Date of Issuance 10/19/2010

Decision 10-10-019 October 14, 2010

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the Commission's Own Motion to Develop Standard Rules and Procedures for Regulated Water and Sewer Utilities Governing Affiliate Transactions and the Use of Regulated Assets for Non-Tariffed Utility Services (formerly called Excess Capacity).	Rulemaking 09-04-012 (Filed April 16, 2009)

DECISION ADOPTING STANDARD RULES AND PROCEDURES FOR CLASS A AND B WATER AND SEWER UTILITIES GOVERNING AFFILIATE TRANSACTIONS AND THE USE OF REGULATED ASSETS FOR NON-TARIFFED UTILITY SERVICES

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DECISION ADOPTING STANDARD RULES AND PROCEDURES FOR CLASS A AND B WATER AND SEWER UTILITIES GOVERNING AFFILIATE TRANSACTIONS AND THE USE OF REGULATED ASSETS FOR NON-TARIFFED UTILITY SERVICES

1. Summary

This decision adopts standard rules for all Class A and B water and sewer utilities[1] regarding affiliate transactions and the use of regulated assets and personnel for non-tariffed utility products and services. The adopted rules are attached as Appendix A.

Until now, some water utilities have operated under affiliate transaction rules adopted in Commission decisions approving applications to form holding companies. In those cases, the rules have differed from case to case. Other water utilities have had few or no affiliate transaction rules in place. The affiliate transaction rules adopted today will provide consistent and understandable rules for all subject water and sewer utilities.

Our newly adopted rules address our goals of protecting ratepayers, ensuring the financial health of the utility, and preventing anti-competitive behavior in the competitive marketplace. We have identified specific concerns in the water industry regarding affiliate transactions which require detailed rules. The rules we adopt today stem from a combination of existing water utility holding company rules and affiliate transaction rules adopted for the energy industry. Our adopted rules take into account the smaller size of water and sewer utilities and smaller scope of their affiliate relationships, using the results of parties' efforts to narrow issues through the workshop process.

[1] All water and sewer utilities with 2,001 or more service connections.

The adopted rules also provide flexibility to account for unique circumstances of certain utilities. For example, we provide exceptions to rules governing non-profit affiliates which provide financing and other services to the utilities (see Rule III.B.8); this will alleviate concerns raised by California-American Water Company. To address concerns raised by Park Water Company, we allow cost allocation issues among regulated utility affiliates to be considered in general rate cases instead of through standard rules (see Rule II.E)..

As part of the rules adopted today, Rule X governs the provision of non-tariffed products and services within water and sewer utilities. Non-tariffed products and services have been governed under Decision 00-07-018. The adopted rule largely continues current rules, with necessary updates. Because there is a strong relationship between non-tariffed products and services and affiliate transactions, we integrate both sets of rules to ensure consistency. The adopted rules also remove an anomaly which prevented certain companies from offering any non-tariffed products and services.

In order to give the water and sewer utilities sufficient time to adapt to the rules adopted today, the rules will become effective in 90 days.

2. Background

Current Water Utility Rules

Currently, six of the nine Class A water utilities have authorized affiliate transaction rules in place, and each utility's set of rules is unique. Over the past 25 years, the Commission has adopted affiliate transaction rules for the following Class A water utilities:

Utility Name	Decision Number
San Jose Water Company	85-06-023
California Water Service Company	97-12-011
Golden State Water Company	98-06-068
California-American Water Company	02-12-068
Valencia Water Company	04-01-051
Park Water Company	04-06-018/06-01-019

Affiliate transaction rules adopted in holding company decisions over time are currently in effect. Of the nine Class A water utilities, five utilities (all the above except for Park Water Company (Park Water)) have operated under holding company decision affiliate transaction rules for a number of years. Adopted separately and at different times, the rules are consistent on some points, but diverge in other areas. Park Water has affiliate transaction rules adopted in Decision (D.) 04-06-018 and D.06-01-019. The other three Class A water utilities in the State of California are currently operating without any formal affiliate transaction rules. These are: San Gabriel Valley Water Company (San Gabriel), Suburban Water Systems (Suburban), and Great Oaks Water Company (Great Oaks). All of the Class B, C, and D water and all of the sewer utilities do not have authorized affiliate transaction rules in place.

Suburban has been operating under a parent company structure since 1975. Suburban's parent has a number of affiliate operations that are larger than its regulated operations, yet Suburban does not follow any formal affiliate transaction rules.[2] San Gabriel operates under a parent/holding company

[2] Suburban filed a holding company application, Application (A.) 09-07-015, and sought to consolidate that application with this proceeding. Suburban's request was denied in the Scoping Ruling. Subsequently, D.10-05-001 dismissed A.09-07-051 without prejudice.

structure, without any formal affiliate transaction rules. D.93-09-036, which approved a direct billing method for charging San Gabriel executives' salaries to its affiliates, does not constitute formal affiliate transaction rules. In addition to D.04-06-018, Park Water also operates under D.06-01-019, which established limited rules to ensure ratepayers are protected against cross-subsidization and financial risk that may occur as the result of Park Water's financing transactions with affiliates. The Commission did not establish any specific annual reporting standards for Park Water for its affiliate transactions.

The size and scale of water utility affiliates is significant. The table below shows the number of affiliates of the nine Class A water utilities, as reported in response to a question in the Rulemaking, and in their 2008 Annual Reports. The table potentially understates the number of affiliates, because the utilities included only those affiliates with which they had transactions in 2008. The total number of affiliates remains unclear.

Number of Affiliates with which Class A Water Utilities Reported Transactions in 2008[3]		
Utility Name	**Responses to R.09-04-012 Question #7 for 2008 Operations**	**CPUC Annual Report Filings for 2008: Sch. E-4**
PARK WATER COMPANY[4] and APPLE VALLEY RANCHOS WATER CO.	3	3
CALIFORNIA-AMERICAN WATER CO.	5	4
CALIFORNIA WATER SERVICE CO.	5	5
GOLDEN STATE WATER CO.	3[5]	4
GREAT OAKS WATER CO.	No response was filed	2
SAN GABRIEL VALLEY WATER CO.	1	1
SAN JOSE WATER CO.	3	3
SUBURBAN WATER SYSTEMS	Response does not specify	2
VALENCIA WATER CO.	No response was filed	5[6]

A few examples of known affiliate relationships may be helpful. California-American Water Company's (Cal-Am) parent, American Water Works Company, Inc., is the largest investor-owned water and wastewater utility company in the United States, and is the parent company of nineteen state

[3] This table only includes Class A water utilities. Class B utilities are not required to submit a report of their transactions with their affiliates in their Annual Report to the Commission, and no Class B utility responded to Question #7 in the Order Instituting Rulemaking (OIR).

[4] Park Water is the parent of Apple Valley Ranchos Water Company.

[5] In its 2008 Annual Report submission Golden State Water Company (Golden State Water) listed Bear Valley Electric Services, which is a division of GSWC and not an affiliate.

[6] Transactions for sections (a), (b), (c), and (f) of Schedule E-4 were reported by Valencia Water Company (Valencia Water) in its 2008 Annual Report with no clear indication of the names or number of affiliates involved in these transactions. The information contained in this schedule, however, is consistent with the five "associated companies" listed in the Annual Report's General Information chart.

subsidiaries and numerous other companies.[7] As another example, California Water Service Company (Cal Water) is part of Cal Water Group which has six subsidiaries that provide regulated and non-regulated water and wastewater utility services in four western states.[8] Suburban is part of Southwest Water Company (Southwest), which, through its operating subsidiaries, owns 132 water and wastewater systems, and operates others under contracts to cities, utility districts and private companies.[9]

The Commission has also adopted rules that govern the water utilities' ability to provide non-tariffed products and services through the use of regulated assets and personnel (formerly called excess capacity rules). The primary decision on non-tariffed utility services is D.00-07-018, adopted in Rulemaking (R.) 97-10-049.[10] These rules distinguish the types of non-tariffed utility offerings as either active or passive,[11] require water utilities to file advice letters for the

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[7] The subsidiaries include American Water Capital Corp., American Water Works Service Company, American Water Operations and Maintenance, Inc., Philip Automated Management Controls, and Utility Management and Engineering, Inc.

[8] The other subsidiaries are CWS Utility Services, New Mexico Water Service Company, Washington Water Service Company, Hawaii Water Service Company, and HWS Utility Services LLC.

[9] Suburban states that it does not provide any services to its affiliates, but that Southwest, as a parent company, provides certain services to Suburban, the costs of which the Commission allocates using its longstanding four-factor methodology. In addition, Suburban states that it benefits from and is charged for information technology shared services.

[10] Two subsequent decisions in that proceeding made corrections, and a third approved in part a petition to modify D.00-07-018. The later decisions are D.01-01-026, D.03-04-028, and D.04-12-023.

[11] D.00-07-018 adopted an Appendix A, which designated many potential non-tariffed offerings as either active or passive, and stated that any non-tariffed utility offerings not

Footnote continued on next page

provision of certain types of active services, and require that the utilities provide certain information regarding each active service and each passive service in their annual reports. The rules also include a methodology for water utilities to allocate revenue from non-tariffed utility services between ratepayers and shareholders depending upon whether the service is active or passive. These rules adopted in R.97-10-049 regarding non-tariffed utility services do not apply to sewer utilities.

Energy Utility Holding Company and Affiliate Transaction Rules Adopted Prior to Electric Restructuring

For energy companies, the Commission issued a series of decisions starting in the mid-1980s which allowed the energy utilities to form holding companies and unregulated affiliates. Affiliate rules were imposed by this Commission on the energy companies first when San Diego Gas & Electric Company (SDG&E) filed for permission to form a holding company pursuant to Public Utilities Code Section 854.[12] The Commission approved this restructuring of the utility in D.86-03-090. Among other requirements, the decision contained several conditions to govern the manner in which SDG&E and its parent and affiliated companies were to conduct their respective transactions with one another and with this Commission. Energy utilities forming holding companies were required to keep track of the transactions they had with these affiliates, keep separate books, use transfer pricing rules imposed by the Federal Energy Regulatory Commission, and report these transactions yearly to the Commission.

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present on the list would be designated as active if the shareholders incurred incremental investments costs of $125,000 or more. D.01-01-026 published that Appendix A.

[12] All statutory references herein are to the Public Utilities Code.

Rather than impose and enforce rules that separate the operations of the utility from those of its affiliates, the Commission found that the parent …

> … and its subsidiaries may receive a number of potential benefits from their affiliation with SDG&E. Some benefits may give SDG&E affiliates an initial advantage over competitors. SDG&E has name recognition; it is a large, well-established utility which has gained the confidence of the business community. This may provide affiliates with improved access to financing. Other potential benefits may involve access to and use of utility expertise and resources. These assets, some of them intangible, were developed with ratepayers' support. If the utility is not compensated, these benefits to affiliates represent a cross-subsidy from utility ratepayers. We believe there will exist, in spite of all preventive measures, certain cross-subsidies that are not identified or adequately measured. (D.86-03-090 at 684.)

The Commission also found that this new holding company structure posed a risk of a "brain drain" and diversion of management attention from utility to affiliates. And although finding that the holding company structure in part shields the utility from the effects of affiliate riskiness, the additional risk posed by these affiliates' ventures was of concern to the Commission:

> Because of these benefits, costs, and unidentified cross subsidies, we believe SDG&E's ratepayers should be compensated by way of a payment from [the parent company] and its subsidiaries to the utility. (*Id.*)

The Commission listed several factors as important to consider in the process of measuring the appropriate compensation to be made to ratepayers, including how management attention will be affected; how the name and reputation of the utility will help the affiliate; the likelihood of cross-subsidy and beneficial personnel transfers for different types of affiliate businesses; the ability of the affiliate to utilize proprietary information, utility assets and expertise; and how to use market measures of value for utility/affiliate transactions.

In D.88-01-063, Southern California Edison Company (SCE) was granted approval to form a holding company. The Commission adopted conditions similar to those adopted in the SDG&E holding company decision.

In 1993, the Commission issued D.93-02-019, "*In re Reporting Requirements for Electric, Gas, and Telephone Utilities Regarding Their Affiliate Transactions.*" This decision requires a comprehensive report of transactions between utility and its affiliates to be submitted each May, covering transactions for the previous year. The following topics are covered in this report:

- Complete organizational structure and organizational detail.
- Officer listings for affiliates,
- Utility manual listing procedural and accounting safeguards,
- Contracts with the affiliates,
- Verbal agreements involving expenditures greater than $100,000,
- List of internal audits of affiliate transactions,
- Provisions of goods and services – from utility to affiliates and from affiliates to utility,
- Transfers of assets – both tangible and intangible/intellectual property,
- All financial transactions, Securities and Exchange Commission (SEC) reports, and all financial statements,
- All nonclerical employee movements between utility and affiliates, by employee and position, and
- Any fees required and paid associated with these movements.

Energy Utility Affiliate Transaction Rules in the Electric Restructuring Period

During the mid-1990s period of restructuring of the energy industry, many unregulated parties expressed concerns that they would be put at a competitive disadvantage if the utilities were allowed to use their market power to benefit

their affiliates. In addition to financial separation and ratepayer cross-subsidy concerns, they mentioned the sharing of proprietary information and the combining of activities (like joint marketing; joint purchases; and sharing of officers, technical expertise, and employees) that would lead to an advantage enjoyed by utility affiliates over their competitors. Such advantages were argued to be distortionary as they represented cost advantages not engendered by the internal efficiencies of the firm.

R.97-04-011/Investigation (I.) 97-04-012 initiated a proceeding to design rules to govern transactions between the utility and its affiliates, resulting in D.97-12-088, modified by D.98-08-035. In summary these rules are comprised of the following:

- Applicability rules (the affiliate must be involved in the energy industry in some way for these rules to apply),
- Non-discriminatory standards (i.e., no preferential treatment or discounts, no tying or assignment of customers, and no steering of customers to affiliates),
- Non-discriminatory disclosure of information and other record keeping rules,
- Separation standards (i.e., no joint purchases or marketing, no joint use of assets or officers, rules restricting sharing of employees, restricted corporate support, restricted sharing of name and logo of utility, and transfer pricing rules), and
- Oversight and audit rules.

Each energy utility has a unit tasked with making sure the utility follows these rules, and must file a compliance plan each year to explain how the utility is in compliance. Further, the utility must notify the Commission through advice letter whenever a new affiliate is created, and whether this affiliate is covered by the application rules.

An issue transferred to the proceeding from the Southern California Gas Company (SoCal Gas) General Rate Case (GRC) proceeding in 1997 added one additional rule regulating the provision of non-tariffed products and services by the utilities. This rule was designed to encourage the utilities to make use of the scope economies available in certain fixed utility assets, and to share the proceeds with the ratepayers who paid for the assets. An example of such a scope economy (sometimes referred to as "excess capacity") is the land available under transmission towers built by the utility which can be leased to tree growers or storage facilities. While the Commission stated that it preferred new products to be generated and sold by affiliates, it allowed utilities to exploit such scope economies if the utilities followed other affiliate transaction rules. Several ongoing programs were grandfathered at the time the rules were created, but new categories can be offered through advice letter showing how the new product or service satisfies the rule. Fewer than ten new categories have been approved by the Commission over the years following the creation of the rules.

These rules have worked for the most part, although auditors have found violations of varying degrees of severity over the years. The most serious violations have been through the sharing of confidential information by SoCal Gas and SDG&E with their affiliate Sempra Energy Trading. This led to a Commission investigation and audit in I.03-02-033, with the result that the holding company (Sempra Energy) no longer allows its head of risk management to provide guidance to SET. No fines or other sanctions were imposed, and the proceeding was closed in D.06-12-034.

The energy utility affiliate transaction rules were revised in D.06-12-029 for California's four largest energy utilities to require more complete reporting to the Commission of utility-affiliate and utility-holding company communications,

prohibit problematic shared services, and ensure a utility's financial integrity is protected from the riskier market ventures of its unregulated affiliates and holding company parent. D.06-12-029 adopted revisions to the affiliate transaction rules for the four largest energy utilities, which are contained in Appendix A-3 to that decision.[13] Section VII of the energy utility affiliate transaction rules addresses utility products and services, including non-tariffed utility services. That decision also revised General Order 77 which governs the reporting of executive compensation. The major revisions to the rules were designed to:

- Ensure that key utility and holding company officers understand the rules and their obligations under them;
- Provide greater security against the sharing within the corporate family, through improper conduits, of competitively-significant, confidential information; and
- Ensure a utility's financial integrity is protected from the riskier market ventures of its unregulated affiliates and holding company parent through new financial protection provisions known as ring-fencing.

Water Industry Affiliate Transactions Rulemaking

R.09-04-012 was opened on April 16, 2009 to develop consistent rules governing affiliate transactions and non-tariffed utility products and services for all water and sewer utilities. The OIR stated that the purpose of the rules was to " …provide appropriate Commission oversight and protect ratepayers. Moreover, regulatory consistency would be improved by adopting standard

[13] The affiliate transaction rules for large energy utilities in Appendix A-3 to D.06-12-029 are available at http://docs.cpuc.ca.gov/published/Graphics/63089.PDF, which contains all of the attachments to D.06-12-029. D.07-03-049 corrected clerical omissions in D.06-12-029, Appendix B.

affiliate transaction and non-tariffed utility service rules in a single rulemaking, as has been done for the energy utilities." The OIR also stated that "(b)ecause most Class A water utilities are now owned by holding companies that in most cases have both regulated and non-regulated subsidiaries, it is essential that this Commission develop rules which address the relationship between the regulated water utility and its parent and affiliates."

