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Decision 06-06-062 June 29, 2006

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking Concerning Relationship Between California Energy Utilities And Their Holding Companies And Non-Regulated Affiliates.	Rulemaking 05-10-030 (Filed October 27, 2005)

OPINION AMENDING ORDER INSTITUTING RULEMAKING

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OPINION AMENDING ORDER INSTITUTING RULEMAKING

1. Summary

Today's order amends the Commission's October 2005 Order Instituting Rulemaking (OIR or R.), both as to scope and schedule, and requests public comment on the extent to which there should be future revisions to the Commission's (1) Affiliate Transaction Rules and (2) General Order (GO) 77-L (which governs the reporting of compensation paid to executive officers and employees of regulated utilities). The amended OIR continues to apply only to the previously designated Respondents, California's major energy utilities and their holding companies: Southern California Edison Company (Edison)/Edison International, Pacific Gas and Electric Company (PG&E)/PG&E Corporation, and Southern California Gas Company (SoCalGas) and San Diego Gas & Electric Company (SDG&E), both owned by Sempra Energy.

2. Background and Amended Scope

The Commission opened this OIR to review "the relationship of the major energy utilities with their parent holding companies and affiliates" in furtherance of two over-arching goals.[1] These goals are "to ensure that the utilities meet their public service obligations at the lowest reasonable cost" and "to ensure that the utilities do not favor or otherwise engage in preferential treatment of their affiliates."[2]

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[1] OIR, *mimeo.*, p. 1.

[2] *Id.*, p. 2.

In its 1997 decision adopting the Affiliate Transaction Rules to serve as standards of conduct governing relationships between California natural gas or electric utilities and their affiliates, the Commission explained, "the development of competitive markets would be undermined if the utility were able to leverage its market power into the related markets in which their affiliates compete."[3] Therefore, the Commission decided "to adopt rules that generally require more separation between a utility and its affiliate, rather than rules that rely almost exclusively on tracking costs. The fewer the transactions between the utility and its affiliate, the greater confidence we have that the affiliate lacks market power. In an ideal world, the utility would treat the affiliate as it would other, nonaffiliated firms."[4]

At least four factors militate for a further review of the relationships now. First, as the OIR notes, the recent enactment of the Energy Policy Act of 2005 (EPAct 2005), Public Law 109-58, has repealed the Public Utility Holding Company Act of 1935 (PUHCA), 15 U.S.C. §§ 79 – 79z-6. Under PUHCA, state commissions had recourse to the Securities and Exchange Commission (SEC) if state laws proved insufficient to protect utility ratepayers from abuses by utility holding companies. With the repeal of PUHCA, this Commission has lost one of the protections underpinning its approval of the formation of the holding

[3] Decision (D.) 97-12-088 (December 16, 1997), 77 CPUC 2d 422, 449, as amended by D.98-08-035 (August 6, 1998) 81 CPUC 2d 607 and D.98-12-075 (December 17, 1998), 84 CPUC 2d 155.

[4] *Id.*, 77 CPUC 2d at 450.

companies that control Edison,[5] SDG&E,[6] and PG&E,[7] as well as a safeguard underlying approval of the SDG&E/SoCalGas merger, which resulted in the creation of Sempra Energy.[8]

Second, the circumstances which create conflicts for the utilities between serving their customers or helping their holding companies and other affiliates are becoming more widespread. The Commission has long recognized such inherent conflicts of interests for each of the California energy utilities and their affiliates.[9] Since the Commission's issuance of the Affiliate Transaction Rules, the California energy utilities' holding companies and/or other affiliates have acquired or built electric generation plants and pipeline facilities, and currently are constructing liquefied natural gas (LNG) facilities and connecting pipelines, and/or acquiring equity interests in new pipeline proposals.[10] The repeal of

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[5] *See* D. 88-01-063, 27 CPUC 2d 347 (Jan. 28, 1988) (Edison/EIX), regarding Edison International.

[6] *See* D.95-05-021, 59 CPUC 2d 697 (May 10, 1995) (SDG&E I); D.95-12-018, 62 CPUC 2d 626 (Dec. 6, 1995) (SDG&E II), regarding Enova Corporation.

[7] *See* D.96-11-017, 69 CPUC 2d 167 (Nov. 6, 1996) (PG&E I); D.99-04-068, 86 CPUC 2d 76 (April 22, 1999) (PG&E II), regarding PG&E Corporation.

[8] *See* D.98-03-073, 79 CPUC 2d 343 (March 26, 1998) (Sempra Merger), regarding Sempra Energy.

[9] *See* D.92-07-084, 45 CPUC 2d 241 (July 22, 1992) (SoCalGas/PITCO); D.93-03-021, 48 CPUC 2d 352 (March 10, 1993) (Edison settlement re: Mission Energy); D.97-08-055, 179 P.U.R.4th 485 (August 1, 1997) (PG&E settlement re: PGT).

