MEMORANDUM

To: Missouri Public Service Commission

From: Geoff Marke, Chief Economist
Missouri Office of the Public Counsel

Subject: Proposed Rulemaking: Water Affiliate Transaction Rules

Date: 22 June 2018

Overview:

The Office of Public Counsel ("OPC") is requesting the Commission open a rulemaking docket in its Chapter 50 Rules—Water Utilities, for the purpose of adding a subsection titled: "Affiliate Transactions" to be codified as subsection: 4 CSR 240-50.015. OPC has included a draft copy of the proposed rules in attachment OPC-1.

The proposed affiliate transactions rules, when coupled with effective enforcement, will provide the public assurance that their utility rates are not adversely impacted by (i.e., being used to subsidize) the utilities' affiliate activities. This specific request for rulemaking for Missouri water utilities would not be overly burdensome as the proposed water rules mirror both the electric (4 CSR 240-20.015) and gas (4 CSR 240-40.015) affiliate transactions rules currently in place.

Extent of Application for Proposed Rules:

OPC believes that all water utilities operating in the state of Missouri should be subject to certain rules relating to affiliate transactions including, for example, requirements for competitive bidding, requirements that the utilities maintain control over their own books, rules related to record keeping & access, rules prohibiting preference except under limited circumstances, rules regarding audits, requirements for reporting affiliate transactions, specific definitions regarding cost determination (and other key terms), rules prohibiting the utility from engaging in non-complying affiliate transactions, and a requirement that the utility must pursue its best interest in affiliate transactions. That being said, OPC is cognizant that the level of detail and requisite compliance to meet the proposed rules for a water utility with less than 8,000 customers will need to be balanced against associated costs and burden of proof. While OPC maintains that the proposed rules should apply, at a minimum, to water utilities with more than 8,00 customers, OPC believes that a rulemaking workshop would be appropriate venue to determine the reasonableness of the attached affiliate transactions rules for the remaining water utilities or whether an abridged affiliate transactions rule (with requisite requirements to be included in the minimum filing requirements for the Company's annual reports to the Commission) would be more appropriate for a water utility with less than 8,000 customers.

Necessity of Proposed Rule:

The necessity of the proposed rules can easily be seen by considering the business practices currently employed by American Water. As articulated most recently in both direct and surrebuttal testimony in Case No. WR-2017-0285, American Water is the only water utility in the United States included in the S&P 500. Headquartered in Voorhees, New Jersey, American Water employs approximately 6,900 people and provides services through its subsidiaries to an estimated 15 million people in 46 states and Ontario, Canada. Among these subsidiaries is Missouri American Water which serves nearly half a million customers with the state.

While Missouri American Water does currently utilize a Cost Allocation Manual ("CAM"), it is not a Commission-approved CAM because there are no affiliate transaction rules in place for water utilities. Missouri American Water's CAM thus lacks any enforceable standards and can only provide minimal protection for the citizens of Missouri when American Water engages in potentially improper subsidization such as its current allocation of Business Transformation System costs to its regulated subsidiaries as opposed to its nonregulated "Market-Based Business" operations. These problems are further exacerbated because the lack of affiliate transaction rules means that regulators must operate at a considerable informational disadvantage in ensuring a transparent and appropriate cost allocation.

Another major area of concern is the interplay between regulated and non-regulated services offered to customers is also a concern. Consider, for example, that American Water's non-regulated affiliate "Homeowner Services" provides services to its subsidiary's customers that include:

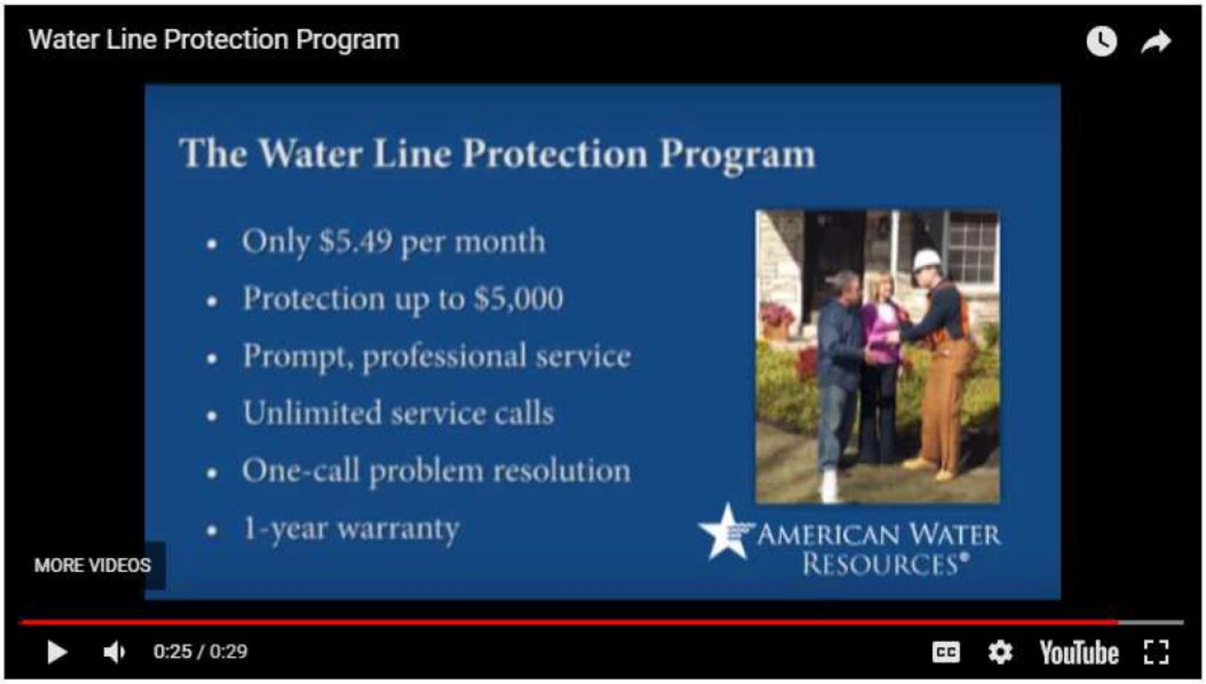
- Water and sewer service line protection;
- In-home plumbing emergency program;
- Electric line protection;
- Power surge protection;
- Heating system repair; and
- Cooling system repair

According to the American Water homepage under Industry & Homeowner Solutions:

> Homeowner Services>
>
> **Many homeowners are not aware that they are legally responsible for the portion of the water and sewer service lines that extend through their property and that repair to these lines are typically not covered by homeowners insurance.** For over fourteen years American Water Resources (AWR) has offered water utility services by protecting homeowners, just like you, against unexpected home repair costs. Through our affordable Protection Programs, hundreds of

thousands of homeowners have peace of mind knowing they will receive prompt, courteous, qualified service from a trusted company. AWR helps protect what most homeowners' insurance policies don't, with the claim forms.[3] (emphasis added) Figure 1 provides a visual snapshot of the American Water: Water Line Protection Program video currently on its website.[1]

Figure 1: Non-regulated water service line protection program[2]



Beyond being mere speculation, improper allocation of services rendered by American Water subsidiaries has been documented by other states. For example, a New Jersey Public Service Commission ordered independent third-party audit concluded that American Water had implemented an accounting and charging allocation method in which "only seven percent of the work performed can be specifically assigned to New Jersey American Water leaving 93 percent of charges allocated" (see OPC-2).

Finally, the OPC's request for affiliate transactions rulemaking will not be overly burdensome for Missouri American Water as American Water already has subsidiaries operating in other states that have to conform to water utility affiliate transaction rules (see OPC-3).

For all of the aforementioned reasons, OPC makes this long-overdue and reasonable request to the Commission.

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[1] American Water Works Company, Inc. (2018) We Keep Life Flowing: https://amwater.com/corp/

[2] American Water Resources (2018) https://awrusa.com/products-services-water-line-protection