3. Procedural Activities

Parties filed statements on July 16, 2009 and replies on August 20, 2009 in advance of the first Prehearing Conference (PHC), which was held on September 30, 2009. At the PHC, parties expressed interest in pursuing discussions through workshops. Administrative Law Judge (ALJ) Gamson suggested parties attempt to develop a detailed set of rules, and divide issues into three categories (referred to as "buckets" in workshops). The first bucket would contain rules and wording with which all parties agreed. The second bucket would include items that, while the parties disagreed regarding need, content or wording, their disagreement could potentially be resolved through further discussion and compromise. The third bucket would contain rules or wording for which the disagreement was so complete that any resolution would require intervention by a disinterested third party (i.e., would either benefit from mediation or need Commission resolution). A Scoping Ruling was issued on November 4, 2009.

After workshops were held on November 11-12, 2009, on December 31, 2009 staff proposed a set of rules (Staff Proposed Rules, attached as Appendix B to this decision) as a starting point for parties to discuss in additional workshops. The proposed rules were derived from (a) various energy utility holding company decisions starting in the 1980s (described above); (b) energy affiliate

transactions rules first adopted by the Commission in D.97-12-088 (later revised in D.06-12-029); (c) water utility holding company decisions (listed above); and (d) D.00-07-018 regarding water utility non-tariffed products and services. Three additional workshops were held, led by Commission staff, on February 23-24, March 8 and March 23, 2010.

At the completion of the workshops, staff prepared a Workshop Report, issued to parties on April 26, 2010 and attached as Appendix C to this decision. The Workshop Report provided an overview of the discussions and broad positions taken by parties in the workshops, as well as a spreadsheet laying out rules as modified from the Staff Proposed Rules where agreements existed, and proposed wording changes from parties where they differed.

Parties commented on the Workshop Report on May 7, 2010, with reply comments on May 17, 2010. Opening comments were filed by California Water Association (CWA), Division of Ratepayer Advocates (DRA), The Utility Reform Network (TURN), Consumer Federation of California (CFC), Park Water, Cal-Am, Cal Water, and SCE.[14] Reply Comments were filed by CWA, DRA, TURN, CFC, Cal-Am and Park Water.[15]

The Workshop Report indicated that much progress was made in the four workshops. The parties identified approximately 150 rules, subsections of rules, or differences in wording to categorize into the three "buckets" described above. The Workshop Report provided a spreadsheet representing the state of

[14] SCE owns a Class C water company on Catalina Island.

[15] In comments, several parties requested the services of a Commission mediator to help narrow or resolve further outstanding issues. Because no mediator was available for a period of time, parties ultimately withdrew their request for a mediator in an e-mail to the ALJ on June 25, 2010.

agreement among parties on proposed rules. The spreadsheet incorporates collective edits made during workshops to the Staff Proposed Rules.

The Workshop Report states that, in general, all parties agreed during the workshops with the Commission's goals stated in the Rulemaking that these rules should be applied uniformly to all similar utilities; that cross-subsidy of affiliates by the utilities should be prevented; and that anti-competitive behaviors of the utilities, if any, should also be prevented. However, even though industry representatives support these overall goals, they argue that, for the most part, their companies already act in concert with them and no significant correction or constraint by this Commission is warranted.

The Workshop Report states:

> Significantly, the industry representatives argue that their utilities have little or no market power, and that their affiliates are not able to engage in anticompetitive behavior as they do not currently provide products and services into competitive markets. Thus, any cost or competitive advantage provided them through their affiliation with the utility would have no impact on the markets they serve. Instead of rules specifically designed to prevent transfer of market power and effect separation between utility and affiliate, such as those governing the transfer of employees from utility to affiliate, the companies argue that it is sufficient to ensure that actual costs are allocated between affiliates and their utilities accurately, using methods that measure cost causation reliably. While DRA and TURN agree that some of the staff's proposed separation rules are not needed, cumbersome, unnecessarily burdensome, or simply unenforceable, such as the proposed prohibition against sharing office space and equipment with affiliates, they are not willing to depend on cost allocation methods entirely and insist on retaining some separation rules.

The Workshop Report cautions that there is "a continuing subtext expressed by the utility representatives that most of these rules are unnecessary because of their claim that most utilities do not have affiliates that provide

products or services to unregulated or competitive markets, or that have California operations."

In comments, parties generally adhered to the views attributed to them in the Workshop Report. Parties' overall comments and comments on specific issues are discussed in more detail below. An exception is CFC. In its comments, CFC states that the Workshop Report does not fairly or accurately represent its position on a number of issues. CFC clarifies its position in edits to the Workshop Report spreadsheet of proposed rules. We consider the views of CFC ands all other parties based on their comments and the overall record, using the Workshop Report spreadsheet as a reference.

We adopt the rules for affiliate transactions and non-tariffed products and services in Appendix A to this decision, based on the discussion below. Our discussion includes our overall objectives and criteria for evaluating the rules to be adopted. For non-controversial "Bucket 1" issues, we adopt the consensus rules as proposed by parties and laid out in the Workshop Report. We discuss the significant issues in contention from "Bucket 2" and "Bucket 3" below.

4. Overview

4.1. Context of Proceeding from the OIR

It is helpful to repeat some of the context discussed in the OIR initiating this proceeding.

The OIR provided a sample set of rules for affiliate transactions (attached as Appendix A to the OIR) and a sample set of rules for the use of regulated assets and personnel for non-tariffed utility products and services (Appendix B to the OIR) to start the discussion. The OIR also asked a series of questions regarding issues that it stated may be addressed in the final rules.

Given the inconsistent and/or non-existent rules for water and sewer utilities, it is timely and appropriate to review, consolidate, and update the current rules in order to provide standard rules applicable to regulated water and sewer utilities, their provision of non-tariffed services, and their transactions with affiliated companies. We see great benefit in clarifying and standardizing the existing rules.

In the OIR, we identified the following issues to consider for affiliate transaction rules:

- The proper goals and objectives for affiliate transaction rules.
- Identification of all laws, policies, practices, rules, and procedures that presently govern transactions between regulated water and sewer utilities and their parent and affiliates.
- Whether and, if so, how, existing affiliate transaction rules for individual water utilities should be updated and/or revised for purposes of standardizing the rules.
- Whether any of the affiliate transaction rules applicable to large energy utilities should be included in affiliate transaction rules for water and sewer utilities.
- Development of a standard set of rules to govern the relationship between regulated water and sewer utilities and their parent and affiliates, if appropriate.
- Whether the affiliate transaction rules adopted in this proceeding should apply equally to all water and sewer utilities or should vary depending, e.g., on the size of the utility.

The rules we adopt in Appendix A respond to each of these issues.

4.2. Overview of Party Positions on Affiliate Transaction Rules

CWA contends that there is no factual basis establishing a need to impose "extensive, complex and burdensome affiliate transaction rules on water

utilities."[16] CWA argues that there is a "complete absence of facts"[17] to justify the need for affiliate transaction rules similar to energy affiliate rules. CWA contrasts this to the Commission's decisions adopting energy affiliate transaction rules, whereby the Commission recounted specific problems and specific incidents among energy utilities and their affiliates.

CWA contends the draft affiliate transaction rules in the Workshop Report are unnecessary, inappropriate, unwarranted and unduly burdensome for water utilities, particularly for those smaller than Class A. CWA argues that the starting point for the Staff Proposed Rules should not be the affiliate transaction rules for energy utilities. It notes that gross revenues of the energy utilities are far larger than any water or sewer utility and argues, as a result, that the energy rules are inappropriate for water and sewer utilities.[18] CWA also contends that the energy utility affiliate transaction rules were developed in light of competitive circumstances – such as energy utility affiliates competing with other energy utilities in California – which do not exist in the California water industry.[19] In particular, CWA contends that the energy industry rules in D.97-12-088 were adopted in the context of restructuring of the energy industry in California, which included significant new competitive opportunities for

[16] CWA May 7, 2010 Comments at 7.

[17] *Id.*

[18] In 2008, Cal Water, the largest water utility in California, had gross revenues of $390 million.

[19] CWA Comments at 2.

energy utilities and new entrants.[20] On these bases, CWA proposes to delete a number of rules as set forth in the Workshop Report.

CFC objects to the proposed deletion by CWA of a number of the Staff Proposed Rules pertaining to the relationship between the utility and its various types of affiliates.[21] CFC argues that these rules are consistent with previous rules adopted by the Commission and should be adopted for the purposes of this Rulemaking. For example, CFC points to D.04-01-051[22] as the basis for rules in the water industry requiring safeguarding utility resources, separation of utility and affiliate resources, precise accounting for transactions, the requirement that a holding company fully fund the utility to maintain a reasonable capital structure, and access to affiliate books and records.

DRA is largely supportive of the Staff Proposed Rules. DRA contends that rules designed to prevent anti-competitive behavior are necessary even if some utilities are not engaged in providing products and services in competitive markets. DRA contends this may occur because it is still possible for affiliate operations to affect other competitive markets (or would-be competitive markets) by using the inherent advantages incumbent utilities have to offer a related product or service at lower costs than competitors can. DRA points to billing

[20] CWA Comments at 4.

[21] CFC specifically objects to CWA's proposed deletion of proposed rules III.A, IV.A, IV.B, IV.C, VI, VII.A, VII.C and VII.B.

[22] D.04-01-051 conditionally approved the transfer of indirect control of Valencia from Newhall Land and Farming Company to Lennar Corporation and LNR Property Corporation. Appendix B to that decision adopted affiliate transaction rules applicable to the transfer.

services, meter reading, customer service, and operations and maintenance of water and wastewater services as areas where competitive markets exist.[23]

DRA agrees with CWA that there are significant differences between water and energy utilities. DRA asserts that it agreed in workshops to various revisions to the Staff Proposed Rules – such as with Staff Proposed Rule IV related to shared officers and services - in order to take such differences into account. However, DRA contends the need for energy affiliate transaction rules arose not out of energy restructuring, but in response to issues in the relationship between energy utilities and their parents or holding companies. DRA contends the same concerns apply in the water industry. Further, DRA points out that concerns about competition (in terms of protecting the ratepayer against cross-subsidization to unfairly benefit unregulated affiliates) were expressly mentioned in the OIR as a goal of this Rulemaking.

Several water utilities provided separate comments from CWA. In many cases, their positions are the same as or similar to those of CWA. In this section and throughout this decision, we reference specific water utility comments when they add meaningful contentions beyond those articulated by CWA.

Park Water is a regulated water utility in California, and is the parent company of Commission-regulated Apple Valley Ranchos Water Company (as well as the Montana-regulated Mountain Water Company). As both a regulated utility and the parent of a California regulated utility, Park Water contends that the rules should consider its unique corporate structure (and those of others).

[23] DRA Comments at 1-2.

For example, Park Water provides a number of specific recommended edits to distinguish between "parent" and "holding company."[24]

Cal Water references Commission decisions which provide different affiliate transaction rules for Cal Water as compared to other water utilities, and calls for uniform rules for all Class A water companies. Cal Water calls for affiliate rules to specifically allow the use of excess capacity accounting where a good or service is being provided to an affiliate consistent with the proposed rules. Cal Water views the prices of non-tariffed goods and services as regulated by the Commission, thereby allowing for their provision to any entity regardless of identity (i.e., affiliate or not). Regarding competition, Cal Water references Commission decisions (e.g., D.91-04-024) and case law and contends that they essentially hold that our policy should be to protect competition as a whole, not to protect every competitor. Absent evidence of the exercise of market power, Cal Water contends there is no basis for additional regulation over and above existing state and federal antitrust laws.

Cal-Am states that it receives essential services from its affiliates, including access to cost effective capital from American Water Capital Corp. and services it now receives on a shared basis from American Water Service Company. It states that both of these are not-for-profit organizations. Cal-Am argues that the affiliate transaction rules should not apply in cases of affiliates providing shared services operating to serve regulated companies on a not-for-profit basis, because the proposed rules would be incompatible with the provision of water utility service under its current structure and have adverse impacts on customer cost and service. Cal-Am contends that rules meant to prevent utility affiliates from

[24] Park Water Comments at 11–12.

leveraging utility assets in a competitive market are not applicable to not for profit affiliates. As an example, Cal-Am cites that it must routinely exchange proprietary and/or other non-public information in order to participate in American Water Capital Corp. and secure advantageous funding. Otherwise, Cal-Am claims it would need to secure its own financing and would have a lower credit rating.[25]

SCE owns and operates a Class C water utility on Catalina Island. SCE argues that it should not be subject to the affiliate transaction rules because all of SCE's activities (including its water utility activities) are already subject to the affiliate transaction rules in D.06-12-029. SCE states that it is also subject to the Commission-approved Gross Revenue Sharing Mechanism in D.99-09-070. SCE argue that these rules should take precedence over the rules developed in this proceeding.

5. Discussion

5.1. Objectives for Adopting Rules

The OIR called for consideration of the proper goals and objectives for rules regarding affiliate transaction rules and the use for non-tariffed utility services of regulated assets and employees included in revenue requirements.

Our overall objectives are consistent with the goals articulated in the OIR, and can be simply stated:

1. Ensure ratepayers pay reasonable rates and receive high service water quality,
2. Ensure water and sewer utilities have the opportunity to earn reasonable profits so as to provide a high quality of service,

[25] Cal-Am Comments at 8.

3. Prevent utilities from assisting their affiliates to unfairly compete against other firms, and
4. Avoid imposing rules which would cause excessive burdens on utilities, as compared to public interest benefits.

These are longstanding and well-established objectives for utility regulation in general, and these objectives are directly applicable to the development of the rules at issue here. These objectives are consistent with the Commission's goals stated in the OIR that these rules should be applied uniformly to all similar utilities; that cross-subsidy of affiliates by the utilities should be prevented; and that anti-competitive behaviors of the utilities, if any, should also be prevented.

Protecting ratepayers and ensuring utility financial integrity are traditional objectives which provide the balancing act of utility regulation. Investor-owned water and sewer utilities cannot consistently provide a high quality of service to their customers without the opportunity to earn reasonable profits. At the same time, ratepayers should only pay rates high enough to allow the utility the opportunity to earn reasonable profits, and neither guarantee such profits nor provide ongoing opportunities to earn excessive profits (the reasonable level of profits, or rate of return in regulatory parlance, is determined by this Commission).

The rules we adopt today must be consistent with these objectives. The adopted rules should not lead to higher rates (or keep rates higher than otherwise) without corresponding value to ratepayers; such rate levels would be considered unreasonable. Nor should the adopted rules lead to sustainably higher profits; in this situation, rates would be unreasonable and should decrease. At the same time, the adopted rules should in no case harm the ability

of the water and sewer utilities to provide high quality service, or lead to a decreased opportunity for the utility to earn a reasonable profit.

As an example, water and sewer utilities should not be allowed to employ personnel at ratepayer expense whose sole functions are to work with utility affiliates (whether directly under the control of the utility or not) for the provision of non-tariffed products and services. These functions are not the core functions of the regulated utility, and would result in higher rates than necessary. At the same time, personnel may be properly hired by the utility and have some of their time allocated to (and thus paid for by) utility ratepayers and other time allocated to other entities. For such personnel (as well as shared equipment and other assets), costs can be allocated between the utility and other entities in general rate cases, in conjunction with rules established in this proceeding.

Objective #3 is a broader public interest objective which is needed to ensure that affiliates of water and sewer utilities do not gain an unfair competitive advantage through leveraging utility assets in a way which would harm ratepayers and/or the competitive market. This objective is consistent with the goals of the proceeding as discussed in D.09-04-012 (and agreed upon by parties during workshops) that cross-subsidy of affiliates by the utilities should be prevented, and that anti-competitive behaviors of the utilities, if any, should also be prevented.

Water and sewer utilities should not be able to increase rates (or keep rates higher than they otherwise would have been) to captive ratepayers in order to subsidize unregulated, competitive endeavors, regardless of where such endeavors fit into the corporate structure. Such action would both be unfair to ratepayers and allow the utility (and/or its affiliates) to lower prices for

competitive activities to the disadvantage of other competitors. It is not our objective to protect other competitors *per se;* however, we have a public interest objective to ensure that regulated monopoly assets are not used to harm the overall competitive market.

In general, we will strive to prevent water and sewer utilities from conferring market power on their affiliates to the detriment of the marketplace. However, we differentiate between benefits provided to affiliates based on subsidies and discrimination in favor of affiliates – both of which we seek to prevent – and benefits provided to affiliates simply based on association with the utility. The latter provide no harm to ratepayers and, while potentially conferring a competitive advantage to an affiliate, are less likely to harm the competitiveness of the marketplace. We recognize that this is a difficult balancing act, requiring clearly-written and consistent rules.

