 ("To inspect books and records of corporations affiliated with public utilities."); NCGS 62-153 ("Contracts of public utilities with certain companies and for services."); and NCGS 62-160 ("Permission to pledge assets.").

[4]The term "nonregulated" is used throughout this article to refer to any subsidiary venture not part of the state-granted monopoly franchise of the public utility. All American businesses contend with government regulation to some extent, starting with the IRS and working from there. Tobacco companies are restricted in advertising, textile companies in international trade. Through its regulation of the utility franchise, the N.C. Utilities Commission regulates in some ways how a utility company interacts with its subsidiaries, as discussed throughout this article. But the Utility Commission *does not* regulate the operations of a utility's subsidiary as an independent business venture. The subsidiaries of utility companies, in many cases, function in the open market, just as a tobacco or textile company does.

In May 1981, the Edison Electric Institute, the trade association of electric companies, released a summary of diversification trends, "Investor-Owned Electric Utility New Business Ventures: A Survey of Utility Diversification Activities." In the "Summary of Results" (Table 2, pp. 4-5), the report listed a total of 247 diversified ventures reported by the electric companies that returned the Edison Electric survey. Of those 247 ventures, the table listed a total of 66 as "regulated." In the category where the highest number of ventures appeared, for example, "Fuel Exploration and Development," Edison Electric listed 36 out of 75 ventures (almost half) as "regulated." These ventures would include the coal subsidiaries of Duke Power Co. and CP&L discussed later in this article.

For the purposes of this article, the authors call all utility subsidiaries, including the Duke Power Co. and CP&L coal ventures, "nonregulated" ventures. This linguistic choice serves to differentiate more clearly the purpose of a subsidiary from that of the utility franchise. This choice of words — "nonregulated" rather than "regulated" for the coal ventures, for example — does not affect the content of the discussion in the article.

[5]*North Carolina Utilities Commission Re Duke Power Company*, Docket No. E-7, Sub 120, February 12, 1971, 88 PUR 3rd, p. 247.

[6]"Before the North Carolina Utilities Commission in the Matter of Application of Piedmont Natural Gas Company Inc. For Increase in Rates, Docket No. G-9, Sub 212," testimony of Robert F. Drennan Jr. and Richard W. Seekamp, Currin and Associates Inc., November 13, 1981, Exhibit C, "Report to the Public Staff," p. 27.

[7]*Ibid.*, Exhibit C, p. 48.

[8]*Ibid.*, Exhibit C, pp. 57-58.

[9]In commenting on a pre-publication draft of this article, PNG President Maxheim contended that of this $467,000, only $81,000 was actually an over-allocation of nonutility expenses to the utility business. "In this case, the Public Staff changed the method of allocation in the merchandising area which had been used for 30 years," Maxheim said. "Except for [amounts resulting from] changes in the accounting formula, the commission found only a difference of $81,000."

[10]"Application by Duke Power Company Inc. for Authority to Adjust and Increase its Electric Rates and Charges," Docket No. E-7, Sub. 338, November 1, 1982, p. 40.

[11]*Duke Power 1982 Annual Report*, p. 42.

[12]"Before the North Carolina Utilities Commission In the Matter of Application of Carolina Power & Light Company for Adjustment in its Rates and Charges Applicable to Electric Service in North Carolina," Docket No. E-2, Sub 461, September 19, 1983, p. 8.

[13]Bill Carter, director of accounting for the Public Staff, computed this figure, summarizing the yearly amounts for Leslie and McInnes.

[14]See "Can 'Advance Approval' Control Diversification" by Louis Iwler, *Electrical World*, June 1982, p. 26.

[15]"1982 Report of the Ad Hoc Committee on Utility Regulation," *op. cit.*, p. 18.

[16]NCGS 62-160.

[17]"Before the North Carolina Utilities Commission In the Matter of Agreement Between Duke Power Company and Western Fuel Inc., for Production and Sale of Uranium," Docket No. E-7, Sub 244, Dissent by Commissioner Hammond, June 7, 1978, pp. 1-2.

[18]*Piedmont Natural Gas Company 1981 Annual Report*, p. 11.

[19]Code of Virginia 13.1-50. Even if this statute is "moot," the Virginia Commission has substantial powers under its code, especially sections 56-55 through 56-75 and 56-78.

[20]*Megatrends: Ten New Directions Transforming Our Lives* by John Naisbitt, Warner Books, 1982, pp. 86-90.

[21]*Piedmont Natural Gas Company 1982 Annual Report*, p. 12.

[22]The threshold levels might vary from utility to utility. The NARUC report explains why in one of its recommendations: "The circumstances of each utility type and even of each utility are different and it would not be appropriate to recommend a single set of standards that all must meet. The utility should bear the burden of showing that its company-specific plan is consistent with the public interest. For example, if a proportion of assets standard is used, it is possible that initially a 5 percent level for an electric utility would be large and that 15 percent for a gas utility would not. An independent telephone company with deregulated CPE [Customer Premise Equipment] and inside wiring might be looking at 35 to 50 percent for functionally related but nonregulated activity." "1982 Report of the Ad Hoc Committee on Utility Regulation," *op. cit.*, p. 82.

[23]Duke Power Company and Western Fuel Inc., *op. cit.*, p. 4.