[10] *See,* e.g., Sempra Energy's website at http://www.sempra.com/companies.htm; Edison's website at http://www.edison.com/ourcompany/affiliate_trans.asp.

PUHCA may result in further acquisitions by the holding companies that control California's energy utilities. It also may lead to an environment in which the holding companies, themselves, become acquisition targets.[11]

Third, the reports submitted by the utilities and their holding companies in response to the OIR, as well as audits of the utilities and letters from them, suggest a highly integrated relationship among the affiliated entities, with potentially detrimental consequences for ratepayers and competitors.

Fourth, but not at all least, recent changes in state law and Commission policies have altered both utility procurement obligations and the oversight responsibilities this Commission bears. California needs to be on a path to ensure resource adequacy on the supply side through the construction of new power plants, transmission lines, pipelines, and storage facilities to meet long-term needs for reliable energy supplies. These new projects may be built and owned by utilities and by non-regulated entities, including the utilities' affiliates. The Commission's regulation of utility resource procurement must meet statewide goals, including resource adequacy and environmental goals and, increasingly the Commission is utilizing pre-approval processes. It is incumbent upon this Commission to ensure that interactions between and among the utilities, their holdings companies and other affiliates do not circumvent California's energy policies, including the important environmental and competitive goals they promote.

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[11] *See* Energy Law Journal, "PUHCA's Gone: What Is Next for Holding Companies" Vol. 27, No. 1 (2006) at 2.

Each of these concerns also calls into question the ability or willingness of the utility holding companies to fulfill their obligations to make the utility's capital requirements a first priority, as the Commission's holding company decisions require (i.e., the first priority condition).[12]

In addition, the comments of the Greenlining Coalition (Greenlining), filed on December 13, 2005, observe that the scope of this OIR necessarily should include review of the impact of executive compensation on utilities and their holding companies. Some of Greenlining's suggestions appear to fall outside the jurisdiction of this Commission. However, we are prepared to consider suggestions within our authority, particularly requirements for more meaningful disclosure of all of the individual components that comprise the total compensation paid to highly compensated executives and employees. Such information is necessary both to ascertain the reasonableness of rates (to the extent monies received from ratepayers fund any part of executive or employee compensation packages, directly or indirectly) and to ensure that the structure of executive/employee compensation does not promote conflicts of interest that disfavor utility concerns over those of the holding company or other affiliate. We recognize that the Commission recently declined to amend GO 77-L to include some of Greenlining's proposals. Now, following the repeal of PUHCA and concurrent with the SEC's movement for greater sunshine on executive compensation, we agree that we should reconsider these issues.[13]

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[12] *See* D. 88-01-063, 27 CPUC 2d at 376; D.95-12-018, 62 CPUC 2d at 651; D.96-11-017, 69 CPUC 2d at 201, as modified, D.99-04-068, 86 CPUC 2d at 126.

[13] *See* the SEC's Proposed Rule "Executive Compensation and Related Party Disclosure" 17 CFR Parts 228, 229, 239, 240, 245, 249, and 274.

3. Discussion

We do not propose revisions to the Affiliate Transaction Rules or GO 77-L in today's order amending the OIR. Instead, we identify the experience of California's major, regulated energy utilities with their holding companies and unregulated affiliates, problems with the existing rules, and some potential solutions to those problems. We require Respondents and invite all interested parties to file concurrent written comments concerning these problems and solutions. After reviewing these written comments, the Commission will prepare draft rule revisions and issue them for further public process (see the revised schedule, below).

3.1. California's Experience

As we see below, the holding companies for each of the major energy utilities took different approaches to the California market in the past.

3.1.1. Edison/Edison International

After its formation as a holding company, Edison International initially chose not to substantially increase the marketing activities of Edison's unregulated affiliates in the California energy market, but instead focused on expanding the affiliates' businesses elsewhere in the United States and abroad.

During California's energy crisis from the Summer of 2000 through the Spring of 2001, Edison was a victim of market manipulation in the California wholesale electric and natural gas markets. The combined effect of the rate freeze under Assembly Bill (AB) 1890 (Stats. 1996, Ch. 854) and skyrocketing wholesale electric prices seriously compromised Edison's financial viability and its ability to serve its electric customers. The Commission's settlement with

Edison (in the federal court litigation Edison filed against the Commission) restored Edison's financial health and creditworthiness.[14]

Edison International and Edison's unregulated affiliates did not benefit financially from exorbitant prices during the California energy crisis, largely due to the holding company's previous decision to limit activity by the unregulated affiliates in the California market. Recently, however, Edison International has expanded the California presence of certain unregulated affiliates.