CWA opposed many of the Staff Proposed Rules, proposed numerous changes and deletions as reflected in the Workshop Report, and argues for further scaling back of some rules in comments. Beyond comparisons to the energy industry, CWA bases its positions on: (a) an inherent lack of competition in core water service, (b) lack of affiliate competition in utility service areas, and (c) the ability to allocate costs among affiliated entities in general rate cases. CWA and individual water companies essentially argue that we should eliminate many current rules; instead, our focus is to provide consistent rules in line with our objectives. Six of the Class A water utilities have had affiliate

transactions rules in place for many years; none of these companies raised significant concerns about compliance with current rules.[26]

While each of the three CWA arguments has some basis, these points do not obviate the need for comprehensive and detailed affiliate transaction rules such as those in place already for some water utilities. Ensuring reasonable rates requires that the relationship between the utility and its affiliates be transparent, and that the regulated revenue requirement is not the source of funding for competitive or unregulated ventures. Affiliate transaction rules which are consistent across the industry and consistently applied to each utility will ensure transparency and help ensure reasonable rates. Reasonable rates satisfy our objective to ensure utility financial integrity.

We note that water utilities do, in fact, have affiliates operating in their own service territory. By definition, each utility parent company operates in the utility territory. In addition, San Jose Water Company has an affiliate called the San Jose Land Company which operates in the utility territory. Also, Great Oaks has an affiliate named Great Oaks, LLC that operates in its service territory. Our objective to prevent utility subsidies to affiliates is not intended to stifle competition or limit formation of affiliates, but to ensure fair competition.[27]

The rules we adopt today do not replace the framework of general rate cases; the rules enhance our ability to conduct these proceedings because the

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[26] The concerns of Cal Water and Golden State Water about restrictions on their provision of non-tariffed products and services are discussed in the context of Rule X.

[27] The adopted rules recognize that certain situations, such as affiliates with operations outside of California and regulated affiliates, present fewer concerns about fair competition. We have provided exceptions from the rules, or the opportunity for utilities to request exceptions, in these cases.

affiliate transaction rules can and will be applied in general rate cases consistently across the water industry, eliminating the current hodgepodge of rules. Objective #3 – ensuring fair competition – is an additional, critical factor in establishing transparent affiliate transaction rules, so that the utility cannot unfairly leverage its monopoly resources to harm competitive or potentially competitive markets. However, the objective of ratepayer protection stands on its own merits, without consideration of competitive issues.

Objective #4 – ensuring no undue regulatory burden – is a theme echoed by parties in their comments. We keep this objective in mind throughout this decision, choosing to retain current rules or impose new rules only when there is commensurate benefit to ratepayers and the public interest. While there is no specific analytical metric available to calculate a cost/benefit ratio for any rule, there needs to be a clear rationale which justifies the effort required to comply with each rule.

Other possible objectives have been discussed in the proceeding which we do not consider as appropriate for developing rules in this proceeding. For example, while no party specifically calls for competition in the core utility business of proving safe water and sewer service to customers, we wish to be clear that we have no intent of introducing competition in these areas.

Finally, we do not start with an objective to essentially duplicate the energy affiliate transaction rules for the water and sewer utilities. We recognize, as all parties agree, that there are significant differences between the regulated energy industry and the regulated water and sewer industries in California. The rules we develop here must consider the unique characteristics of the regulated water and sewer companies. Further, we agree with CWA and other parties that

there are certain market conditions in the energy industry, such as limited retail competition, which do not exist in the water and sewer industries.

At the same time, we cannot ignore that there are significant similarities among regulated industries. The OIR specifically called for consideration of whether any of the affiliate transaction rules applicable to large energy utilities should be included in affiliate transaction rules for water and sewer utilities, and consideration of the use of regulated assets and personnel for non-tariffed purposes. The most important similarity is that both the regulated energy and water and sewer utilities are monopolies that provide essential services to their ratepayers. Further, while there are significant differences in industry structure and the structures of individual utilities, energy, water, and sewer utilities have (or may have) structures which include parent companies, regulated affiliates and unregulated affiliates.

The combination of regulated monopoly provision of essential services and complex corporate structures requires us to consider parallels in rules for affiliate transactions for energy, water, and sewer utilities. We reject CWA's contention that the energy affiliate transaction rules were developed solely in response to restructuring of the energy industry. Many of the energy industry affiliate transactions rules stem from holding company decisions before the energy restructuring era; most of those rules are still in effect. Similarly, affiliate transaction rules for water utilities date back to 1985.

As the consumer parties point out, there have been a number of instances in the water industry where concerns have arisen about the relationship between water utilities and their affiliates. Much of the discussion in the Commission's energy holding company decisions and affiliate transactions decisions (with the exception of discussions applicable to electric restructuring) is applicable to the

water and sewer industries. Indeed, many of the adopted water holding company rules are parallel to those in place for the energy industry. The rules we adopt today are intended to address these similar concerns.

There is no contradiction between considering inter-industry parallels and avoidance of a rote grafting of energy rules onto the water industry. Instead, it is entirely appropriate to look to the generic energy rules, as well as the current rules for five water utilities, for guidance where appropriate when creating generic rules for the water and sewer industries. At the same time, we will make appropriate changes, deletions and additions to the energy rules to ensure that the final rules are crafted with a clear understanding of their impact on the water and sewer industries. We will look at each possible rule to ensure the different size and circumstances of the water and sewer utilities, and individual firms within the industry, are taken into consideration.

In the following sections, we will discuss each of the affiliate transaction rules proposed by staff. The Workshop Report lists seven Staff Proposed Rules as Bucket 3 issues, where no consensus was possible. In several cases, the water utilities fundamentally oppose the proposed rules. We will discuss the seven Staff Proposed Rules individually in the appropriate section, along with many of the Bucket 2 issues. While not all issues are discussed individually, significant controversies are addressed. Unless specifically noted, the Bucket 1 consensus issues are generally adopted as proposed by the parties.

5.2. Commission Authority With Regard to Utility Affiliates

There are no statutes that specifically authorize the Commission to establish affiliate transaction rules for water and sewer utilities. However, as discussed below, our authority to establish these rules derives from Pub. Util. Code, including §§ 451, 701, 706 and 851.

A review of court decisions shows that the Courts have broadened the Commission's authority over affiliate corporations in past decades and this history is important to interpreting the law today. In 1950, in *Pacific Telephone & Telegraph Co. v. Public Utilities Commission*, the California Supreme Court determined that the Commission only had jurisdiction over affiliated corporations to the extent that the Legislature expressly provided.[28] The following year, in response to this stringent ruling, the Legislature passed § 701 to give the Commission jurisdiction over "all things…which are necessary and convenient" to the supervision and regulation of public utilities. Subsequent cases enforced this expanded jurisdiction by determining that the absence of any specific mandate did not necessarily bar the Commission from regulating an issue.[29] Furthermore, if the Commission's action was motivated by a desire to improve services to customers, § 701 provided the Commission with the necessary authority.[30]

The Commission has authority under § 851 to review any water or sewer utility effort to "sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or any part of its…line, plant, system, or other property necessary or useful in the performance of its duties to the public…" In addition, § 852 provides that "No public utility, and no subsidiary or affiliate of, or corporation holding a controlling interest in, a public utility, shall purchase or acquire, take or hold, any part of the capital stock of any other public utility, organized or existing under or by virtue of the laws of this state, without having

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[28] *Pacific Tel. & Tel. Co. v. Public Utilities Com.*, 34 Cal.2d 822, 832 (Cal. 1950).

[29] *General Tel. Co. v. Public Utilities Com.*, 34 Cal.3d 817, 825 (Cal. 1983).

[30] *Id.* at 822.

been first authorized to do so by the commission; provided, however, that the commission may establish by order or rule categories of stock acquisitions which it determines will not be harmful to the public interest, and purchases within those categories are exempt from this section." Next, § 853 provides further guidance regarding ownership changes and transactions.

Under § 854(a):

> No person or corporation, whether or not organized under the laws of this state, shall merge, acquire, or control either directly or indirectly any public utility organized and doing business in this state without first securing authorization to do so from the commission. The commission may establish by order or rule the definitions of what constitute merger, acquisition, or control activities which are subject to this section. Any merger, acquisition, or control without that prior authorization shall be void and of no effect. No public utility organized and doing business under the laws of this state, and no subsidiary or affiliate of, or corporation holding a controlling interest in a public utility, shall aid or abet any violation of this section.

The Commission asserted its authority to adopt affiliate transaction rules for energy utilities in D.97-12-088. The Commission summarized this authority in D.97-12-088 as follows:

> The Commission has the power and the obligation under Article XII, section 6 of the California Constitution and §§ 451, 701, and 761 of the California Public Utilities Code to actively supervise and regulate natural gas and electric public utilities in California and do all things which are necessary to ensure adequate and reliable public utility service to California ratepayers at just and reasonable rates. *See Camp Meeker Water System, Inc. v. Pub. Util. Comm'n* (1990) 51 Cal.3d 850, 861-862; *Sale v. Railroad Comm'n* (1940) 15 Cal.2d 607, 617.

The only court decision to expressly address the issue of the Commission's authority over affiliate corporations was a decision that granted the Commission limited jurisdiction to enforce conditions imposed on holding companies under

§ 854.[31] This decision arose out of an investigation (I.01-04-002) that the Commission initiated in 2001 to determine whether the parent holding companies of three large California energy utilities violated the conditions imposed by the Commission during the formation of the holding companies. The utilities and their parent holding companies were made parties to the investigation.

Soon after I.01-04-002 was initiated, the three parent holding companies involved in the proceeding (PG&E Corporation, Edison International, and Sempra Energy) filed a motion to dismiss the proceeding as it pertained to them for lack of jurisdiction. The parent holding companies argued that they were not "public utilities" subject to Commission regulation. On January 9, 2002, the Commission issued D.02-01-037 to deny the motion to dismiss. The utilities and parent holding companies filed applications for rehearing of D.02-01-037 in February 2002. The rehearing applications were denied in D.02-07-044. The utilities and parent holding companies then sought judicial review. The California Court of Appeal, First Appellate District, affirmed the Commission's decision to deny the motion to dismiss for lack of jurisdiction.[32]

In its order affirming the Commission's decision, the First Appellate District repeatedly stressed that it was not ruling on the Commission's exercise of general regulatory control over the holding companies.[33] This conclusion is nevertheless relevant due to the court's interpretation of § 701. The court

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[31] *PG&E Corp. v. Public Utilities Com.*, 118 Cal.App.4th 1174, 1201 (Cal. App. 1st Dist. 2004).

[32] See *PG&E Corp. v. Public Utilities Com.*, supra.

[33] *Id.* at 1197.

explained that nothing in § 701 limits the statute's reach to public utilities, thereby allowing the statute to govern interactions with affiliate corporations.[34] Furthermore, the court allowed the Commission to liberally construe § 701 as long as such an interpretation did not disregard express regulatory directives and the authority sought was "cognate and germane" to utility regulation.[35]

In light of the above, we conclude that we have authority to promulgate affiliate transaction rules for water and sewer utilities, as long as the rules are "cognate and germane" to utility regulation.

5.3. Rule I -- Applicability of Rules

This Rule identifies the jurisdiction of the Commission over utility activities with regard to their affiliates and the use of regulated assets for non-tariffed utility services, and the circumstances when the rules apply. Rule I, which consists of nine sub-rules, is adopted consistent with the discussion below, and consistent with our overall policies and objectives discussed in this decision.

5.3.1. Rule I.A -- Applicability to Different Utility Classes

The OIR did not limit the applicability of the rules to be developed here to any subset of regulated water and sewer utilities and their affiliates. Staff Proposed Rule 1.A states: "These (rules) shall apply to California public utility water and sewer corporations or companies subject to regulation by this Commission."

No party argues that the rules should not apply to Class A utilities. CWA would modify Staff Proposed Rule I.A to give the Division of Water and Audits

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[34] *Id.* at 1198.

[35] *Id.* at 1199.

(DWA) discretion to determine the extent that the affiliate transaction rules would be applied to Class B, C and D utilities. CWA would have the rules initially apply only to Class A utilities, because of minimal concerns about those companies leveraging market power or unfairly advantaging the few affiliates that may exist.[36] TURN does not believe that DWA should have sole authority to decide whether to apply these rules to Class B, C or D utilities. Instead, TURN suggests allowing these utilities to request an exemption from the rules through the filing of a Tier 3 Advice Letter.[37] DRA suggests that specific criteria should be developed for granting exemptions, but does not enumerate such criteria.

While the rules we adopt today could in theory be applicable to any water or sewer utility which has affiliates, the practical concerns driving the adoption of the rules decrease substantially with smaller sized utilities. An exemption process would be a resource-intensive method of considering applicability. We agree with the consensus among parties that these rules should be applied uniformly to all similar utilities. Allowing DWA the discretion to determine which non-Class A utilities should be exempt could lead to a lack of uniformity.

Certainly, the concerns which give rise to these rules decrease with smaller size. Class B utilities have the greatest potential for concern among the remaining companies. To promote uniformity and certainty and focus resources on the utilities with the likelihood of significant concern, we will apply the rules adopted herein to all Class A and B water and sewer utilities, but not to Class C and D water and sewer utilities.

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[36] CWA Comments at 10.

[37] TURN Comments at 6.

5.3.2. Rules I.B -- Applicability to Regulated Affiliates

Staff Proposed Rule I.B states: "For purposes of a combined water and sewer utility, these (rules) apply to all utility transactions with affiliates engaging in the provision of a product that uses either water or sewer services that relate to the use of water or sewer services." Staff Proposed Rule I.C states: "These (rules) apply to transactions between a Commission-regulated utility and another affiliated entity…" In combination, these Staff Proposed Rules apply the affiliate transaction rules to water and sewer utilities and all of their affiliates, unless there is an exemption.

TURN argues that the affiliate transaction rules should apply both to transactions between the regulated utility and unregulated affiliates, and also between affiliated regulated utilities. TURN contends that applying the affiliate transactions rules consistently to all transactions will increase the transparency of the process for the public as well as the Commission.[38] CWA argues that the draft rules should be modified to apply only to transactions between the regulated utility and unregulated affiliates, because the operations of regulated affiliates will be examined in general rate cases.

We agree with CWA that there is sufficient regulatory oversight in general rate cases to deal with transactions between regulated entities, as long as both regulated entities are rate-regulated by this Commission or a utilities Commission in another state. We will adopt modifications to the Staff Proposed Rules to this end, and combine them into a new Rule I.B. However, we adopt Rule IV.B to prevent regulated utilities from subsidizing affiliates, including their regulated affiliates. We also modify Rule I.B to recognize that the adopted rules

[38] TURN Comments at 3-4.

encompass the use of regulated assets for non-tariffed utility services, in addition to affiliate transactions.

In comments on the Proposed Decision, CWA suggests adding language to Rule I.B so that the Rule would "apply to transactions between a Commission-regulated utility and another affiliated entity *that is engaged in the provision of products that use water or sewer services or the provision of services that relate to the use of water or sewer services in the state of California" (*proposed additional language in italics). This language would generally parallel language in the energy industry rules. We agree that this clarification is appropriate, as we are generally concerned with market power issues only if there is some connection to water or sewer services (examples would include affiliates involved in plumbing or insurance for water lines). We will not limit applicability to California, as ratepayer subsidies and/or market power would apply out of state as well.

5.3.3. Rules I.D and I.E -- Relationship to Existing Rules

Staff Proposed Rule I.G states: "Existing Commission rules for each utility and its parent holding company shall continue to apply except to the extent they conflict with these (rules). In such cases, these (rules) shall supersede prior rules and guidelines…" Staff Proposed Rule I.H states: "Where these (rules) do not address an item currently addressed in a utility's existing rules, imposed by this Commission, which govern that utility's transactions with its affiliates(s), the existing utility-specific rules shall continue to apply for that item only."

All parties agree that in order to provide certainty, the rules adopted here should supersede existing rules where there is a conflict. Parties also agree that the Commission may add future rules. TURN argues that these rules should be

complementary to existing rules, which may be utility-specific, as existing rules can fill in the interstices between the rules adopted today.[39] CFC and DRA agree. CWA proposes to delete proposed rule language that would make it a rebuttable presumption that existing Commission rules for each utility or parent company would still apply except where those rules conflict with those adopted today.

The rules we adopt today are wide-ranging, but not all-encompassing. We determine that the affiliate transaction rules we have adopted for specific utilities in the past should be superseded in many or most cases. As anticipated by the OIR, we find that regulatory consistency would be improved by adopting standard affiliate transaction and non-tariffed utility service rules in a single rulemaking. We recognize that there may be current rules that are outside of the boundaries of the rules adopted here; these rules will continue to apply. However, it is not our intent that parties should be able to pick and choose which rules (existing or new) should apply. We will modify the language from Staff Proposed Rules to include a rebuttable presumption that the rules adopted today apply. In this way, only older rules clearly outside of the bounds of the new rules will not be superseded. The adopted Rules are Rule I.D and I.E.

As discussed in the context of Rule VII, we specify that rules developed in holding company decisions pertaining to financial obligations of parent companies are not superseded by the rules adopted today.

In comments to the Proposed Decision, Suburban Water seeks clarification that interim affiliate transaction rules adopted in D.10-09-012 on September 2, 2010 would be superseded by the rules adopted in today's decision. We agree with Suburban and modify Ordering Paragraph #2 to clarify this point.

