

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the Matter of the General Rate Increase)
for Water and Sewer Service Provided by)
Missouri-American Water Company.) Case No. WR-2003-0500

STAFF’S MEMORANDUM TO THE COMMISSION
CONCERNING THE
AFFILIATE TRANSACTIONS RULE FOR WATER UTILITIES

COMES NOW the Staff of the Commission and files this Memorandum concerning the Parties inability to reach resolution regarding the provisions of the Water Affiliate Transactions Rule. Staff states as follows:

1. The following Parties to this rate case: Missouri-American Water Company (MAWC or Company), the Office of the Public Counsel (OPC) and the Staff of the Commission (Staff) were ordered in this case to file an Affiliate Transactions Rule applicable to water utility companies.

2. On page 9 of the Commission’s Report and Order approving the Stipulation and Agreement in this case, the Commission ordered the Company, the OPC, and the Staff to “cooperate to obtain promulgation of a Commission rule on affiliate transactions applicable to Company and its affiliates by April 16, 2005.”¹

3. As a result of that Order, the Company and the Staff have exchanged proposed language for an affiliate transactions rule and have engaged in discussions regarding these proposals. This information and proposed language has been shared and discussed with the OPC. Staff is not of the opinion that any additional meetings or conferences, including a

¹ On April 13, 2005, MAWC, Staff and OPC requested an extension of four months, until August 15, 2005, to file a proposed affiliate transaction rule for water corporations. The Commission granted this extension on April 14, 2005.

technical conference, will result in agreement among the Parties concerning the provisions of an affiliate transactions rule applicable to water utilities.

4. Despite the Parties inability to agree, the Staff recommends that the Commission proceed with promulgation of an affiliate transactions rule for water utilities. The Commission has affiliate transactions rules applicable to the other major utilities in the state and similar rules should also apply to the major water utility in the state. MAWC's structure creates the same risk for improper cross-subsidization, resulting in detrimental impacts on customers, as do the structures of other utility companies in the state.

5. The Staff has, therefore, drafted a proposed affiliate transactions rule for water utilities, which includes record-keeping and reporting requirements. The proposed rule specifically excludes small water utility companies from the annual reporting provisions of Staff's proposed rule. Even though many of these companies do have affiliates and thus have the potential for cross-subsidization, the Staff does not believe an annual reporting requirement is necessary considering the volume and complexity of the affiliate transactions. Instead, the rule would require that small regulated water companies maintain pertinent books and records with regard to affiliate transactions, on a calendar year basis, with the information to be available for review by the Staff or the OPC when requested.

6. Staff began the process of negotiation with the Company using the current Commission affiliate transactions rules governing gas companies, 4 CSR 240-40.015, as the format. The gas rule is almost identical to the affiliate transactions rule for electric and steam utilities with the exception of a section concerning marketing affiliate transactions, 4 CSR 240-40.016. Staff used the current rules to form the basis for the water rule because similarly situated

utilities in this state should have similar, if not identical, rules governing affiliate transactions. While a water company has some distinct characteristics, in many ways it is similar to other utility companies in the state.

7. Staff also used the current rules as the basis for proposing a water rule because the currently effective affiliate transactions rules were challenged in court by most of the major gas, electric and steam utilities in this state and the rules were upheld by the Missouri Supreme Court. *State ex rel. Atmos Energy Corp. v. Public Service Comm'n*, 103 S.W.3d 753 (Mo. 2003). The current rules, therefore, form a solid basis for rules applicable to other Missouri regulated utility companies.

8. In discussions with the Staff and OPC, MAWC proposed, among other things, to alter the rules to exclude transactions with its affiliated service and capital companies. Staff could not agree with this proposal. First, the current rules applicable to other utility companies in this state do not exclude transactions between a service company and the regulated utility. Second the level of allocated affiliated service company expense has increased significantly in recent years and now accounts for approximately \$21 million or 27% of the Company's Operations and Maintenance costs. In addition, the capital corporation arranges a significant portion of the financing used by MAWC. Excluding transactions with these affiliates could also permit improper cross-subsidization to occur if there are inadequate records and inadequate review of these transactions. The Supreme Court explained the incentive for a company to shift costs to its regulated operations:

In its brief, the PSC explained that the rules are a reaction to the emergence of a profit-producing scheme among public utilities termed "cross-subsidization," in which utilities abandon their traditional monopoly structure and expand into non-regulated areas. This expansion gives utilities the opportunity and incentive to shift their non-regulated costs to their regulated operations with

the effect of unnecessarily increasing the rates charged to the utilities' customers. See *United States v. Western Elec. Co.*, 592 F.Supp. 846, 853 (D.D.C.1984) ("As long as a [public utility] is engaged in both monopoly and competitive activities, it will have the incentive as well as the ability to 'milk' the rate-of-return regulated monopoly affiliate to subsidize its competitive ventures....") To counter this trend, the new rules--and in particular, the asymmetrical pricing standards--prohibit utilities from providing an advantage to their affiliates to the detriment of rate-paying customers.

103 S.W.3d at 764

Further, there would be little need for a rule if the service and capital companies were exempt, since transactions with these two entities constitute most of the Company's affiliate transactions.