3.1.2. PG&E/PG&E Corporation

After its formation, the holding company PG&E Corporation devised a somewhat different corporate strategy from the one followed by Edison International/Edison. PG&E Corporation increased the activities of PG&E's unregulated affiliates in California, in energy markets in other parts of the United States, and to a limited extent, in international markets. Like Edison, PG&E was overwhelmed by the California energy crisis. As a result of soaring wholesale electric prices, in April 2001, PG&E filed a Chapter 11 petition with the Bankruptcy Court. PG&E's settlement with Commission staff, later modified and approved by the Commission and subsequently approved by the Bankruptcy Court, restored PG&E's financial health and creditworthiness.[15]

In July 2003, PG&E's affiliate, National Energy & Gas Transmission, Inc. (NEGT) filed a Chapter 11 petition with the Bankruptcy Court. Unlike PG&E, NEGT did not emerge from bankruptcy as a subsidiary of PG&E Corporation. On October 29, 2004, when NEGT's plan of reorganization became effective,

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[14] *See Southern California Edison Co. v. Peevey* (2003) 31 Cal. 4th 781

[15] *See* PG&E's 2004 10K (filed with the SEC) at 1.

PG&E Corporation's equity interest in NEGT was cancelled.[16] However, PG&E Corporation currently is examining new business opportunities in the unregulated sector of the energy market, and therefore, the Commission expects that in the future, PG&E will have unregulated affiliates again.

3.1.3. SoCalGas/SDG&E/Sempra Energy

Following the Commission-approved merger of SoCalGas and SDG&E into the new Sempra Energy, the utilities' unregulated affiliates became Sempra Energy Trading (SET) and Sempra Energy Resources (SER). These affiliates were very active in the energy markets for the western United States and in other national and international markets. During the California energy crisis, because SDG&E was no longer under the AB 1890 rate freeze, SDG&E did not face the same risks as Edison and PG&E. Shareholders in SDG&E's holding company, Sempra Energy, were less exposed also. SDG&E's ratepayers were not protected, however; they had no choice but to pay the excessive California energy prices.[17]

Because they were active participants in the volatile California energy markets, SET and SER, the SDG&E and SoCalGas unregulated affiliates, made significant profits from the high prices.[18] Sempra Energy subsidiaries engaged in

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[16] *See* PG&E's 2004 10K (filed with the SEC) at 2.

[17] The California Legislature expeditiously passed a new law, which capped SDG&E's rates to its retail customers, but which did not place SDG&E at risk, because the costs were placed in a balancing account ultimately to be borne by SDG&E's ratepayers. *See* Cal. Pub. Util. Code § 332.1.

[18] For example, on January 25, 2001, Sempra Energy issued a financial news release, which reported higher earnings in 2000 than in 1999, due primarily to improved results in its energy trading, generation and international operations. SET's net income grew to $155 million in 2000 compared to $19 million in 1999, and 21% of SET's net trading revenue came from trading power in the 11-state western region of the United States.

Footnote continued on next page

marketing activities, constructed generation plants and built natural gas facilities in Baja California, Mexico prior to or during the California energy crisis. Subsequently, Sempra Energy's subsidiaries have constructed generation plants and at present are constructing a LNG import terminal and expansions of pipelines in Baja California, Mexico, which would supply natural gas in Mexico, as well as to California and other states.[19]

3.1.4. Lessons Learned

We are not interested in conducting additional discovery in this rulemaking or litigating, here, what happened in the past. We want to apply, going forward, lessons learned from this troubled chapter in regulatory history. In particular, we want to recognize what this experience has to tell us about potential problems in the holding company structure and about failures or weaknesses in the current rules. Several lessons emerge.

First of all, we need to protect the financial health of California's regulated energy utilities. This is important not solely to protect utility ratepayers and shareholders, or to ensure a truly competitive energy market, but also because the State of California depends upon these utilities to provide the resource adequacy to meet future energy needs, whether through infrastructure development or procurement from third parties. As PG&E Corporation's own experience points out, utility affiliates can face enormous risks. To protect the utilities' financial health, we must require sufficient measures to shield the

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The Commission takes official notice of this news release, which currently may be found on Sempra Energy's website.

[19] *See,* Sempra Energy's website at http://www.sempra.com/companies.htm.

utilities from this risk exposure. We must also ensure that Respondents respect the first priority condition which underlies the Commission's approval of each of the holding companies.

Second, we need to ensure that the utilities do not take advantage of their monopoly status and exercise their market power to unfairly benefit their unregulated affiliates, holding companies, or the holding companies' shareholders and, to undermine a competitive energy market. The ramifications of such behavior are varied but potentially have extremely broad and long-term implications.

Third, we need to ensure that the drive to increase the profitability or market share of a nonregulated business does not raise the level of utility rates.