[39] TURN Comments at 3.

5.3.4. Rule I.G and Rule I.H -- Applicability of Rules to Operations Outside of California

Staff Proposed Rule I.K (now Rule I.G) would allow water and sewer utilities to seek an exemption from the rules for "transactions between the utility solely in its capacity serving its jurisdictional areas wholly outside of California, and its affiliates." The Commission does not have the authority to regulate the operations of utilities and their affiliates in other states. However, the Commission does have the authority – and has consistently exercised the authority – to adjust rates for regulated utilities which operate in California to account for transactions with their affiliates, including affiliates that operate entirely outside of California.

DRA would add the words "if such out-of-state operations do not affect the utility's operations and the operating costs inside California." CWA supports the proposed rule, but without the DRA addition.[40]

As proposed, the rule allows utilities to seek exemptions for affiliate transactions related to out of state operations of the California utility, but does not provide any standard for considering the exemption request. DRA's suggestion appropriately clarifies the standard to be used in seeking exemptions to this rule. However, we will add the word "substantially" to DRA's language, so that affiliates of out of state utility operations with *de minimus* contact with the California utility can still be exempted from the rule. We will adopt the Staff Proposed Rule to allow for the utility to file for an exemption for affiliate transactions related to out-of-state utility operations, with the DRA language added.

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[40] CWA Comments at 11.

We also address the question of affiliates with wholly out-of-state operations in Rule I.H. Our concerns about anti-competitive and market power issues pertain to our jurisdiction in California. We intend that our rules apply to affiliate transactions outside of California only to the extent that such transactions impact the California utility. Therefore, we will exempt affiliates with wholly out-of-state operations from Rule III.B (market advantages to affiliates) and Rule III.C (non-discriminatory access). However, affiliates with wholly out-of-state operations will be subject to other rules such as Rule VIII (regulatory oversight) as they impact the California utility.

5.4. Rule II -- Definitions

This Rule defines a number of terms for the purposes of the rules, including "Parent Company," "Utility," "Water Utility," "Sewer Utility," "Affiliate,"[41] "Costs" (including "Direct Costs," "Direct Overhead Costs," "Indirect Overhead Costs," and "Fully-Loaded Costs"), "Transaction," "Property," "Real Property," "Customer," "Customer Information," and "Cross-subsidy." As with other rules, the origin of these definitions was the energy industry rules first adopted in 1997. Several definitions were agreed to in workshops, but parties continue to disagree in a number of areas. These definitions are adopted consistent with the discussion below, and consistent with our overall policies and objectives discussed in this decision.

[41] Under Rule II.E defining the term "affiliate," "substantial operational control" is a defined term. In response to comments, in Rule II.A we change the term "controlling interest" to "substantial operational control" for consistency.

5.4.1. Rule II.E – Definition of Affiliate

The key question is whether an affiliate is defined by having 10% or 50% of the voting securities owned or controlled directly or indirectly by a utility or its controlling corporation. DRA argues that 10% is the appropriate percentage, as this is the SEC threshold for effective control. TURN also would use 10% as the threshold, because the advantages conferred to an affiliate by virtue of having access to bills and customer information are the same regardless of the level of ownership.[42] CWA argues that 50% is a more appropriate percentage because the Commission defines control under §§ 851-854 as more than 50% for purposes of approval of transfers of control.[43]

Park Water requests the definition of affiliate be amended to address its specific corporate structure and advocates that the affiliate transaction rules should not apply to out of state regulated utility affiliates of California regulated water utilities. Park Water contends that the current language serves no useful purpose and its suggested change would remove burdensome requirements.[44]

CWA is mistaken. Pub. Util. Code §§ 851-854 do not define the ownership threshold for its provisions. The energy affiliate rules use a 5% threshold for the analogous rule. DRA and TURN appear to find a higher 10% threshold acceptable in order to accommodate differences with the water industry. We find a 10% ownership threshold reasonable to ensure that any affiliate with a significant relationship to a water or sewer utility is covered by the rules. We

[42] TURN Comments at 7.

[43] CWA Comments at 12.

[44] Park Water Comments at 2-3.

will not make the definitional change requested by Park Water, as its regulated affiliates are categorically exempt under adopted Rule 1.B.

For clarity in considering other Rules, we highlight that the Rule II.E definition of "affiliate" includes the utility's parent company.

5.4.2. Rule II.L – Definition of Cross-Subsidy

DRA proposes that a definition of "cross-subsidy" is needed in the rules. DRA proposes the following language: "A cross-subsidy occurs when captive ratepayers pay part or all of the cost of providing a device or expense that provides no benefits to utility ratepayers, such as services offered by the regulated utility's parent or other affiliates." CWA proposes a different definition: "The assignment of costs among affiliates entities inconsistent with the causation of such costs."[45]

"Cross-subsidy" is not a defined term in the energy affiliate rules. There appears to be a need to define the term here. There are a variety of definitions to be found in economics and accounting references. For example, *The Dictionary of Accounting Terms*[46] uses the following definition: "improper assignment of costs among objects such that certain objects are overcosted while other cost objects are undercosted relative to the activity costs assigned." Similarly, *Accounting-Dictionary.com* (2010) defines cross-subsidy as "the process of deliberately assigning costs to items in an account in such a way that some items are undercosted and some overcosted." Both of these definitions are reasonable, but do not fully capture the specific issue at hand: our concern that captive ratepayers may be forced to pay more (and potential competitors may be

[45] CWA Comments at 13.

[46] Copyright © 2005, 2000, 1995, 1987 by Barron's Educational Series, Inc.

harmed) because the utility and/or its affiliate assigns costs to the utility which should be assigned to the affiliate.

Neither DRA's nor CWA's proposed definitions of cross-subsidy are quite right. DRA captures the ratepayer protection issue, but may be too restrictive. CWA misses the ratepayer protection issue altogether. For the purposes of affiliate transaction rules, we will adopt as Rule II.L a definition of cross-subsidy consistent with ratepayer protection and dictionary definitions: "The unauthorized over-allocation of costs to captive ratepayers resulting in under-allocation of costs to a utility affiliate."[47]

5.5. Rule III -- Utility Operations and Service Quality

Rule III addresses the Commission's objectives to protect ratepayers, ensure utility financial health, and prevent cross-subsidization. The primary responsibility of each public utility that we regulate is to provide "adequate, efficient, just, and reasonable service" to its ratepayers as is "necessary to promote the safety, health, comfort, and convenience of its patrons, employees, and the public."[48] Consequently transactions between a utility and its affiliates should not result in any adverse changes in utility services or be contrary to the public interest policies with respect to service to customers, employees, operations, financing, accounting, capitalization, rates, depreciation, maintenance, or other matters affecting the public interest or utility operations.

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[47] By "unauthorized," we allow for the possibility that the Commission may authorize a utility with a regulated affiliate (such as Park Water), or a utility with more than one district (such as Golden State Water) to allocate costs among regulated affiliates or districts in ways which do not necessarily reflect cost causation or other commonly used cost allocation methodologies.

[48] §§ 451 and 2701.

Moreover, the utility and/or its parents should ensure that there is no adverse impact on customer service as a result of affiliate transactions (e.g., no degradation of reliability, efficiency, adequacy, or cost of utility service).

It is Commission policy to encourage the efficient use of utility capital and to encourage the development of new markets and improved products and services for the benefits of California residents, consistent with continued provision of utility service. As such, the utility's customers should remain at least indifferent as a result of transactions between a utility and its affiliates.[49]

In its comments on the policy statements, DRA seeks to ensure any such language does not imply that the need to develop new markets and improve services could impair the utility obligation to fulfill its obligations to ratepayers. We see no inconsistency between the statutory obligations of §§ 451 and 2701, and a policy to encourage new products and services through utility affiliates. One major purpose of these affiliate transaction rules is to ensure that actions by affiliates do not harm captive ratepayers. Once captive customers are protected, they should be indifferent to affiliate activities. At the same time, the state of California can benefit from new products and services.[50] While we affirm this policy, there is no need to include this or other policy language in the adopted rules, since such general policy statements do not establish separately enforceable requirements.

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[49] These preceding policy statements were originally included as part of Rule III in the Staff Proposed Rules. Since our rules generally do not contain policy statements, we have deleted them from the Staff Proposed Rule III and discuss them as part of this decision.

[50] This statement should not be read to require any water or sewer utility to offer any new product or service, or continue to offer any current product or service, through an affiliate.

CFC contends that the utility should be required to maintain local offices so customers can have a place to ask questions, complain, pay bills, etc.[51] We do not agree with CFC that the maintenance of local offices should be a general rule. Rather, questions of whether a utility should maintain local offices are best considered in general rate cases.

5.5.1. Staff Proposed Rule III.B – Prohibitions on Specific Utility Interactions With Affiliates

Rule III.B lists seven restrictions on the utility with regard to providing benefits to its affiliates:

1. Providing leads to its affiliates;
2. Soliciting business on behalf of its affiliates;
3. Acquiring information on behalf of or to provide to its affiliates;
4. Sharing market analysis reports or any other types of proprietary or non-publicly available reports, including but not limited to market, forecast, planning or strategic reports, with its affiliates;
5. Requesting authorization from its customers to pass on customer information exclusively to its affiliates;
6. Giving the appearance that the utility speaks on behalf of its affiliates, or that the affiliate speaks on behalf of the utility; and
7. Representing that, as a result of the affiliation with the utility, its affiliates or customers of its affiliates will receive any different treatment by the utility than the treatment the utility provides to other, unaffiliated companies or their customers.

Cal-Am contends that much of the information constraints in Rule III.B should not be applicable to corporate support services provided by its affiliates which provide access to capital and customer service for various regulated water utilities under the parent of Cal-Am. Specifically, Cal-Am objects to restrictions

[51] Workshop Report, spreadsheet at 23.

on the utility acquiring and sharing market reports or other types of restrictions in Rule III.B.3, 4, 5, and 6. Cal-Am argues that its corporate structure would no longer be viable, and ratepayers would lose significant benefits, unless these entities can continue to share non-public or proprietary reports and otherwise coordinate activities.

Similarly, CWA proposes to delete provision 4 prohibiting the utility from sharing "market analysis reports or any other type of proprietary or non-publicly available reports, including but not limited to market, forecast, planning or strategic reports, with its affiliates" because some parents (or other affiliates) of water utilities, in particular Cal-Am, provide these types of services to their affiliated utilities.[52] CFC disagrees, arguing that an affiliate should not be given, free of charge, information which is the property of the utility.

Our general concern is that the ratepayers should not be required to pay for utility assets which are then used for the benefit of utility affiliates and to the detriment of competitors to these affiliates.[53] Rule III.B imposes specific restrictions to this effect. However, the utility is still free to market certain assets in a non-discriminatory manner. For example, Rule III.B.4 does not prevent the utility from selling market information at a market price, either to affiliates or other entities (Rule VI addresses the pricing of this information). We will adopt the proposed Rule III.B.

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[52] CWA Comments at 14.

[53] In the non-tariffed products and services rules, discussed later in this decision, we allow the utility itself to use certain assets in limited ways beyond the core provision of water or sewer services.

For the specific case of Cal-Am,[54] we determine that it is reasonable to allow the utility to provide certain benefits from a utility to affiliates whose sole purpose is to serve regulated utility functions – in this case, across a number of regulated utilities within and outside of California – or non-profit or governmental organizations. In response to comments on the Proposed Decision, we also add the parent company of regulated utilities as allowable entities. We agree that centralized support functions for regulated entities are beneficial to the regulated entities and their ratepayers due to lower costs and greater efficiencies from this type of entity, as compared to the utility raising its own capital or providing its own customer services. Concerns about cross-subsidies or misuse of confidential information are minimal if the affiliate is a not-for-profit organization (as with Cal-Am) and does not serve profit-seeking organizations. In this specific situation, the restrictions in Rule III.B.3, 4, 5, and 6 are relaxed; we add Rule III.B.8 to the adopted rule for this purpose.

However, we do not allow the exceptions to Rule III.B in situations where the centralized support functions – aside from corporate support services addressed under Rule V - serve both regulated and non-regulated entities.[55] Otherwise, the restrictions on sharing of non-public or proprietary information adopted in Rule III.B could easily be circumvented, defeating the purpose of that rule.

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[54] This discussion would also be applicable to any other water or sewer utility which adopts a similar structure in the future.

[55] To ensure clarity, notwithstanding Rule V, Rule III.B does not allow sharing of non-public or proprietary information between a utility and an affiliate which provides access to capital, or customer service functions, to both utilities and non-regulated entities.

In comments on the Proposed Decision, CWA suggests that Rules III.B.4 and III.B.6 need to contain an exception to allow parents of utilities to obtain the proprietary information referenced in this rule, and to speak on behalf of the utility. We agree, and have made these changes. For clarification, we have also modified Rule III.B.4 to eliminate the restriction on affiliates speaking on behalf of utilities, as this provision serves no specific purpose.

In response to comments from Cal-Am, we add a new Rule III.B.9 stating "Utilities may file an Advice Letter seeking an exemption to Rule III.B.8 within ninety days of the effective date of the Commission decision adopting these rules, requesting that a non-profit affiliate subject to Rule III.B.8 be allowed to serve the functions of other affiliates, as long as those other affiliates provide no more than five per cent of the annual revenues of the non-profit affiliate." This one-time process allows Cal-Am and any other similarly situated utility to request to continue provision of certain non-profit support services from an affiliate to a small number of existing affiliates, which would otherwise be prohibited.

5.5.2. Rules III.C and III.D – Non-Discrimination

Staff Proposed Rule III.C provides that:

> Except as provided for elsewhere in these (rules), a utility shall provide access to utility information, services, and unused capacity or supply on the same terms for all similarly situated market participants. If a utility provides supply, capacity, services or non-public or proprietary information to its affiliate(s) for use in competitive markets, it shall contemporaneously make the offering available to all similarly situated market participants, which include all competitors serving the same market as the utility's affiliates.

Staff Proposed Rule III.D provides that:

> A utility shall provide customer information to its affiliates and unaffiliated entities on a strictly non-discriminatory basis, and only with prior affirmative customer written consent.

CWA would delete Staff Proposed Rule III.D, and modify Staff Proposed Rule III.C to read:

> Except as provided for elsewhere in these (rules)… if a utility provides customer information to an affiliate that is operating in a competitive market in California, it shall make the same information available to all similarly situated market participants in that same competitive market, consistent with state law and the utility's policies on privacy.

CWA argues that there is no evidence that any transactions beyond those involving customer information between a water utility and its affiliate could or would have any adverse impact on a particular competitive market. CWA also claims it is unrealistic and unworkable for the utility to have to identify and contact all similarly situated market participants to make available to them information or services they may or may not want before such information or services can be shared with an affiliate.

These rules provide the heart of the affiliate transaction rules. As described in Section 6.1, our objectives include both ratepayer protection and the public interest protection of competitive markets. Under Rule III.C as modified by CWA, a water or sewer utility would have the ability to provide various services (except for certain information) to its affiliates on different terms and conditions than to competitors of its affiliates. Further, absent Rule III.D, there would be no requirement to provide such services to affiliates and competitors at the same time. In combination, under CWA's proposed rule there would be no obligation to provide any such services to competitors at all.

This is exactly the type of discrimination which would confer an unfair advantage for water or sewer utility affiliates in the competitive marketplace, and exactly the type of unfair advantage we wish to prevent. We do not have a concern with affiliates of the utilities using the name, logo or other association with the utility to attract customers.[56] Nor do we wish to prevent affiliates of utilities from competing in various non-monopoly markets. One concern is that utilities (or their parents) would not form affiliates rather than comply with non-discrimination requirements.

The table below shows 422 new energy utility affiliates have been formed since 1998, per Advice Letters filed with Energy Division in that period.[57] The table shows that energy utilities operating under rules similar to the Staff Proposed Rule III.C (as well as other affiliate transaction rules more detailed and stringent than we adopt today for water and sewer utilities) have formed numerous affiliates since the energy affiliate transaction rules were adopted in 1998. The affiliate transaction rules did not appear to provide any significant barrier to forming affiliates to energy utilities, and we see no reason the rules we adopt today will have any different impact.

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[56] The energy affiliate rules include certain restrictions on use of the utility name and logo, which were not part of the Staff Proposed Rules here.

[57] Starting in 2007, Rule II.B adopted in the energy utility holding company decision D.06-12-029, required the energy utilities to report the creation of all new affiliates; before this the energy utilities reported only those they deemed covered by the energy utility affiliate transaction rules. Therefore, this table may undercount new affiliates created before 2007. On the other hand, an unknown number of the reported affiliates may no longer exist.

New Energy Utility Affiliates Since 1998

Date	*PG&E**	*SCE*	*SDG&E/SoCal Gas*	*Others*	***Totals***
1998	0	0	3		3
1999	0	6	0		6
2000	6	7	54		67
2001	49	16	16		81
2002	12	2	10		24
2003	8	1	12		21
2004	2	0	21		23
2005	0	8	21		29
2006	5	21	10		36
2007	0	0	20	1	21
2008	2	19	35	2	58
2009	1	22	10		33
2010	2	4	14		20
Totals	87	106	226	3	422

* Pacific Gas and Electric Company.