9. The Company has also objected to the rule governing Commission access to the records of affiliates. In the *Atmos* case, the Supreme Court addressed this issue, noting that unless an affiliate is kept substantially separate and apart, there is the opportunity for cross-subsidization, and the Commission has jurisdiction to review the records of that affiliate. The Court explained.

In addition, to police compliance, the rules require the utilities to ensure that they and their affiliates maintain records of certain transactions.

The PSC's authority to enact these regulations is set out in chapter 393. Section 393.130.2 precludes a utility from "directly or indirectly by any special rate ... or other device or method ... [from] collect[ing] or receiv[ing] from any person or corporation ... greater or less[er] compensation" for that utility's services than it charges every other person or corporation. Section 393.140(1) states that the PSC shall have "general supervision" over all gas utilities, electric utilities, and heating utilities. Reading section 393.130.2 in conjunction with the broad supervisory power granted under section 393.140(1), the PSC's authority to require utilities to maintain records so that it may determine whether utilities are following their obligations under section 393.130.2 is firmly established.

Likewise, the PSC has authority to extend the reach of the rules to a utility's affiliates. Section 393.140(12) precludes regulation of a utility's affiliate where the affiliate is "substantially kept separate and apart" from the business of the utility. However, that section also states that the PSC shall have the

“right to inquire as to, and prescribe the apportionment of, capitalization, debts and expenses fairly and justly to be awarded to or borne by the ownership, operation, management or control of such gas plant, electric plant, [or heating plant]....” Section 393.140(12) *see State ex rel. Associated Natural Gas Co. v. Pub. Serv. Comm’n*, 706 S.W.2d 870, 880-81 (Mo.App.1985). Thus, where the affiliate is not one “substantially kept separate” from the utility, the PSC is authorized to “inquire” into certain aspects of the affiliate's operations as they relate to the capitalization, debts, expenses, etc., of the utility. By requiring affiliates to maintain records of certain transactions with regulated utilities, the rules at issue do no more than is prescribed in Section 393.140(12).

103 S.W.3d at 764-765.

As the Court noted, it is reasonable for the Commission to review the records of affiliates, which are not kept substantially separate and apart, to assure that utility companies are meeting their statutory obligations. It is not reasonable for the Commission to adopt a rule in this case that is substantially different from the rule that applies to other similarly situated utility companies in this state

10. MAWC has also objected to the fully-distributed-cost-in-comparison-to-market pricing standard included in Staff’s draft rule. This requirement is specifically directed toward ensuring that the utility does not provide a financial advantage to any affiliated entity by paying an affiliate more for services or products that it would pay a non-affiliate. This requirement is also designed to assure that the utility charges the affiliated entity the same amount the utility would charge a non-affiliate for the same goods or services. This provision is essential to preventing cross-subsidization of non-regulated affiliates by the regulated utility. Staff has reviewed affiliate transactions rules from many other states and this pricing provision is central to many states’ affiliate transactions rules.

11. The Company has claimed that implementation of the rule would cause it to incur significant expenses. This is the same argument made by the other utility companies when the current electric, gas and steam rules were promulgated. Staff is not aware of any major utility in

Missouri incurring material cost increases as a result of the implementation of the affiliate transactions rules currently in effect. While Staff is not interested in water rates increasing, cross-subsidization can also increase rates beyond what is just and reasonable. As the Public Utility Commission of Texas has noted, an analysis of the costs of such a rule must recognize a utility company's continuing incentives:

[T]here is a strong likelihood that a utility will favor its affiliates where these affiliates are providing services in competition with other, non-affiliated entities. . . . [In addition,] there is a strong incentive for regulated utilities or their holding companies to subsidize their competitive activity with revenues or intangible benefits derived from their regulated monopoly businesses. . . .

The potential benefits to consumers from preventing discriminatory transactions and cross-subsidization between regulated . . . utilities and their unregulated affiliates can take several forms. First, discrimination and cross-subsidization may artificially increase the costs of the regulated utility, as costs incurred for the benefit of the affiliate are shifted to the regulated firm. Under a rate-of-return regulatory regime, higher costs will result in increased prices in the regulated market. Second, such conduct may increase costs in unregulated markets by displacing innovative, lower-cost suppliers and entrants with a higher-cost affiliate of the local regulated distribution utility.

Public Utility Commission of Texas, 23 Tex. Reg. 5294 (May 22, 1998).

WHEREFORE, for the reasons noted above, the Staff recommends that the Commission open a separate case for this rulemaking and order the Staff to proceed with the process to promulgate an affiliate transactions rule applicable to water utility companies.

Respectfully submitted,

DANA K. JOYCE
General Counsel

/s/ Lera L. Shemwell

Lera L. Shemwell MO Bar #43792

Senior Counsel

Missouri Public Service Commission

P. O. Box 360

Jefferson City, MO 65102

(573) 751-7431 Telephone

(573) 751-9285 Fax

lera.shemwell@psc.mo.gov

Attorney for the Staff of the
Missouri Public Service Commission

Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or electronically mailed to all counsel of record this 15th day of August, 2005.

/s/ Lera L. Shemwell