In the near term, for example, a utility may act to increase affiliate /holding company profits or limit the risks of affiliate actions. As Sempra Energy demonstrated during the California energy crisis, a utility's unregulated affiliates can earn substantial profits during times of tight supply in the utility's energy market. As PG&E's affiliates demonstrated, the activities of a utility's affiliates can result in significant risks for the holding company. With such substantial profits or risks at stake, there are strong incentives within the holding company structure to take advantage of confidential utility information or use ratepayer-subsidized utility facilities, whether to help affiliates maximize their profits or bail them out from risks. Such assistance may occur through a utility's affirmative actions or, conversely, where a utility avoids actions which might remedy a situation that is adverse to its ratepayers' interests but beneficial or potentially beneficial, to its affiliates. The Commission must be better informed about interactions between the energy utilities and their affiliates and must monitor these interactions more proactively.

Longer-term, utility actions may have even broader consequences. A utility's affiliates are in competition with third parties for the utility's business or the business of other California entities. If a utility abuses its market power, access to confidential information, or ratepayer-subsidized resources in order to give its affiliates an unfair advantage over competitors, California stands to lose the benefits competition can provide. Such a loss generally results in higher prices; it also may mean loss of resources (both supply and facilities), which other companies would be willing to commit toward California's future energy needs.

3.2. Problems with the Existing Affiliate Transaction Rules

It is important that a utility and its employees recognize and respond to the utility's needs and public service obligations rather than to the unregulated affiliates' goals. Utilities have monopoly franchises to provide efficient and reliable service at the lowest reasonable cost to millions of captive residential and business customers. The more interactions that they have with their affiliates, the more they may blend the conflicting objectives. The Affiliate Transaction Rules, as originally developed, were intended to provide a safeguard against this blending of conflicting objectives. As noted previously, the rules rely upon greater structural separation, rather than accounting mechanisms, to prevent confidential information from flowing back and forth between the utilities and their affiliates.

However, review of current implementation of the Affiliate Transaction Rules reveals that the original intention has not been fulfilled. The failure is attributable largely to the numerous exceptions to the rules, some of them expressly stated, but many of them products of the utilities' overly-narrow interpretations and observances.

3.2.1. Applicability to the Utility Holding Company

The utilities interpret the existing Affiliate Transaction Rules to be inapplicable to the relationship between them and the holding company which owns and controls them. Although the Rule I. A. defines the word "affiliate" to include "the utility's parent or holding company, or any company which directly or indirectly owns, controls, or holds the power to vote 10% or more of the outstanding voting securities of the utility (holding company)," the definition continues with the phrase "to the extent the holding company is engaged in the provision of products or services as set out in Rule II. B." Rule II. B., entitled "Applicability" limits covered affiliate transactions to those that have something to do with the provision of products or services relating to natural gas or electricity. The utilities have taken the view that their holding companies do not engage in the provision of such products or services.

How effective can any of these rules be if the holding company's relationship with the utility is not governed by these rules? The potential for abuse is myriad and far-reaching, since the holding company has the authority to exercise ultimate control over the utility and unregulated utility affiliates. For example, if the Affiliate Transaction Rules do not apply to the holding company, the holding company could serve as a conduit for communications prohibited between the utility and its affiliates. Likewise, the holding company could direct the utility and its affiliates in ways that accomplish results which the rules prohibit the utility and the affiliate from achieving. Unless key aspects of the Affiliate Transaction Rules govern the relationship between a utility and its holding company, these rules and the underlying reasons for them can be totally circumvented at the top of the corporation where the significant decisions are made.

3.2.2. Applicability to Specific, Unregulated Affiliates

Similarly, the utilities appear to perceive that they should determine which affiliates are covered by the Affiliate Transaction Rules and which are not. Moreover, their assessments generally rely on very narrow interpretations of the rules—distinguishing between whether a consultant is providing advice relating to energy services (a covered service) or simply, advice on financial services relating to energy services (purportedly not covered).[20] In addition, utilities are required to notify the Commission upon the creation of a new affiliate that is covered by the rules. (Rule VI.) If utilities are permitted to determine, in effect, which new affiliates they are required to report, it is entirely possible that this will leave important new affiliates unreported. The Commission does not agree that the utilities should decide which affiliates are covered.