We will adopt Staff Proposed Rule III.C to ensure that the water or sewer utility and its assets cannot be used exclusively or in a discriminatory manner by utility affiliates in the marketplace. We agree with CWA that it may not be feasible to offer all services and provide information contemporaneously to both affiliates and other market participants. At the same time, the principle of non-discrimination requires that affiliates not be given unfair temporal advantages. We will modify Rule III.C to require that utility and customer information, services, and unused capacity or supply may be offered to both affiliates and competitors in a timely manner, consistent with our policy of non-discrimination. We will not adopt Staff Proposed Rule III.D, as the provision of information to affiliates and market participants is already covered in Rule III.C.[58]

[58] Provision of customer information outside of the utility must be consistent with state and federal privacy laws, as well as applicable Commission regulations.

5.6. Rule IV -- Separation

This section establishes the rules for the utility to maintain accounting records with regards to affiliates. The sub-rules in Rule IV are adopted consistent with the discussion below, and consistent with our overall policies and objectives discussed in this decision.

5.6.1. Rule IV.B – Cost Allocation

The Staff Proposed Rule states: "The utility and its parent and other affiliated companies shall allocate common costs between them in such a manner that the ratepayers of the utility shall not subsidize any parent or other affiliate of the utility." The Workshop Report shows that CWA proposed changing this rule to read: "The utility and its parent and other affiliated companies shall allocate indirect costs amongst them in a manner consistent with cost causation principles, so that neither the ratepayers of the utility, nor the utility itself, shall subsidize any parent or other affiliate of the utility."

CWA in its comments also proposes revising the last sentence to add the words "not regulated by the Commission" at the end. CWA claims the Commission will have full jurisdiction over the regulated affiliate and can ensure that neither utility subsidizes the other.[59] TURN opposes CWA's proposed revision because TURN contends ratepayers should not be expected to subsidize the services and products provided by any affiliate, regulated or not.[60] While there seems little justification to allow one utility to subsidize another, and while the Commission can in theory scrutinize and prevent subsidies between regulated affiliates, without clear guidance on this point, utilities may find it

[59] CWA Comments at 16-17.

[60] TURN Comments at 14.

acceptable to propose such subsidies in their general rate cases or implement such subsidies in their operations. The better and simpler approach is to prohibit these subsidies from occurring in the first place.

CWA's Workshop Report revisions mainly add the words "consistent with cost causation principles." It is unclear what the purpose of this phrase would be. To the extent that indirect or overhead costs would not be covered by cost causation principles, CWA's wording could lead to mis-costing of transactions.

We will adopt the rule as proposed in the Staff Proposed Rule, with minor wording changes.

5.7. Rule V - Shared Corporate Support

This section establishes the rules for sharing corporate support services between a utility, its parent company and separate affiliates. Rule V is adopted consistent with the discussion below, and consistent with our overall policies and objectives discussed in this decision.

CWA would reconstitute this section, as compared to the Staff Proposed Rules.[61] CWA proposes a general principle that "a utility may share with its affiliates joint corporate oversight, governance, support services, and personnel as further specified…" CWA would add that such permitted sharing "may include the exchange of non-public or proprietary information that is necessary to provide the corporate support services being shared or when necessary or required for appropriate corporate governance or for compliance with financial or corporate governance laws and regulations." CWA contends that this language is necessary because a number of water utilities have parents or

[61] CWA notes that the Workshop Report does not accurately reflect its position regarding this section.

affiliates which provide a broad array of services to the utility and its affiliates. Therefore, CWA claims undue restrictions on the flow of non-public or proprietary information would seriously impair existing operations of these entities, and make it difficult to adopt and implement sound corporate governance procedures.[62]

CWA would also add language stating the general principle that any permitted sharing of services "shall not…provide a means to create an unfair competitive advantage for the utility affiliates, lead to customer confusion, or create opportunities for cross-subsidy by a utility or its affiliates." CWA also includes a list in the proposed rule which would illustrate, but not limit, examples of services which may be shared. This list is the same as in the Staff Proposed Rule V, except that CWA adds corporate governance and oversight to the list of examples.

Alternatively, CWA proposes a new rule (not mentioned in the Staff Proposed Rules) which would permit a utility and its affiliates to jointly employ the same officers and other employees subject to requirements including that all direct and indirect costs be fully allocated among the utility, its parent and other affiliated companies. CWA contends that separating utilities and their affiliates into different legal entities with different boards of directors, officers and employees is unnecessary and impractical in the water industry. CWA claims that implementing this policy would lead to ratepayers bearing the full cost of utility officers and directors, thereby increasing rates.

DRA recommends retaining the Staff Proposed Rule V. However, DRA's position relies on ensuring that the affiliate transaction rules overall include

[62] CWA Comments at 18-19.

safeguards to ensure protection of ratepayers and the public interest. For example, DRA urges that a strict and efficient cost allocation procedure is needed for shared services (based on cost causation principles), as well as a thorough reporting requirement and full access to the accounting records and officers of the utility and relevant affiliates.[63]

DRA's concerns are valid, and have been addressed in other parts of the adopted rules. Specifically, Rule IV addresses cost allocations and Rule VIII addresses access to affiliate records and officers. We recognize that it would be impractical for all water and sewer utilities to individually provide various corporate support services which are common functions within the corporate structure. Even with the much larger energy utilities, we allow significant sharing of these types of services. In D.97-12-088, we allowed a utility and its affiliates to use joint corporate support on an exclusive basis, as long as it is priced and reported according to the Separation and Information Standards adopted elsewhere in the rules. As we stated in D.97-12-088 at 59, "sharing of centralized functions generates scope economies and as such can increase production efficiency."

CWA would specifically add "non-public or proprietary information that is necessary to provide the corporate support services being shared" as allowable to share under Rule V. This language was not in the energy utility affiliate transaction rules. We have already provided an exemption in Rule III.B to accommodate Cal-Am's unique organizational structure. However, the energy utilities have done business under this restriction for a number of years. CWA and the utilities have not shown that there is anything different for water and

[63] DRA Comments at 11-12.

sewer utilities (other than Cal-Am) which compels this modification. We will not allow the sharing of non-public or proprietary information for shared corporate services.

Staff Proposed Rule V lists examples of shared corporate services to which Rule V would apply, but does not limit applicability to this list. We recognize the there may be other legitimate shared corporate services to which Rule V should apply. However, we do not intend to allow unlimited applicability. From the Staff Proposed Rule, we will retain a list of examples of services which cannot be shared under Rule V.

CWA's proposed Rule V would also eliminate certain wording from the Staff Proposed Rule V. Specifically, CWA would eliminate the requirement for verification of the mechanisms in a compliance plan. We adopt a compliance plan for various other purposes in Rule VIII.C. There is no reason shared corporate services should be exempt from such a plan.

5.8. Rule VI -- Pricing of Goods and Services Between the Utility and its Affiliate(s)

Rule VI concerns the pricing of goods or services transferred from the utility to an affiliate, or vice-versa. The sub-rules in Rule VI are adopted consistent with the discussion below, and consistent with our overall policies and objectives discussed in this decision.

5.8.1. Rule VI.D – Sales on the Open Market

Staff Proposed Rule VI.4 (now Rule VI.D) states: "Goods and services produced, purchased or developed for sale on the open market by the utility will be provided to its affiliates and unaffiliated companies on a nondiscriminatory basis, except as otherwise required or permitted by these (affiliate transaction rules) or applicable law." CWA proposes to limit this language to items "offered

on the open market." CWA claims there are no such goods and services, and the language in the Staff Proposed Rules is necessary.[64] DRA does not disagree with the facts, but argues that the rules are meant to be comprehensive and must take future possibilities into account.

It is not clear that there are no goods and services, beyond regulated water and sewer service, offered on the open market by water and sewer utilities. Some water utilities, for example, appear to be offering antenna services and billing services to the public at this time. We agree with CWA that water utilities do not appear to "produce, purchase or develop" good or services for sale on the open market, but can and do "offer"[65] certain good and services stemming from excess capacity. In other words, certain goods and services are or may be produced, purchased or developed for the utility, but are or may be offered on the open market as non-tariffed goods and services. This Rule goes hand-in-hand with Rule X (our non-tariffed products and services rules discussed later in this decision), in particular the new rule that water and sewer utilities can only provide non-tariffed products and services to affiliates through the affiliate transaction rules.

5.8.2. Rule VI.E – Transfers from Utilities to Affiliates

Staff Proposed Rule VI.6 (now Rule VI.E) concerns pricing of transfers from the utility to an affiliate of goods and services not produced, purchased or developed for sale by the utility. This Rule would price such transfers at fully loaded cost plus 5% of direct labor cost for the utility.

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[64] CWA Comments 19-20.

[65] We prefer the term "offer" to "sold" for several of the sub-rules in Rule VI, as this term covers all transactions, such as rents and leases, instead of simply including sales.

CWA would eliminate the 5% adder for this Rule, because CWA contends no justification for this addition has been given.[66] DRA argues that adding 5% to the fully loaded cost is intended to eliminate any lower cost advantage that might be created for affiliates who otherwise have to pay fair market costs of these services.[67] TURN argues that the true percentage of work performed on behalf of the affiliate by utility employees should be reflected in the application of fully allocated costs, which may be more or less than 5%.[68]

As with many of the Staff Proposed Rules, the origin of this rule goes back to the Commission's holding company decisions. As noted in Section 2, D.86-03-090 held that "although the holding company structure in part shields the utility from the effects of affiliate riskiness…because of these benefits, costs, and unidentified cross subsidies, we believe SDG&E's ratepayers should be compensated by way of a payment from [the parent company] and its subsidiaries to the utility."

In D.86-10-026, a Pacific Bell (PacBell) general rate case, the Commission considered the recommendation of DRA to require the utility to charge its affiliates fully-loaded costs (direct plus all allocated overheads plus a return on investment), which was PacBell's current practice, but to add a markup of 35% to recognize "the embedded value of PacBell's talent and expertise, developed and refined over the years as a result of reimbursement by PacBell's ratepayers." (D.86-10-026 at 268.) The Commission agreed with DRA that a markup to recognize "the embedded training and development costs," funded by rates over

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[66] CWA Comments 20.

[67] DRA Comments at 13.

[68] TURN Comments at 16.

the years, should be imposed; this expertise was now available to PacBell's affiliates, and ratepayers should be reimbursed. The Commission decided that the appropriate markup should be 10%, and imposed this on the transfer price to be used by PacBell when charging its affiliates for work it performs (see D.86-10-026, Finding of Fact 11).

The Staff Proposed Rule is taken directly from the energy utility affiliate transactions rules decision, which reduced the markup to 5%.

The theory the Commission articulated in the two decisions cited above from 1986 and followed upon in the energy affiliate rules still holds: in the provision of certain goods and services from the utility to an affiliate, there are unidentified cross-subsidies which accrue to affiliates from the investments and training funded by ratepayers. CWA has not provided any rationale for why we should change the long-standing policy of adding a percentage to the transfer price to account for this value. A 5% adder is a reasonable percentage. We will adopt the Staff Proposed Rule.

5.9. Rule VII -- Financial Health of the Utility

The sub-rules in Rule VII are adopted consistent with the discussion below, and consistent with our overall policies and objectives discussed in this decision. We note that there are certain rules in holding company decisions which are not addressed by these Rules. For example, there are rules in D.97-12-011 and D.98-06-068 which require the utility to issue its own debt, and which address loans from the utility to the holding company. Rules I.D and I.E establish when existing holding company rules are superseded. To avoid any ambiguity, we specifically determine that certain existing financial rules in holding company decisions are not superseded by the Rules adopted today (see Rule VII.G).

5.9.1. Rule VII.A – Capital Obligation of Parent

Staff Proposed Rule VII.A states: "The parent shall provide the utility, or enable the utility to acquire, adequate capital to fulfill all of its service obligations prescribed by the Commission."

CWA would strike this language. CWA asserts that it is the utility's obligation, not the parent company's obligation, to acquire adequate capital to fulfill its service obligations. CWA further argues that the utilities have no authority to obligate or otherwise agree to the imposition of requirements on their parent organization.[69]

DRA would retain the language in the Staff Proposed Rule. DRA argues that the parent must be willing to provide safeguards for the financial well-being of the regulated utility against the poor performance of its parent. DRA contends that a primary obligation of the parent must be to ensure the regulated utility is able to provide service to its customers, which requires adequate capital resources.[70]

We have discussed above our conclusion that we have sufficient, although limited, authority to impose regulations on a parent company of a utility within our jurisdiction in order to properly regulate the utility. There are clearly circumstances where a parent company could either help or hinder the utility's ability to maintain adequate capital to carry out its obligations. For example, a utility could be required to provide excessive dividends to a parent which would harm the utility, or a parent could infuse capital into the utility to assist it. There may be strategic considerations within the corporate structure for either of these

[69] CWA Comments at 20-21.

[70] DRA Comments at 14.

actions, or other actions which impact the utility's ability to acquire or retain sufficient capital.

An enforceable policy is needed that will enable the utility to maintain financial health through adequate access to capital at all times.[71] For water utilities which have holding companies, certain of the holding company decisions already provide specific and detailed rules regarding financial obligations of parent companies. For example, D.97-12-011 for Cal Water includes a requirement that states: "The capital requirements of the utility shall be given first priority by the utility and the holding company's board of directors." D.98-06-068 for Golden State Water has similar language. However, other holding company decisions do not include similar language. A major purpose of this decision is to harmonize rules applicable to all similarly-situated water and sewer utilities; in this case, utilities with parent companies. We will adopt Rule VII.A, as it contains appropriate language which should be extended to all water and sewer utilities with a parent company.

5.9.2. Proposed Rules on Dividends and Debt

The following two suggested financial rules are taken from the OIR (footnotes omitted):

> In each year, utility shall not exceed its five-year average payout percentage ($ amount of payout divided by $ total Net Income) of

[71] This discussion does not address other circumstances which may threaten the financial health of the utility. For example, poor management or poor regulation may negatively impact the financial health of the utility. In addition, other factors such as weather, changes in supply or demand, and changes in other legal or regulatory structures beyond the Commission may have negative impacts to the extent the utility is not protected from these events through balancing accounts or other regulatory mechanisms.

> transfer/payment of net income/dividend to parent company. If current year payment/transfer percentage exceeds this five-year average, the utility shall notify the Director of the Commission's Division of Water and Audits.
>
> Debt of utility's parent/affiliated companies shall not be issued or guaranteed or secured by utility.

DRA contends that an area of concern is to avoid any potential threat to the utility's financial health and ability to meet its public service obligations. Thus, DRA believes the utility should be adequately insulated from the financial risks and debts of its unregulated parent and affiliates. As with Rule VII.A, DRA would make conditions imposed on water utility holding companies regarding financial safeguards part of the affiliate transaction rules.[72]

CWA generally contends that the sample affiliate transaction rules attached to the OIR as Appendix A are more appropriate for the Commission-regulated water utilities than the energy utility rules. CWA recommends that the sample rules – which largely are derived from the affiliate transaction rules adopted for Cal Water, Golden State Water, and Cal-Am – be used as a starting point. However, CWA disagrees with DRA regarding the need for a rule on dividends. CWA contends there are many circumstances that legitimately cause a utility to defer or accelerate paying dividends to the holders of its preferred and common stock, such as short-term needs to invest in capital projects, unfavorable conditions for issuing new debt, or the need to prudently manage its capital structure. Therefore, CWA claims it is important that the utility be able to

[72] DRA Prehearing Conference Statement at 12.

manage its dividend payment levels in response to complex financial considerations.[73]

As CWA acknowledges, the proposed financial rules in the OIR were taken directly from existing water utility holding company rules. However, the proposed rule on dividends does not appear in any water utility holding company decision. This rule was derived from the energy affiliate rules. There is no evidence that these specific reporting requirements on dividends are required. The general rule adopted as Rule VII.A suffices to ensure that parents of water and sewer utilities cannot extract dividends from the utility in a way which would harm the financial health of the utility.

On the other hand, the suggested rule on debt from the OIR does exist in various forms in water utility holding company decisions. For example, both D.97-12-011 and D.98-06-068 include a rule stating "Holding Company debt and debt of other affiliates shall not be issued or guaranteed by the utility without prior Commission approval." Similarly, D.02-12-068 includes a rule stating: "Debt of Cal-Am's affiliated companies shall not be issued or guaranteed by Cal-Am without prior approval of the Commission," and D.04-01-051 includes a substantively identical rule for Valencia Water. These rules have not caused any problems, and serve a valid purpose of protecting the utility and its ratepayers. We will adopt the suggested rule on debt from the OIR as Rule VII.D.

5.9.3. Proposed Rule – Capital Structure

Staff Proposed Rule VII.C would require the utility "to maintain a balanced capital structure consistent with that determined to be reasonable by

[73] CWA Prehearing Conference Statement at 13.

the Commission in its most recent decision on the utility's capital structure." The proposed rule also requires the utility to seek a waiver of the rule "if an adverse financial event at the utility reduces the utility's equity ratio by 1% or more."

CWA would strike this proposed rule. CWA contends this proposed rule has nothing to do with affiliate transactions. While there is such a rule on the energy side, CWA claims it was developed in response to competitive concerns which are not present on the water side. CWA contends that capital structure issues should be considered in cost of capital proceedings. Further, CWA claims the proposed rule is impossible to comply with, as many Class A water companies have imputed capital structures and, for others, borrowing of small amounts of debt would change the utility's equity ratio by 1% or more.[74]

DRA contends the issue of financial viability of the regulated utility in the context of affiliate transactions and its relationship with its parent must be in these rules. DRA would be willing to increase the waiver requirement to 3% if 1% is onerous, but would not eliminate it.[75]

We agree with CWA that cost of capital proceedings are the appropriate place to consider capital structure issues. Further, we agree that this rule was imposed on the energy utilities in response to competitive pressures that do not exist in the water and sewer industries. To the extent that further guidance is necessary, rules in water utility holding company decisions (specifically, D.97-12-011 and D.98-06-068) regarding provision of adequate capital are sufficient to protect the utility and its ratepayers from concerns about the parent

[74] CWA Comments at 20-21.

[75] DRA Comments at 15.

of a utility negatively impacting the financial health of the utility with regard to capital. We will not adopt this proposed rule.

5.9.4. Rule VII.E -- Financial Separation

DRA proposed a new Rule regarding financial separation, calling for a tool (known as ring-fencing) to ensure the utility does not get pulled into a bankruptcy of its parent. The proposed new Rule states:

> Within three months of the effective date of the decision adopting this amendment to the Rules, a utility shall obtain a non-consolidation opinion that demonstrates that the ring-fencing around the utility is sufficient to prevent the utility from being pulled into bankruptcy of its parent holding company. The utility shall promptly provide the opinion to the Commission. If the current ring-fencing provisions are insufficient to obtain a non-consolidation opinion, the utility shall promptly undertake the following actions:
>
> 1. Notify the Commission of the inability to obtain a non-consolidation opinion;
> 2. Propose and implement, upon commission approval, such ring-fencing provisions that are sufficient to prevent the utility from being pulled into the bankruptcy of its parent holding company; and then
> 3. Obtain a non-consolidation opinion.

CWA contends that ring-fencing provisions were adopted in the context of bankruptcy circumstances in the energy industry and are unnecessary in the less risky, less competitive water industry. CWA claims these provisions would increase the costs of providing utility service without corresponding benefits.[76] Park Water points out that it is both a regulated utility and a parent company of a regulated utility; if the rule (which Park Water opposes) remains, Park Water

[76] CWA Comments at 21.

requests that the term "parent holding company" be changed to "holding company" so that the rule does not reference a utility being pulled into the bankruptcy of another utility.[77]

DRA contends this rule is important to insulate a regulated utility's capital and capital-raising ability from the consequences of poor financial performance of its parent or other affiliates.[78] DRA points to the recent example of Cal-Am, which was acquired and later spun off by RWE Aktiengesellschaft (RWE), with the spin-off causing the credit rating of Cal-Am's parent, American Water, to be lowered by both Moody's and Standard & Poor's credit rating agencies.[79] In D.02-12-068, the Commission adopted conditions related to the utility's financial health in Cal-Am's merger with RWE, along with the set of affiliate transaction rules on Cal-Am.

The ring-fencing rule was not part of the energy affiliate transaction rules in D.97-12-088, but was put in place for the four largest energy utilities in D.06-12-029. CWA is not correct that this provision in the energy utility affiliate transaction rules was developed solely in response to the bankruptcy of an electric utility or the narrow circumstances of electric restructuring. Indeed, there are a variety of circumstances which could lead to the bankruptcy of a parent company of a water or sewer utility, ranging from management problems to market conditions to *force majeure* situations. D.06-12-029 at 10 states:

> The Revised Affiliate Transaction Rules have been designed to close existing loopholes, primarily by ensuring that key utility and

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[77] Park Water Comments at 9.

[78] DRA Comments at 3.

[79] *Ibid.* at 18.

> holding company officers understand the Rules and their obligations under them, by providing greater security against the sharing within the corporate family, through improper conduits, of competitively-significant, confidential information, and by ensuring a utility's financial integrity is protected from the riskier market ventures of its unregulated affiliates and holding company parent.

The essence of this proposed financial separation rule is that, regardless of the underlying circumstances, the core functions of the water or sewer utility need to be protected from significant problems elsewhere in the corporate structure. This concept is central to protecting the interest of ratepayers, and is as applicable in the water and sewer industries as in the energy industry, as shown in DRA's example of Cal-Am. CWA claims that the benefits of the proposed rule would be outweighed by the cost to the utility. Certainly, there would be legal costs involved in obtaining the proposed non-consolidation opinion, and possibly in modifications to the corporate structure. However, CWA provides no supporting evidence that the costs would be greater than the substantial benefits to ratepayers from removing the risk that bankruptcy of the parent would impose on the water or sewer utility. We will not adopt Park Water's suggested revision; the fact that Park Water is both a utility and a parent of a utility does not change the need to protect the subsidiary utility from a potential bankruptcy of the parent (or vice versa).

In comments on the Proposed Decision, CWA and others contend this Rule would be difficult or impossible to comply with, as it would require fundamental corporate-wide reorganization of most utilities and be prohibitively expensive. Further, because the water affiliate rules considered here (unlike the energy affiliate rules) do not require strict separation of utilities from their affiliates and parent companies (i.e., the water affiliate rules allow shared corporate services), there is an inherent mixing of certain officers, employees , resources and assets

between water utilities and their parent companies and affiliates. This mixing would thus preclude the very non-consolidation opinion required under DRA's proposed rule.

We agree with CWA that rigorous non-consolidation opinions may be difficult or impossible to implement, as well as very costly to obtain. We will not adopt the DRA-proposed rule. However, the fundamental concept of protecting the utility from the financial woes of the parent is sound. Therefore, we will require each subject water utility with a parent to file a Tier III Advice Letter proposing provisions that are sufficient to prevent the utility from being pulled into the bankruptcy of its parent company. The process specified by the Advice Letter Filing shall include a verification that the provisions have been implemented and signed by the utility's senior management (e.g., the Chief Executive Officer, Chief Financial Officer, and General Counsel. This rule provides each utility with the flexibility to implement financial separation provisions as appropriate for individual corporate structures, and the ability to modify such provisions as necessary.

5.10. Rule VIII -- Regulatory Oversight

The sub-rules in Rule VIII are adopted consistent with the discussion below, and consistent with our overall policies and objectives discussed in this decision.

5.10.1. Rule VIII.A – Requirement to Testify

Staff Proposed Rule VIII.A states: "The officers and employees of the utility and its affiliated companies shall be available to appear and testify in any proceeding before the Commission involving any transaction between the utility and the affiliate in connection with the provision of products or services, as set forth in Rule 1.B. If, in the proper exercise of the Commission staff's duties, the

utility cannot supply appropriate personnel to address the staff's reasonable concerns, then the appropriate staff of the relevant utility affiliated companies including, if necessary, its parent company, shall be made available to the Commission staff."

CWA proposes to delete the words "and its affiliated companies" in the first sentence. This has the effect that the relevant officers and employees primarily available to testify would come from the utility. In the second sentence, CWA proposes what it terms as clarifying language that the issues for which affiliates will be made available, by adding "for specific transactions between the utility and an affiliate or between a utility and its parent."

DRA would retain this proposed rule. DRA contends that there needs to be effective measures in place to monitor and evaluate compliance with laws and rules impacting affiliate transactions, and that this proposed rule is a crucial part of such oversight.[80]

TURN points to D.10-02-015 (regarding a transfer of control involving Valencia Water) where the Commission imposed several conditions on the approval of the transfer, including a requirement that "the officers and employees of Valencia and its affiliated companies shall be available to testify in any proceeding before the Commission involving Valencia." (D.10-02-015, Appendix C.)[81] TURN contends the Commission has clear, although limited, authority over unregulated or out-of-state affiliates of regulated utilities. TURN

[80] DRA Comments at 16.

[81] See also D.08-01-018 wherein the Commission imposed an identical condition on a request from Lodi Gas Storage, L.L.C. for transfer of control to Buckeye Gas Storage. In that decision, the Commission required that the officers of the six entities involved in the transaction be made available to testify.

claims that within the limits is the authority to require officers and employees of those affiliates to appear before the Commission on specific matters.[82]

We will adopt the Staff Proposed Rule. We agree with DRA that there needs to be effective measures in place to monitor and evaluate compliance with laws and rules impacting affiliate transactions. This rule is within our authority to impose, in that officers and employees[83] of utility affiliates would only be required to testify if there is a nexus between the regulation of the utility and its affiliate. This rule is consistent with conditions we have imposed in the past, in all holding company decisions since 1985,[84] and in the energy affiliate rules. The rule serves an important purpose to ensure enforcement and compliance with our regulatory program.

5.10.2. Rule VIII.B – Access to Books and Records

Staff Proposed Rule VIII.B states: "The utility and its affiliated companies shall provide the Commission, its staff, and its agents with access to the relevant books and records of such entities in connection with the exercise by the Commission of its regulatory responsibilities in examining any of the costs sought to be recovered by utility in rate proceedings. The utility shall continue to maintain its books and records in accordance with all Commission rules. The

[82] TURN Comments at 17-18.

[83] In D.97-12-011 and D.98-06-068, the Commission included directors, as well as officers and employees, of the utility and its affiliates to "be available to appear and testify in any proceeding before the Commission involving the utility." Directors were not included in the analogous rules adopted in D.02-12-068 or D.04-01-051.

[84] D.85-06-023 did not include an explicit requirement that officers and employees be required to appear and testify before the Commission.

utility's books and records shall be maintained and housed available in California."

In recent rate cases, DRA claims that it has found it difficult to obtain parent company and affiliate information to ensure the reasonableness of general cost allocations between regulated and non-regulated operations. DRA cites the most recent case of Cal-Am's audit of its General Office when DRA's auditors (Overland Consulting) encountered difficulties in obtaining requested books and records from the parent company and affiliates, making it impossible to attest to the reasonableness of the cost allocations to Cal-Am.[85]

CWA agrees with this paragraph,[86] except that it would add the words "or in connection with a transaction or transactions between the utility and its affiliates" at the end of the first sentence. CWA agrees that when a transaction with an affiliate has the potential to impact utility service, the Commission should have access to the affiliate's relevant books and records.[87]

Pub. Util. Code § 314(b) states:

> Subdivision (a) also applies to inspections of the accounts, books, papers, and documents of any business which is a subsidiary or affiliate of, or a corporation which holds a controlling interest in, an electrical, gas, or telephone corporation with respect to any transaction between the electrical, gas, or telephone corporation and the subsidiary, affiliate, or holding corporation on any matter that might adversely affect the interests of the ratepayers of the electrical, gas, or telephone corporation.

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[85] DRA Prehearing Conference Statement at 5.

[86] CWA categorized this issue as "Bucket 3" in workshops and opposed the Staff Proposed Rule. However, CWA modified its position in comments as discussed.

[87] CWA Comments at 23.

Concern was raised at the workshop that by leaving water corporations out of this section, the Legislature did not intend to give the Commission authority over the records of the affiliates of water utilities. One Commission decision, D.93-09-006, supports this contention. When San Gabriel refused to produce the financial records of its affiliates and, based on the argument that § 314(b) does not extend to water utilities, DRA's motion to compel discovery was denied. (1993 Cal. PUC LEXIS 629 (Cal. PUC 1993).)

D.93-09-006 is not a broad interpretation of § 314(b). The Commission did not address at the time whether § 701 provides the authority to allow access to water utility books and records. As discussed in Section 6.1 of today's decision, we conclude that § 701 provides sufficient, although limited, authority to regulate affiliates of water and sewer utilities for matters which are cognate and germane to the regulation of the utility.

This requirement is not new. Each of the five water utility holding company decisions by the Commission between 1985 and 2004 includes a provision guaranteeing Commission access to books and records of affiliates, within the context of "the exercise of the Commission's regulatory responsibilities."[88] We also note that while CWA raises the concern that § 314(b) may not allow the Commission to examine the books and records of water utility affiliates, CWA has conceded the point that access to the books and records of its

[88] This or very similar language is found in attachments laying out affiliate transaction rules in D.97-12-011, D.98-06-068, D.02-12-068 and D.04-01-051. D.85-06-023, Ordering Paragraph 4, states "SLW Corp and any other affiliated company transacting business with San Jose Water Company shall, upon request, make all books and records available for Commission review and inspection."

affiliates is permissible in the context of utility transactions with an affiliate that have the potential to impact utility service.

No party opposes the proposed rule as modified by CWA. The rule is reasonable as modified, and we will adopt the Staff Proposed Rule with CWA's modification.

5.10.3. Rule VIII.C – Compliance Plan

Staff Proposed Rule VIII.C would require each utility subject to these rules to file a compliance plan by advice letter. The compliance plan would include a list of affiliates and their purposes or activities, and a description of the procedures in place to assure compliance with the rules. The compliance plan would be updated once every two years, or under specified circumstances. Pub. Util. Code § 587 requires gas, electrical and telephone (but not water or sewer) corporations to prepare an annual report regarding affiliate transactions. As discussed elsewhere in this decision, § 701 provides sufficient authority for the Commission to extend this provisions to water and sewer utilities, as appropriate.

CWA would eliminate Staff Proposed Rule VIII.C, arguing that verification of compliance should not be a difficult task if simple, straightforward rules are adopted. Instead of this rule, CWA would have utilities include a statement in their annual reports that they have taken adequate measures to inform their directors, officers and other management personnel of the requirements of the rules and to ensure their compliance with them. CWA also points out that DRA and DWA can always request additional information if necessary.[89]

[89] CWA Comments at 22.

DRA contends that a compliance plan is necessary to ensure the safeguards adopted in this decision are actually complied with. DRA and TURN contend that CWA failed to explain why it would be burdensome to provide the information called for in the compliance plan. TURN argues that providing information to directors, officers and management is insufficient unless the managers also provided such information to field personnel and other relevant staff. DRA and TURN do not object to the filing of the compliance plan concurrently with, or as part of, the utility's annual report.

We agree with CWA that the requirements for ensuring compliance should be simple and straightforward. However, we do not agree that there should be no compliance plan at all but simply a statement of compliance in the utility annual reports. Inevitably, more information will be needed to verify any such statement; this information should be transparent and available to all interested parties. The best way to ensure this occurs is with a clear requirement for a periodic compliance plan. At the same time, the compliance plan should not be onerous. The proposed rule requires potentially many updates of the compliance plan, for every new affiliate or changed circum stance. We consider reporting for new affiliates in Rule VIII.D. We will modify Staff Proposed Rule VIII.C.3 to simply require a biennial report. The first report will be required in 2011 as part of the utility's 2010 annual report.

5.10.4. Rule VIII.D – New Affiliates

Staff Proposed Rule VIII.D states: "Upon the creation of a new affiliate, the utility shall immediately notify the Commission of its creation, as well as posting notice of this event on its web page board. No later than 60 days after the creation of this affiliate, the utility shall file an advice letter with the Director of the Commission's Division of Water and Audits and the Division of Ratepayer

Advocates. The advice letter shall state the affiliate's purpose or activities, whether the utility claims that Rule I.B makes these (rules) applicable to the new affiliate, and shall include a demonstration to the Commission that there are adequate procedures in place that will assure compliance with these (rules)."

CWA would have this rule apply only to affiliates which have transactions with the utility. CWA points out that the various water utilities have hundreds of affiliates through their parent companies which do not interact with California water utilities. CFC disagrees, contending that the Commission should decide to which affiliates the rules should apply, as opposed to having the utilities decide when notification is appropriate. DRA would apply this proposed rule to reporting of new affiliates that have the potential to affect a utility's regulated operations, assuming that proposed rule VIII.C(3) is adopted regarding a compliance plan.[90]

We agree with CFC. The Commission, not the utility, should determine whether an affiliate is subject to these Rules. At the same time, we do not want to continuously monitor those affiliates which would have no impact on a utility's operations. DRA's proposal is too vague, as it may not be possible to know which affiliates have the potential to affect a utility's regulated operations. We will retain Staff Proposed Rule VIII.D, but revise it to state that the utility may include in its advice letter a request, including supporting explanation, that these Rules not be applied to the new affiliate.

[90] DRA Comments at 18.

5.10.5. Rule VIII.E – Independent Audit

Staff Proposed Rule VIII.E states: "The utility shall have an audit performed biennially by independent auditors. The audits shall cover the last two calendar years which end on December 31, and shall verify that the utility is in compliance with the (rules) set forth herein. The Division of Water and Audits shall post the audit reports on the Commission's web site. The audits shall be at shareholder expense."

CWA contends this audit is unnecessary because it would duplicate what occurs in general rate cases. Park Water would also remove the proposed rule. Alternatively, due to the expense involved with an audit, Park Water would have the rule be triggered only if unregulated affiliates generate revenue exceeding some percentage of the total revenue of the combined entities.[91] CFC would keep the proposed rule, because it believes that affiliate transaction rules are unlikely to be given sufficient attention in a general rate case, given all of the other matters in such a proceeding. DRA similarly claims that general rate cases are becoming very large and complex, and argues that another complex issue should not be added to those proceedings.[92]

Pub. Util. Code § 314.5 states, in pertinent part: "The commission shall inspect and audit the books and records for regulatory and tax purposes (a) at least once in every three years in the case of every electrical, gas, heat, telegraph, telephone, and water corporation serving over 1,000 customers, and (b) at least once in every five years in the case of every electrical, gas, heat, telegraph, telephone, and water corporation serving 1,000 or fewer customers. An audit

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[91] Park Water Comments at 9.