3.2.3. Scope of Covered Transactions

As mentioned above, the utilities interpret affiliate transactions to mean only the contractual provision of natural gas or electricity as a product or a service. The wording of Rule II. B. suggests a broader scope, however, since it refers to the provision of service that "relates to" the use of electricity or natural

[20] For example, in a June 21, 2004 letter from William L. Reed, SDG&E's and SoCalGas' Senior Vice President, to Paul Clanon, then Director of the Commission's Energy Division, Mr. Reed stated that the utilities' earlier designation in 2001 of Risk Capital Management Partners (RCMP) as a covered affiliate was an error. Although the utilities' marketing affiliate, SET, had acquired a 49% financial interest in RCMP, the utilities decided that RCMP's advice to Sempra Energy concerning its Energy Risk Management was not a service relating to the use of gas or electricity under Rule II.B., but was a "financial service." The Reed letter further acknowledges that if RCMP were an affiliate, the acquisition violated the Commission's Affiliate Transaction Rules. The letter also contends that no harm to the energy market occurred, and that SET was in the process of divesting its interest in RCMP at the time the letter was written.

gas. Furthermore, Rule II. I. explicitly provided: "These Rules should be interpreted broadly, to effectuate our stated objectives of fostering competition and protecting consumer interest."[21]

The utilities' narrow interpretation essentially limits the Affiliate Transaction Rules to business deals between a utility and its affiliates, only, and thus, renders the rules unable to address some of the most fundamental affiliate abuse problems that can occur. By example, we describe an extreme, hypothetical case of affiliate abuse, where a utility artificially increases electric or natural gas prices to help its affiliates' profits but does not have a purchase agreement with the affiliate. Such a utility might offer in its defense the narrow interpretation of scope favored by the major energy utilities, i.e., that because there was no contract, the rules were inapplicable and thus, no violation of the rules occurred.

The stated intention of the Affiliate Transaction Rules was to prevent preferential treatment for a utility's unregulated affiliates, especially through the exercise of market power. Unless authorized explicitly in the Affiliate Transaction Rules (see Rule III. A. 2) or other Commission order, or by the Federal Energy Regulatory Commission, a utility is prohibited from providing preferential treatment to its affiliate, even if there are no direct business dealings between them. However, certain utilities' practices suggest some lingering confusion remains and may warrant further clarification of the Affiliate Transaction Rules.

[21] *See* Affiliate Transaction Rules, II. B. and II. I.

3.2.4. Express Exceptions in the Rules

Increasingly in recent years, the utilities and their affiliates have used some of the same attorneys, regulatory affairs representatives, consultants and contractors. Furthermore, whether voiced in Commission proceedings or outside of them, with increasing coincidence the utilities' positions and their affiliates' positions seem to be consistent and at times, it has not been possible to determine which entity an individual was representing. We must wonder whether the obligations of dual representation are blurring abilities to differentiate and distinguish between the objectives of the utilities and the objectives of their affiliates, or more bluntly, require these individuals to choose between conflicting goals.

The Corporate Support section in the Affiliate Transaction Rules (see Rule V. E) explicitly includes the following among the examples of shared services: financial planning and analysis, regulatory affairs, lobbying and legal. It is noteworthy that this section also states that joint utilization should not provide a means to transfer confidential information between the utility and the affiliate, provide preferential treatment or create an unfair advantage. As a practical matter, we now question whether such separation is possible. How can an attorney or a consultant giving advice to an affiliate, completely avoid transmitting confidential utility information that he or she also holds? Even if the attorney or consultant does not disclose the confidential information, how could it not at least influence the attorney's or consultant's advice?

Similarly, other existing exceptions cause concern about too much integration between the utilities and their affiliates. Examples include shared directors and officers, employee transfers between a utility and its affiliates, temporary or intermittent assignments or rotations of utility employees to

affiliates, and locating employees of a utility and an affiliate in the same building (see Rule V. G). The lack of sufficient structural separation increases the frequency of interactions between a utility and its affiliates, which increases the likelihood of violations or circumvention of the Affiliate Transaction Rules.

3.2.5. Conflicts of Interest

To the extent that utility management or other highly compensated employees, including attorneys, receive bonuses or other compensation connected in any way to the financial success of the utility's affiliates, incentives are created that further exacerbate conflicts of interests within the holding company structure. Conflicts of interest also exist if compensation levels at the holding company or utility affiliates are so high as to attract utility personnel or induce them to assist the affiliates in order to gain support for a transfer. While the Commission has general information about utility salaries and benefits, it has limited information about compensation elsewhere within the holding company structure. The Affiliate Transaction Rules do not address this issue and the Commission's GO 77-L only requires information about compensation to utility personnel.

While the annual audit required by Rule VI. C seemingly provides a check on compliance with the Affiliate Transaction Rules, at present the utility is permitted to hire the auditing firm and to direct the audit, both of which give rise to potential conflicts of interest.