[92] *Id.*

conducted in connection with a rate proceeding shall be deemed to fulfill the requirements of this section." The required audit in the statute is essentially a financial audit. The audit in the proposed rule pertains to affiliate transactions. We consider this a separate audit function. Deferring to the required audit from § 314.5 would not ensure that affiliate transactions would be specifically reviewed. In order to ensure this, we will adopt the Staff Proposed Rule. In order to avoid adding shareholder costs for situations with de minimus affiliate activities, we will add a provision such that the audit is required only if all unregulated affiliates of that utility generate revenues exceeding 5% of the total revenue of the utility plus all of its affiliates.

5.11. Rule IX -- Confidentiality

There is no controversy regarding Rule IX. Staff Proposed Rule IX is adopted consistent with our overall policies and objectives discussed in this decision.

6. Rule X -- Non-Tariffed Products and Services

6.1. Background

The Commission has adopted rules that govern the water utilities' ability to provide non-tariffed products and services (NTP&S) through the use of regulated assets and personnel (formerly called excess capacity rules). The primary NTP&S decision is D.00-07-018, adopted in R.97-10-049. Two subsequent decisions in that proceeding made corrections, and a third approved in part a petition to modify D.00-07-018.[93] However, the basic substance of D.00-07-018 remained in place.

[93] The later decisions are D.01-01-026, D.03-04-028, and D.04-12-023.

D.00-07-018 distinguished the types of non-tariffed utility offerings as either active or passive. The decision adopted an Appendix A, which designated many potential non-tariffed offerings as either active or passive, and stated that any non-tariffed utility offerings not present on the list would be designated as active if the shareholders incurred incremental investments costs of $125,000 or more.[94] D.00-07-018 required water utilities to file advice letters for the provision of certain types of active services, and required that the utilities provide certain information regarding each active service and each passive service in their annual reports. The rules include a methodology for water utilities to allocate revenue from non-tariffed utility services between ratepayers and shareholders depending upon whether the service is active or passive. The NTP&S rules adopted in D.00-07-018 do not apply to sewer utilities.

The rules governing the water utilities' use of regulated assets and personnel for non-tariffed services are particularly distinguishable from comparable rules for the energy industry in two ways: (1) the list of products and services for water utilities contained two additional categories, "Operation and Maintenance Contracts" and "Customer Ancillary Services;" and (2) water utilities were given authority to offer new non-tariffed services under these two broad categories without first filing an advice letter with the Commission.[95] These two distinctions have provided flexibility to the water utilities, but they have also created confusion. Pursuant to the direction of the OIR in this proceeding, the water utilities provided a list of NTP&S currently in existence.

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[94] D.01-01-026 published that Appendix A.

[95] *See* Re Southern California Edison Co. (1999) 1 CPUC3d 579, 596.

6.2. Positions of Parties

CWA would keep the NTP&S rules that were first adopted for the water utilities in 2000 in D.00-07-018 (with subsequent modifications), contending that no problems have arisen that would warrant a change in the existing rules. CWA points out that the rules adopted in D.00-07-018 were modeled after rules adopted for SCE in 1999, and that SCE has continued to operate under these rules with virtually no changes since then. In addition, CWA provides specific comments on the Staff Proposed Rules for NTP&S and the Workshop Report.

TURN generally opposes the revisions made by CWA, preferring the language in the Staff Proposed Rules, with certain changes from the workshops. CFC objects to the entire idea of multiple uses of ratepayer assets. DRA notes that both the regulated water companies and their affiliates provide non-tariffed services to their own customers, such as Suburban's Residential Houseline Program[96] (repair and replacement of water service lines).[97] DRA also cites the case of Golden State Water whose affiliate, American State Utility Services provides non-regulated utility services via contracts with various cities, while Golden State Water's employees provide the day-to-day utility services under these contracts. In Golden State Water's GRC A.02-11-007, it requested that related cost allocations pertaining to serving these contracts should be dealt under the cost and revenue sharing mechanism as provided in the Excess Capacity Decision (D.00-07-018), rather than the cost allocation guidelines in Golden State Water's affiliate transaction rules (pursuant to D.98-06-068). In D.04-03-039, the Commission concluded that Golden State Water should follow

[96] Cal Water at one time provided a similar service to its own customers.

[97] DRA Reply Comments at 2-4.

the policies and guidelines adopted in Golden State Water's holding company decision, D.98-06-068, regarding affiliate transactions.[98]

TURN, DRA and CWA all agree that if excess capacity is used by affiliates to provide NTP&S, or if the utility provides such services to its affiliate, those activities should be subject to the affiliate transaction rules.[99] However, CWA would grandfather in pre-existing contracts and transactions where NTP&S are provided from utilities to their affiliates, as these arrangements were made pursuant to D.00-07-018.

Cal Water argues that, going forward, affiliate rules should specifically allow the use of excess capacity accounting where a good or service is being provided to an affiliate consistent with the proposed rules. In Cal Water's view, the prices of non-tariffed items sold by a utility should be considered "regulated by a state agency" within the meaning of this provision, regardless of the identity of the buyer. Cal Water contends there is no economic basis for charging a different price when such goods or services are sold to an affiliate from the price at which they are sold to a third party.

6.3. Discussion

In the OIR that began this proceeding, we discussed the need to develop new NTP&S rules. We noted that the current rules on non-tariffed water utility services adopted in R.97-10-049 have been considered in several dockets.[100] The

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[98] DRA Prehearing Conference Statement at 6.

[99] TURN Comments at 19; DRA Comments at 21; CWA Comments at 26.

[100] See, D.03-09-021 in A.01-09-062 et al., D.04-03-039 in A.02-11-007, D.07-11-037 in A.06-02-023, D.07-12-055 in A.06-07-017 et al., and D.09-03-007 and D.10-04-053 in A.08-01-004. Related issues are being considered in A.08-05-019 and A.08-07-004, which are still open.

combination of the four decisions in R.97-10-049 has made it somewhat confusing to determine the exact rules in effect. In several recent proceedings, the Commission has found considerable confusion regarding how each water utility is interpreting and operating under the non-tariffed utility service rules.

We stated in the OIR that more guidance is necessary, in particular when the service offering involves the use of utility personnel and the assets used to provide basic utility service. Furthermore, the current non-tariffed utility service rules do not address the issues of: (1) providing either active or passive services to affiliates; (2) allowing an affiliate to use a regulated utility's personnel or facilities to provide its unregulated services; (3) the lag in time before the Commission is notified of those non-tariffed services that, pursuant to the rules adopted in R.97-04-011, do not require approval through an advice letter; and (4) possible confusion/crossover with affiliate transaction rules.

In addition, we are aware that Cal Water and Golden State Water are currently limited in providing NTP&S by their holding company decisions (D.97-12-011 and D.98-06-068, respectively). D.07-12-055 (regarding Cal Water rate cases) at 45-46 discusses a prohibition for Cal Water:

> Cal Water asserts that its affiliate transaction rules prohibit it from directly offering an unregulated service. We have reviewed the relevant sections of Cal Water's affiliate transaction rules, and find that Cal Water is correct. Cal Water's affiliate transaction rules state that unregulated operations and employees whose primary responsibilities are to conduct unregulated operations should be transferred from the utility to the affiliate.[101] Thus, under its affiliate

[101] Footnote 76 from D.07-12-055: Cal Water cites to D.97-12-011, Appendix A, XII. This section of the settlement agreement adopted by Cal Water's holding company decision states, in relevant part: "A. Unregulated operations, including all pertinent contracts, that are performed by the Utility shall be transferred to the appropriate affiliate as soon

Footnote continued on next page

> transaction rules, Cal Water may not offer an unregulated service; only its affiliate may offer an unregulated service. We recognize that this limits the type of services Cal Water may offer.

Golden State Water is constrained, but not prohibited, from offering NTP&S. D.98-06-068 (regarding the holding company application of Southern California Water, which changed its name to Golden State Water) included the following rule:

> Unregulated Operations & Transfer of Employees. A. Unregulated operations, if any, including all pertinent contracts, that are performed by Utility shall be transferred to appropriate affiliate as soon as all requisite consent is obtained. B. Utility shall avoid a diversion of management that would adversely affect Utility. C. Utility shall not use its directors and employees, including officers, to conduct unregulated operations if such use would adversely affect the utility or its ratepayers. D. Utility shall endeavor to transfer to its affiliates any employee whose primary responsibility is to conduct unregulated operations, taking into consideration the Utility's obligations to any such employee, its obligations under any contract with its unions or other, and the cost of providing terms of employment.

We do not agree with CFC that there should be no NTP&S allowed; there are appropriate uses of excess capacity or slack resources which can benefit the utility, the marketplace and (if there is revenue sharing and there are appropriate safeguards in place) ratepayers. Allowing more efficient use of resources under a reasonable set of rules will not prevent us from scrutinizing utility operations

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as the requisite consents are obtained . . . C. The utility shall endeavor to transfer to its affiliates employees whose primary responsibility is to conduct unregulated operations. The timing of such transfer will take into consideration the Utility's employment obligations to such employees, its obligations under its Union contracts and the cost of providing comparable terms of employment." (D.97-12-011, 1997 Cal. PUC LEXIS 1212, *14-15.)

in general rate cases to ferret out attempts to pad payrolls to allow provision of NTP&S. We also will not tolerate any loss of focus by the utility on the core utility services it provides.

We also do not agree with CWA that the NTP&S rules in place since 2000 should be left in place, unchanged. Now is the time to look at updates and changes to the rules. Rule X of the rules in Appendix A will supersede the rules regarding NTP&S from D.00-07-018 (and as later modified). Similarly, notwithstanding settlement provisions approved by D.07-12-011 for Cal Water and by D.98-06-028 for Golden State Water, these two utilities will be allowed to offer non-tariffed products and services consistent with the rules we adopt today.

Overall, the current NTP&S rules are a good starting point. We find no specific concerns which require a complete overhaul of the current NTP&S rules, but acknowledge that some clarifications and updates are required. We use the Staff Proposed Rules and the comments as the vehicle. As discussed in the OIR, the biggest problem stemming from these rules has been inconsistent applicability among different water companies. There is no good reason why some water utilities in the same class should be subject to different rules for NTP&S than others, or why the rules should not apply equally to sewer utilities. We will modify the rules so that they apply equally to all covered water and sewer utilities.

A second issue is the relationship between NTP&S rules and affiliate transactions rules. Currently, it is unclear whether a water utility may provide NTP&S to its affiliate, or under what conditions. For example, Cal Water has provided billing and marketing for Extended Service Protection (ESP) to its affiliate, CWS Utility Services. The affiliate has contracted with an unrelated

entity, Home Emergency Insurance Solutions, for the actual ESP service. After the Commission issued D.07-12-055, Cal Water gave its utility customers notice that they were being switched from CWS Utility Services to Home Services for the ESP service unless they opted out within a set time. In A.08-05-019, Cal Water seeks a Commission order confirming the action above complies with D.07-12-055 and approving the accounting. In a related application, A.08-07-004, Cal Water requests to modify its holding company decision (D.97-12-011) to allow it to directly offer the non-tariffed billing and marketing service to Home Emergency Insurance Solutions under the Commission's excess capacity rules.

We will not allow the provision of NTP&S from a water or sewer utility to its affiliates other than under the provisions of the affiliate transaction rules, in particular Rules III.C, VI.A and VI.C in addition to Rule X, ,adopted herein. These are inherently affiliate transactions and must be considered as part of the rules we adopt today. If we were to do otherwise, water and sewer utilities could sidestep the other affiliate transaction rules and provide advantages to their affiliates without the ratepayer and market protections provided for in the affiliate transaction rules. We will not adopt CWA's suggestion to grandfather in any existing arrangements to provide NTP&S between utilities and their affiliates. This exception would provide a loophole which could undercut the effectiveness of our rules.

We also do not adopt Cal Water's view that the prices of non-tariffed items sold by a utility should be considered "regulated by a state agency" within the meaning of this provision, regardless of the identity of the buyer. By definition, non-tariffed products and services do not have rates, prices or tariffs regulated by this Commission. As discussed above, we do not allow provision of NTP&S to an affiliate except under the adopted affiliate transaction and NTP&S rules.

Rule VI.D forbids discrimination among affiliated and non-affiliated entities for good and services offered on the open market, thus preventing a utility from charging different prices to an affiliate and a third party.

We adopt the NTP&S rules in Rule X of Appendix A consistent with the discussion in this decision. We note that certain issues in Rule X are parallel to those in the other rules in Appendix A (e.g., use of terms such as "excess or unused capacity" in Rule X.A.C.1); in these cases, we follow the same outcomes throughout the rules.

6.3.1. Commission Approval for NTP&S

Water utilities currently do not have to seek approval from the Commission to offer NTP&S. At one point, such review was required. D.03-04-028, Ordering Paragraph 2, stated:

> Any water utility which proposes to engage in a sale of non-tariffed goods or services provided, in whole or in part, by assets or employees reflected in the utility's revenue requirement, which would be proposed to be classified as active as described herein, shall file an advice letter seeking Commission approval, except for those activities designated as active in attachment A.

Later, D.04-12-023, Ordering Paragraph 3, deleted this requirement and modified D.03-04-028 to provide that:

> Water utilities that have made non-tariffed offerings of products and services, provided in whole or in part, by assets or employees reflected in the utility's revenue requirement, shall submit, as part of their annual report, a list describing each active and passive investment, and aggregate revenues derived from its non-tariffed offerings.

As the OIR indicated, we were not certain exactly what NTP&S were provided by water utilities at the time. While the water utilities have now provided such as list as part of this proceeding, we otherwise do not find out

about changes or additions to NTP&S except through annual reports, as there is no other notification or approval now required. Changes to NTP&S can have significant impacts to ratepayers, such as diversion of utility resources. While most changes are likely to be benign, it is important for there to be transparency and a method for review of NTP&S offerings. We will require the water and sewer utilities to file an advice letter for any new NTP&S, defined as (a) an NTP&S not currently designated in Appendix A; (b) a significant extension of a current NTP&S (e.g., billing systems currently offered to utilities, now offered to other customers); or (c) a change from "passive" to "active" designation (or vice-versa), along with a rationale for this change.

6.3.2. Rule X.B.3 – Utility Employees

DRA generally opposes the use of utility employees for NTP&S, because allowing such use would imply an "acceptable" level of inefficiency ultimately borne by ratepayers. DRA contends that, as the utility grows, any excess capacity[102] should diminish, and therefore any NTP&S business based on this excess capacity would be unsustainable.[103] TURN offers that excess capacity should refer to assets that are carried on a utility's books (i.e., capital-related, and not employees).

CWA counters that there is no evidence that any water utility has designed its operations to include undue resource capacity (including employee levels) or to be capable of only handling current demand. CWA contends that utility

[102] While CWA would prefer not to use the term "excess capacity," there was no agreement on a better term for these purposes. This term is not intended to imply that utility systems contain unnecessary capacity or were intentionally designed or built too large in order to benefit shareholders.

[103] DRA Comments at 21.

employees are capable of handling additional assignments in non-peak operating periods, without harming ratepayers.[104]

The current NTP&S rules allow assets or employees reflected in the utility's revenue requirement to be involved in the provision of NTP&S. It is impractical to fully exclude the use of employees in the provision of NTP&S, as the use of capital assets to provide NTP&S could not be achieved without some incidental use of employees. However, we do not intend that the utility hire and put into rates additional labor costs which are not necessary for the provision of regulated utility service. Therefore, we will adopt the Staff Proposed Rule in this respect.

6.3.3. Rule X.D – Cost Allocation

In response to comments by CWA and other utilities on the Proposed Decision, we delete language which would have required non-incremental investments and costs incurred for labor and capital joint used for non-tariffed and tariffed products and services to be fully allocated between ratepayers and shareholders. This language was ambiguous, as it could have been read to either require a change to revenue requirement or simply a tracking of costs. As CWA and others point out, it would be improper to reduce the utility revenue requirement for NTP&S costs while at the same time providing for sharing of gross revenues between shareholders and ratepayers. We do not believe there is a clear benefit to tracking such costs, thus we delete the language.

[104] CWA Reply Comments at 21 – 22.

7. Motions

On July 16, 2009, Cal Water filed a Motion to file documents under seal. The documents relate to its 2007-2008 direct labor costs for non-regulated services in response to Question #23 (c) of the Rulemaking. No party objected to the Motion. We will grant the Motion.

On October 10, 2010, Cal-Am filed a "Motion for Oral Argument Before the Commission." Rule 13.13(b) of the Rules of Practice and Procedure gives parties in quasi-legislative and ratesetting proceedings the right to make a final oral argument before the Commission if the party follows the specified process. However, Rule 13.13(b) is only applicable in proceedings in which hearings were held. Rule 13.13(a) allows the Commission in any proceeding to "direct the presentation of oral argument before it," but does not grant parties a right to oral argument.

This proceeding is categorized as quasi-legislative. No hearings have been held. We will deny Cal-Am's Motion for Oral Argument.

8. Comments on Proposed Decision

The proposed decision of Commissioner Bohn in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were filed on October 4, 2010 by DRA, TURN, CFC, CWA, Cal Water, Cal-Am, Park Water, Suburban Water and Golden State Water, and reply comments were filed on October 11, 2010 by DRA, TURN, CFC, CWA, Cal Water, Cal-Am, Park Water, Suburban Water and Golden State Water.

In response to comments, we have made the following changes to the Proposed Decision:

1. Rule I.B is clarified so that the Rule now states that the Rules "… apply to transactions between a Commission-regulated utility and another affiliated entity *that is engaged in the provision of products that use water or sewer services or the provision of services that relate to the use of water or sewer services."* (Additional language in italics.) This clarification is made because we are generally concerned with market power issues only if there is some connection to water or sewer services (including affiliates involved in plumbing or insurance for water lines).
2. Ordering Paragraph #2 is clarified so that interim affiliate transaction rules adopted in D.10-09-012 for Suburban Water are superseded by the rules adopted in today's decision.
3. Rule III.B allows the utility to provide certain benefits from a utility to affiliates whose sole purpose is to serve regulated utility functions – in this case, across a number of regulated utilities within and outside of California – or non-profit or governmental organizations. In response to comments on the Proposed Decision, Rule III.B is modified to add the parent company of regulated utilities as allowable entities.
4. Rules III.B.4 is modified to contain an exception to allow parents of utilities to obtain proprietary information as referenced in this rule, and to speak on behalf of the utility. Rule III.B.6 is modified to eliminate a restriction on affiliates speaking on behalf of utilities, as this provision serves no specific purpose.
5. Rule V.D is modified to strike "employee recruiting" from the list of services prohibited from being shared between the utility and its affiliates.
6. Rule VII.E is modified from a requirement to obtain a non-consolidation opinion (a so-called "ring-fencing" provision), to a requirement that each subject water utility with a parent file an Advice Letter proposing provisions that are sufficient to prevent the utility from being pulled into the bankruptcy of its parent company.
7. Rule X.D is modified to delete language which would have required non-incremental investments and costs incurred for labor and capital joint used for non-tariffed and tariffed products and services to be fully allocated between ratepayers and

shareholders. This language was ambiguous, potentially counter-productive and unnecessary.

8. In order to give the water and sewer utilities sufficient time to adapt to the rules adopted today, the rules will become effective in 90 days.
9. Typographical errors and minor factual errors are corrected.

9. Assignment and Categorization of Proceeding

This proceeding was categorized as quasi-legislative. John A. Bohn is the assigned Commissioner and David M. Gamson is the assigned ALJ.

Findings of Fact

1. The Commission's goals for this proceeding are that these affiliate transactions and non-tariffed products and services rules should be applied uniformly to all similar water and sewer utilities, that cross-subsidy of affiliates by the utilities should be prevented, and that anti-competitive behaviors of the utilities, if any, should also be prevented.

2. Five Class A water utilities currently operate under affiliate transaction rules adopted in holding company decisions. Additionally, Park Water operates under certain affiliate transaction rules adopted in a non-holding company decision.

3. Currently, there are inconsistent and/or non-existent affiliate transaction and non-tariffed products and services rules for water and sewer utilities.

4. There is no evidence that the current affiliate transaction rules have caused any harm to any water utility, except for restrictions on non-tariffed products and services applicable to some water utilities and not others.

5. Pub. Util. Code § 701 provides that the Commission may supervise and regulate every public utility in the State and may do all things, whether

specifically designated in this part or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction.

6. There have been a number of documented incidents of problems regarding affiliate transactions in the water industry, which have been detrimental to ratepayers and/or the competitive marketplace.

7. There are significant similarities and significant differences between water and sewer utilities, and energy utilities.

8. The most significant similarity between water and sewer utilities, and energy utilities is that they all provide basic, regulated monopoly services.

9. Both water and sewer utilities and energy utilities have unregulated affiliates, including a significant number of affiliates formed while operating under affiliate transaction rules.

10. Water and sewer utilities are significantly smaller in number of customers and revenue than energy utilities that are subject to affiliate transaction rules. Affiliates of water and sewer utilities tend to be smaller than affiliates of energy utilities. However, some water and sewer utilities have complex affiliate relationships which do not exist in the energy industry.

11. Absent appropriate affiliate transaction rules, water and sewer utilities have the ability to provide unfair competitive advantages to their affiliates, through such means as cross-subsidies, preferential use of ratepayer-funded assets by affiliates, differential treatment of affiliates as compared to other competitive firms, and sharing of non-public and proprietary information with affiliates.

12. Park Water is both a utility and a parent company of a utility, Apple Valley Ranchos Water Company.

13. Cal-Am is served by two not-for-profit affiliates that provide capital and customer service to various water utilities.

14. Cal Water is currently prohibited from offering unregulated services. Golden State Water is constrained in offering unregulated services.

15. The affiliate transaction rules proposed by Commission staff were substantially taken from affiliate transaction rules in place for the energy industry.

16. The parties in workshops agreed upon a number of issues, designated as "bucket 1" issues. A number of issues with minor disagreements in wording were designated as "bucket 2" issues. Some "bucket 2" issues involve issues of substance. Issues designated by parties as "bucket 3" issues involved substantial differences.

17. Class A and B water and sewer utilities are significantly larger than Class C and D water and sewer utilities. The Class A and B utilities have significantly greater ability to transfer market power to their affiliates, absent appropriate affiliate transaction rules.

18. There is sufficient regulatory oversight in general rate cases to scrutinize transactions between regulated entities, consistent with a general rule that regulated utilities and their regulated affiliates should not subsidize one another without explicit Commission authorization.

19. Regulatory consistency would be improved by adopting standard affiliate transaction and non-tariffed utility service rules in a single rulemaking.

20. There are current affiliate transaction rules in Commission holding company decisions that are outside of the boundaries of the rules adopted in this proceeding.

21. Some water and sewer utilities have affiliates with operations entirely outside of California, some of which have few or no transactions with the California utility.

22. The Commission's energy affiliate transaction rules use a 5% ownership threshold for the definition of an affiliate, while the Securities and Exchange Commission uses a 10% threshold for effective control.

23. "Cross-subsidy" is not a defined term in the energy affiliate rules. There are a variety of definitions to be found in economics and accounting references.

24. Centralized support functions provided for regulated entities are beneficial to the regulated entities and their ratepayers due to lower costs and greater efficiencies from this type of entity, as compared to the utility raising its own capital or providing its own customer services.

25. Absent effective non-discrimination rules, the monopoly water or sewer utility and its assets can be used exclusively or in an unfair manner by its affiliates in the marketplace.

26. There is no justification for allowing one utility to subsidize another unless upfront explicit regulatory approval is granted to achieve an identifiable public benefit.

27. It would be impractical for all water and sewer utilities to provide various shared corporate support services in-house. Sharing of centralized functions generates scope economies and as such can increase production efficiency.

28. In the provision of certain goods and services from the utility to an affiliate, there are unidentified cross subsidies which accrue to affiliates from the investments and training funded by ratepayers.

29. There are circumstances where a parent company could either help or hinder the utility's ability to maintain adequate capital to carry out its

obligations; for example, a utility could be required to provide dividends to a parent that could harm the utility, or a parent could infuse capital into the utility to assist it.

30. There is no evidence that rules from current water utility holding company decisions restricting water utilities from issuing or guaranteeing debt have caused any problems for water utilities. On the other hand, eliminating such restrictions could lead to increased costs for the utility and its ratepayers.

31. Cost of capital proceedings are the appropriate regulatory mechanism to consider capital structure issues.

32. There are a variety of circumstances which could lead to the bankruptcy of a parent company of a water or sewer utility, ranging from management problems to market conditions to *force majeure* situations.

33. Bankruptcy or other financial hardship of a parent company of a water or sewer utility could lead to financial pressures on the utility, unless the utility is effectively protected from such hardships.

34. There needs to be effective measures in place to monitor and evaluate compliance with laws and rules impacting affiliate transactions.

35. An audit of the implementation of affiliate transaction rules would ensure the rules are properly followed.

36. Not all Class A and B water utilities are subject to the current NTP&S Rules. Cal Water and Golden State Water are currently limited in providing NTP&S by their holding company decisions.

37. There are appropriate uses of excess capacity or slack resources by water and sewer utilities which can benefit the utility, the marketplace and (if there is revenue sharing and there are appropriate safeguards in place) ratepayers.

38. The rules for NTP&S have been inconsistently applied among different water companies.

39. Currently, it is unclear whether a water utility may provide NTP&S to its affiliate, or under what conditions.

40. If NTP&S were allowed to be offered to affiliates other than under affiliate transaction rules, water and sewer utilities could provide advantages to their affiliates without the ratepayer and market protections provided for in the affiliate transaction rules.

41. Water utilities currently provide a list of NTP&S through annual reports; no other notification or approval is now required. Changes to NTP&S can have significant impacts to ratepayers, such as diversion of utility resources.

42. Allowing available ratepayer-funded capital assets to be used more efficiently necessarily entail some incidental use of utility employees.

Conclusions of Law

1. There is no statute which directly addresses Commission jurisdiction over water and sewer utility affiliate transactions.

2. It is reasonable to adopt as goals for affiliate transactions rules that the rules should be applied uniformly to all similar water and sewer utilities, cross-subsidy of affiliates by the utilities should be prevented, and anti-competitive behaviors of the utilities, if any, should be prevented.

3. Affiliate transaction rules should not provide an undue burden on water and sewer utilities.

4. It is timely and appropriate to consolidate, clarify, standardize and update the current rules in order to provide standard rules applicable to regulated water and sewer utilities, their provision of non-tariffed services, and their transactions with affiliated companies.

5. The Commission has authority under Pub. Util. Code §§ 851-854 to regulate changes of ownership which pertain to water and sewer utilities.

6. The Commission has authority under Pub. Util. Code § 701 to regulate affiliate transactions of water and sewer utilities as long as such an interpretation does not disregard express regulatory directives and the authority is "cognate and germane" to utility regulation.

7. Ensuring reasonable rates requires that the relationship between the utility and its affiliates be transparent, and that the regulated revenue requirement is not the source of funding for competitive or unregulated ventures.

8. It is in the public interest to ensure that water and sewer utilities do not promote or provide unfair competitive advantages for their affiliates in competitive markets.

9. It is necessary to develop or revise affiliate transaction rules for water and sewer utilities to protect ratepayers and prevent unfair competitive activities by utility affiliates stemming from ratepayer funds, while ensuring the opportunity for water and sewer utilities to earn a reasonable profit.

10. Affiliate transaction rules in the water and energy industries have not been shown to be a barrier against formation of affiliates in either industry.

11. Water and sewer utility affiliate transaction rules should not be the same as energy utility affiliate transaction rules.

12. It is reasonable to use energy utility affiliate transaction rules as the starting point to develop water and sewer utility affiliate transaction rules, as long as appropriate modifications are made to take into account the unique characteristics of the water and sewer industry and individual water and sewer utilities.

13. The affiliate transaction and NTP&S rules designated by parties as "bucket 1" issues should be adopted consistent with parties' proposals and the discussion in this decision, as laid out in Appendix A. The affiliate transaction and NTP&S rules designated by parties as "bucket 2" issues which were not substantial issues should be adopted as consistent with the principles and discussion of this decision, as laid out in Appendix A.

14. Affiliate transaction and NTP&S rules should be applicable to Class A and B water and sewer utilities.

15. Affiliate transactions rules should not apply to transactions between regulated entities, except for the rule that regulated utilities and their regulated affiliates should not subsidize one another without explicit Commission authorization.

16. The affiliate transaction and NTP&S rules adopted in this decision should supersede existing rules where there is a conflict.

17. Financial rules developed in holding company decisions which are not specifically addressed in the affiliate transaction rules in this decision should not be superseded.

18. There should be a rebuttable presumption that the affiliate transaction rules adopted in this decision apply, so that only older rules clearly outside of the bounds of the new rules will not be superseded.

19. Water and sewer utilities should be allowed to seek exemptions from affiliate transaction rules for affiliates with wholly out-of-state operations and with little or no contact with the California utility if such out-of-state operations do not affect the utility's operations and the operating costs inside California.

20. A 10% ownership threshold as the definition of substantial operational control of a water or sewer utility affiliate is reasonable to ensure that any

affiliate with a significant relationship to a water or sewer utility is covered by the rules.

21. There is a need to define the term "cross-subsidy" for the purposes of these rules. A reasonable definition which captures both ratepayer protection and competitive concerns would be: "The unauthorized over-allocation of costs to captive ratepayers resulting in under-allocation of costs to a utility affiliate."

22. While it is reasonable to allow water and sewer utilities to provide certain benefits to their affiliates, in accordance with established rules, utilities generally should not provide non-public and proprietary information to their affiliates. However, it is reasonable to allow a water or sewer utility to provide non-public and proprietary information to a not-for-profit affiliate whose sole purpose is to serve regulated utility, not-for-profit and governmental functions.

23. It is reasonable to allow water and sewer utilities to share non-public or proprietary information with their affiliates for the limited purposes of shared corporate services, as long as there are sufficient limits on other sharing of non-public or proprietary information.

24. With limited exceptions, a monopoly water or sewer utility should not be permitted to provide exclusive or discriminatory access to utility information, services, and unused capacity or supply to its affiliates in the marketplace.

25. A 5% adder to fully loaded costs to the price paid by an affiliate to a water or sewer utility for goods and services not provided on the open market is a reasonable percentage to account for unidentified cross-subsidies which accrue to affiliates from the investments and training funded by ratepayers.

26. Financial rules adopted in water utility holding company decisions should not inadvertently be superseded by these affiliate transaction rules, if existing holding company rules are not specifically addressed in these rules.

27. The parent companies of water and sewer utilities should be required to ensure that water and sewer utilities have adequate capital or adequate access to capital. This requirement ensures that parents of water and sewer utilities cannot extract dividends from the utility in a way which would harm the financial health of the utility.

28. Ensuring reasonable rates requires that water and sewer utilities not issue or guarantee or secure debt for their affiliates.

29. It is reasonable to allow water and sewer utilities which have parent companies to propose individual methods to ensure core water and sewer utility functions are protected from significant financial problems which may befall the parent of the utility.

30. Officers and employees of utility affiliates can be required to testify in Commission proceedings if there is a nexus between the regulation of the utility and its affiliate, and the testimony is cognate and germane to the regulation of the utility.

31. The required audit in § 314.5 would not ensure that affiliate transactions would be specifically reviewed. A separate audit specifically focused on affiliate transactions is necessary.

32. All Class A and B water and sewer utilities should be subject to uniform Non-Tariffed Products and Services Rules.

33. It is reasonable to use the NTP&S Rules developed in D.00-07-018 (as modified by D.01-01-026, D.03-04-028 and D.04-12-023) as the starting point for new rules, using the Workshop Report as a means to accomplish this.

34. NTP&S rules should apply equally to all covered water and sewer utilities.

35. NTP&S should not be provided from a water or sewer utility to its affiliate other than under the provisions of the affiliate transaction rules, because these are inherently affiliate transactions.

36. In order to provide transparency and a method for review of NTP&S offerings, water and sewer utilities should be required to file an advice letter for any new NTP&S.

37. It is not reasonable to allow a water or sewer utility to carry extra employees or put into rates additional labor costs which are not necessary for the provision of regulated utility service, in order to provide NTP&S.

O R D E R

1. The rules for affiliate transactions and the provision of non-tariffed products and services for water and sewer utilities in Appendix A of this order are adopted for all Class A and Class B water and sewer utilities.

2. The affiliate transaction rules I through IX in Appendix A supersede affiliate transaction rules adopted in Decision 85-06-023, Decision 97-12-011, Decision 98-06-068, Decision 02-12-068, Decision 04-01-051 and Decision 10-09-012, consistent with Rules I.D, I.E and VII.G in Appendix A of this order.

3. Rule X in Appendix A, regarding non-tariffed products and services, supersedes non-tariffed products and services rules adopted in Ordering Paragraph 1 of Decision 00-07-018, as modified by Decision 01-01-026, Decision 03-04-028 and Decision 04-12-023.

4. Notwithstanding Section XII of the Settlement Agreement approved by Decision 97-12-011 and attached thereto, California Water Service Company may offer non-tariffed products and services consistent with the rules in Appendix A.

5. Notwithstanding Paragraph 20 of the Settlement adopted by Decision 98-06-068 and attached thereto, Golden State Water Company may offer non-tariffed products and services consistent with the rules in Appendix A.

6. The July 16, 2009 Motion of California Water Service Company to file documents under seal is granted.

7. The October 10, 2010 Motion of California American Water for Oral Argument Before the Commission is denied.

8. The rules adopted in Appendix A are effective 90 days from the effective date of this decision.

9. This proceeding is closed.

Dated October 14, 2010, in San Francisco, California.

MICHAEL R. PEEVEY
President
DIAN M. GRUENEICH
JOHN A. BOHN
TIMOTHY ALAN SIMON
NANCY E. RYAN
Commissioners