3.2.6. Discovery from the Utility Holding Company and Affiliates

The Commission's authority to obtain meaningful information from the holding company and utility affiliates is clear.[22] The Commission's ability to monitor and enforce compliance with the Affiliate Transaction Rules requires access to meaningful information about interactions within the holding company structure. This ability is undermined when a utility's holding company or its affiliates resist discovery rulings issued by the Commission, whether signed by an Assigned Commissioner or an Administrative Law Judge (ALJ). For example, in one Commission proceeding, after subpoenas were issued and subsequent ALJ rulings went against SET, it challenged the discovery rulings both in the California Court of Appeal and the Federal District Court.[23] The Commission sees a need to reiterate the duty of the utilities' holding companies and affiliates

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[22] In D.88-01-063, 27 CPUC 2d at 363-64 (Edison/EIX), the Commission reviewed Cal. Pub. Util. Code § 314(b), which codifies the Commission's broad authority to request information from a utility holding company and affiliates, and cited the statute's legislative history, which clearly states that this authority extends to "*any matter that might adversely affect the interests of ratepayers* of a public utility—not confined to rates or expenses…" (emphasis added). The Commission put parties on notice that it would interpret § 314(b) broadly, and placed the burden on the utility and its affiliates to establish the unreasonableness of any request. *Id.*, 27 CPUC 2d at 363-64, 375 (Ordering Paragraph 1). Many of the conditions imposed on the formation of Edison's holding company are based expressly upon the Commission's expansive rights to documents from the holding company and the affiliates, as well as the presumptive validity of its administrative requests for documents from them. *Id.*, 27 CPUC 2d at 363-64, 374-75 (Ordering Paragraphs 2-12). The Commission reiterated this authority in the other holding company decisions and imposed like conditions on the holding company formations. *See* D.95-12-018, 62 CPUC 2d at 650; D.96-11-017, 69 CPUC 2d at 200.

[23] *See Sempra Energy Trading Corp. v. Brown* (N.D.Cal. 2004) 2004 U.S. Dist. LEXIS 24483 * 12-14.

to comply with document requests from Commission staff and with Commission-issued rulings on discovery matters.

3.3. Possible Solutions

The Commission is considering the following proposals in response to the lessons that recent regulatory history teaches and in an effort to minimize, if not cure, one or more of the various problems identified above. Because of the overlap between problems, the proposals described below may apply to more than one problem or have more than one purpose. However, except for the first item (protecting the utility's financial health), the other proposals are centered mostly upon the need to address a utility's relationship with its holding company and with unregulated affiliates engaged in energy activities in or near the utility's service area. As discussed above, one holding company already has extensive affiliate involvement in energy markets in the western United States and the other two holding companies may be increasing their affiliate activities in this market.

Commenters should note that each of these proposals will be considered, together with the comments, as we develop draft rules revisions in the future. As we consider the comments, some proposals may be rejected, some may be developed into new rules or revisions to existing rules, and other proposals, not identified below, may emerge.

3.3.1. Protecting and preserving the utility's financial health

a) The Commission is considering whether to adopt a rule requiring "ring fencing" in order to insulate the financial health of a utility from any

financial risks posed by its holding company or affiliates.[24] Comments should focus on the types of ring fencing that might be appropriate in this context.

b) The Commission determines the capital structure (i.e., the equity ratio) that each utility should retain. At present, PG&E also must file an advice letter or application for waiver whenever a financial event reduces its equity ratio by at least 1% below the Commission-approved ratio. The Commission is considering applying this requirement to the other major energy utilities.

c) Respondents submitted reports to enumerated Commission staff in response to six questions we posed in the OIR. In order to ensure compliance with the first priority condition that underlies each of the holding company decisions, the Commission is considering a requirement that Respondents prepare annual reports to update the information submitted in response to this OIR.

3.3.2. Strengthening separation rules governing a utility, its unregulated affiliates and the holding company

a) We need to unequivocally state that the Affiliate Transaction Rules apply to the utility holding companies. There are several approaches. One, expressly state that all of the existing rules apply to utility/holding company relationship. This approach recognizes that specific exceptions to the rules (e.g., for taxes, financial reports) in the Corporate Support section (see Rule V. E) exist because of holding company needs. Two, specify in each rule whether or not that rule applies to the holding company relationship, and if it does, whether

[24] Ring-fencing is the legal walling off of certain assets and liabilities within a corporation, such as when a company forms a new subsidiary to protect (or ring-fence) specific assets from creditors. *See* Fetter, Steve, "Don't Fence Me Out" (2004) Public Utilities Fortnightly, 142, No. 10 (2004), pp. 20-22.

limited exceptions should be allowed for circumstances unique to the holding company.

b) The Commission is also considering a reduction in the number of shared activities allowed for corporate support. While certain exceptions to the rules should remain (e.g., for taxes and filing financial reports with the SEC), we could exclude financial planning, regulatory affairs, lobbying, legal, and/or risk management from shared services. The Commission also is considering extending the prohibition on joint employees to consultants and contractors, or at least prohibiting the same consultants or contractors from working for utilities and their affiliates at the same time, or consecutively. Additional options include further limiting a utility's ability to make temporary or intermittent assignments of its employees to affiliates and/or requiring greater physical separation between the utility, its affiliates, and the holding company.

c) The Commission has authority to grant an exemption from its own rules in individual circumstances, when warranted, and this exemption authority may need to be utilized if we adopt more comprehensive rules, as suggested in 2(a), above. We may amend the Affiliate Transaction Rules to include a rule governing individual exemptions.

3.3.3. Increasing reporting requirements regarding interactions between a utility and its affiliates

Even with enhanced structural separation, utility personnel may meet with personnel from an affiliate or the holding company at various times. Although utilities are prohibited from providing preferential treatment to their affiliates or transmitting confidential information about the utilities' energy business to affiliates without publicly disclosing the information to the market (see Rules III. A. and IV. B.), there currently is no way to know exactly what is

being communicated. The Commission is considering a requirement that a utility create minutes for any meetings or discussions between the utility and its holding company or affiliates, and that the minutes be made available to the Commission or its staff.

In order to provide greater distance between the auditor and the subject of the audit, the Commission also is considering requiring that Commission staff, rather than the utility, direct the annual Affiliate Transaction Rules compliance audits.

3.3.4. Prohibiting utility procurement from affiliates without prior Commission approval

Recent statutes or Commission decisions generally require Commission pre-approval of a methodology for utility procurement of electricity.[25] Recent Commission decisions require pre-approval processes for natural gas utilities' LNG contracts and interstate pipeline contracts.[26] Our experience to date is too limited to assess whether these current processes adequately monitor any potential for affiliate abuse. On the electric side, the check on abuse includes the ongoing involvement of peer review groups and third party evaluators.

No pre-approval requirements are in place for other natural gas supplies. The Commission is considering additional pre-approval requirements in this sector including a requirement for more extensive review of a utility's procurement strategies, to the extent that the utility's affiliates sell in the same market or benefit from such sales in the market. Alternatively, the Commission

[25] *See,* e.g., Cal. Pub. Util. Code § 454.5 (electric procurement requirements).

[26] D.04-09-022 (September 2, 2004)

is considering a requirement that a utility must procure natural gas supplies from competitors of its affiliates, if reasonable terms are provided, in order to justify similar procurement from affiliates.

3.3.5. Reiterating cooperation required in discovery from holding companies and utility affiliates

The Commission is considering an amendment to the Affiliate Transaction Rules and/or GO 77-L to expressly recognize the Commission's broad right to receive information from the utilities' holding companies and affiliates, one of the major conditions the Commission imposed on its authorization of the utilities' reorganization into holding companies.

3.3.6. Increasing reporting of information about compensation packages from utilities and requiring information from holding companies and utility affiliates

The Commission is considering revisions to GO 77-L to require utilities, their affiliates (in the western United States energy market) and their holding companies to include the following information in an annual basis: for executive officers or employees earning $250,000 or more per annum, details of the total, aggregate compensation package; disclosure of the proportion of that compensation paid, directly or indirectly, by a utility's ratepayers; and, for utilities, a statement explaining the method for determining compensation to a utility's executive officers and employees and explaining how that method avoids tying compensation to the profitability of the utility's holding company.

4. Content of Comments

The OIR contemplates that "this proceeding will be conducted through a written record" and today we expand the process to include a workshop and oral argument. Today's order directs Respondents to participate fully and we

invite all other interested persons and entities to participate as well. Our release, today, of this amendment to the OIR marks the commencement of what we hope will prove to be a candid public discussion.

Comments, filed in accordance with the schedule set forth below, should focus on the discussion of the problems and potential solutions and should (a) explain the reasons for the position advanced and (b) in the case of opposition to any proposed solution, suggest an alternative or alternatives to avoid the underlying problem. Comments should focus, in particular, upon the cost or relative burden of implementing a proposed solution and the magnitude of the harm likely if the solution is not implemented, to the extent qualification and/or quantification of the of latter can be approximated. We will consider all comments as we develop draft revisions to the Affiliates Transaction Rules and GO 77-L.

5. Schedule

The preliminary schedule in the OIR is amended as follows:

Written comment on amended OIR	July 27, 2006
Draft rules mailed	August 25, 2006
Workshop	September 21, 2006
Draft Decision mailed for comment	October 10, 2006
Oral Argument	October 18, 2006 1:30 – 3:30 p.m.
Comment on Draft Decision	October 30, 2006
Reply Comment on Draft Decision	November 6, 2006
Draft Decision on Commission Public	November 9, 2006

Meeting Agenda	

The schedule revisions set forth above have been structured to provide ample time for thoughtful written comment, the preparation and release of draft rules, and an interactive public workshop to assist in the further development of those draft rules. Following the release of the draft decision, the schedule provides for oral argument before the assigned Commissioner and any other Commissioners who are available to attend, as well as the statutorily-required comment and reply comment on the draft decision. These schedule revisions retain fidelity to the Commission's stated preference for prompt resolution of this matter.

6. Service of This Ruling; Eligibility to File Comments and Participate in Oral Argument

This ruling will be filed on the service list established to date for this proceeding and also on the service list for Rulemaking (R.)97-04-011 and R.03-08-019, the rulemakings (now closed) in which the Commission adopted the current versions, respectively, of the Affiliates Transaction Rules and GO 77-L. To be eligible to file comments in this proceeding, R.05-10-030, or thereafter to participate in oral argument, a person or entity must be listed as an Appearance on the service list for this proceeding, or must become an Appearance. Likewise, to receive further service for the purposes of monitoring this proceeding, a person or entity must be listed in the State Service or Information Only sections of the service list for this proceeding or must ask to be added to the service list.

To be added to any category of the service list for this proceeding, please follow the steps set forth in Ordering Paragraph 4 by July 14, 2006. All comments on the proposed rules attached to today's order must be filed in this proceeding, and served on the current service list for this proceeding, as of the

date service is undertaken. Commission service lists, updated on an ongoing basis, are available from the Commission's website: www.cpuc.ca.gov.

As provided for in the OIR, service of all documents is to be made by electronic means and will be used in lieu of paper mail when an electronic address has been provided. (See Rule 2.3(a) and Rule 2.3.1 of the Commission's Rules of Practice and Procedure.) Assigned Commissioner Geoffrey F. Brown (gfb@cpuc.ca.gov) and Administrative Law Judge Jean Vieth (xjv@cpuc.ca.gov) are to be served electronically at the email addresses indicated. Any party on the service list who has not provided an electronic mail address shall serve and take service by way of paper mail. (See Rule 2.3(a) of the Commission's Rules of Practice and Procedure.)

7. Category of Proceeding and Need for Hearing

This order reiterates the OIR's preliminary determination that this proceeding should be categorized as quasi-legislative. We do not foresee the need for evidentiary hearing in this quasi-legislative proceeding.

8. Ex Parte Rules

Because this is a rulemaking proceeding, ex parte communications are permitted and no reporting requirement applies.[27]

O R D E R

[27] Since no evidentiary hearings are contemplated, Rule 1.1 et seq. governs this proceeding, rather than Rule 7(d). The result is the same, however, since neither framework prohibits ex parte communications in rulemaking proceedings.

IT IS ORDERED that:

1. The Order Instituting Rulemaking (OIR) that initiated this proceeding on October 27, 2005 is amended as set forth herein to include review of the problems and potential solutions identified herein, including future revision applicable only to Respondents, of the Commission's Affiliate Transaction Rules and General Order 77-L.

2. Respondents to the OIR, as amended by Ordering Paragraph 1, above, continue to be California's major energy utilities and their holding companies: Southern California Edison Company/Edison International, Pacific Gas and Electric Company/PG&E Corporation, and Southern California Gas Company and San Diego Gas & Electric Company, both owned by Sempra Energy.

3. The Commission's Executive Director shall cause today's order to be served on the service list for this proceeding and the service lists for Rulemaking (R.)97-04-011 and R.03-08-019. The Commission's Executive Director shall cause today's order to be served on the service list for this proceeding and the service lists for Rulemaking (R.)97-04-011 and R.03-08-019.

4. Persons or entities who are not now listed on the service list for this proceeding and who wish to be placed on it shall follow the directions below:

a) Appearance category. By July 14, 2006, contact the assigned Administrative Law Judge (ALJ) in writing, via e-mail (xjv@cpuc.ca.gov) or at CPUC, 505 Van Ness Ave., San Francisco, CA 94102 and describe your interest in the proceeding, how you intend to participate, and list all relevant contact information (name; person or entity represented; mailing address; telephone number; e-mail address).

b) Information Only category or State Service category. If you intend only to monitor this proceeding, contact the

Commission's Process Office in writing by July 14, 2006, via e-mail at (Process_Office@cpuc.ca.gov) or at CPUC, Process Office, 505 Van Ness Ave., San Francisco, CA 94102), to specify the service category desired and list the same contact information detailed in subparagraph (a), above.

5. The schedule for this proceeding is set forth herein. Appearances listed on the service list for this proceeding, or those added at the direction of the assigned ALJ may file comments and participate in oral argument.

6. The schedule may be changed, if necessary, by ruling of the Assigned Commissioner Ruling or assigned ALJ.

7. The category for this proceeding is preliminary determined to be "quasi-legislative" as that term is defined in Rule 5(d) of the Commission's Rules of Practice and Procedure (Rules).

8. Ex parte communications are permitted under Article 1.5 of the Rules, at Rule 1.1 *et seq*.

This order is effective today.

Dated June 29, 2006, at San Francisco, California.

MICHAEL R. PEEVEY
President
GEOFFREY F. BROWN
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
Commissioners