

Agenda Date: July 28, 2004

Item Number: D1 and D2

Dockets: A-021178 and TO-030288

RE: Financial Reporting Rules

Staff: Fred Ottavelli, Rulemaking Lead
Sharyn Bate, Rulemaking Analyst
Karen Caillé, Administrative Law Judge
Kathy Folsom, Regulatory Analyst
Bob Colbo, Regulatory Analyst
Danny Kermode, Regulatory Analyst
Tom Schooley, Regulatory Analyst
Sam Thompson, Government Liaison
Greg Trautman, Assistant Attorney General
Don Trotter, Assistant Attorney General

Recommendation:

Direct the Secretary to file a Notice of Proposed Rulemaking (CR-102) with the Office of the Code Reviser in **Docket A-021178** proposing revisions to Chapters 480-70 WAC (Solid Waste Collection Companies), 480-90 WAC (Gas Companies), 480-92 WAC (Low Level Radioactive Waste), 480-100 WAC (Electric Companies), 480-110 WAC (Water Companies), 480-120 WAC (Telephone Companies), and 480-121 WAC (Registration, Competitive Classification and Price Lists of Telecommunications Companies), and repeal of Chapter 480-146 WAC (Commission General—Securities, Liens, Affiliated Interests, Refunding of Notes, Lease of Utility Facilities).

Direct the Secretary to file a Notice of Proposed Rulemaking (CR-102) with the Office of the Code Reviser in **Docket TO-030288** establishing Chapter 480-73 WAC (Pipeline Companies).

Discussion:

On October 2, 2002, the Washington Utilities and Transportation Commission (Commission) filed with the Code Reviser a Preproposal Statement of Inquiry (CR 101) in Docket A-021178 to initiate a rulemaking to examine the need to reorganize, revise, repeal, and adopt financial reporting rules, and to consider establishing rules relating to reporting of

transactions between regulated utility and transportation companies and their affiliated interests and subsidiaries. On October 28, 2002, the Commission filed a supplemental CR-101 with the Code Reviser clarifying which industries are affected by rules adopted in this docket.

On March 13, 2003, the Commission filed with the Code Reviser a CR-101 in Docket TO-030288 to initiate a rulemaking to consider developing a new chapter applicable to the economic regulation of Hazardous Liquid Pipeline Companies regulated as common carriers by the Commission, including, but not limited to, financial reporting requirements.

The Commission instituted this rulemaking in recognition of increasing concern with the financial viability of regulated utilities and the negative financial and operational impacts of failed diversification on regulated utilities. The regulated transportation and utility business environments have undergone a number of significant developments that include corporate and industry restructuring, competition, difficulty obtaining reasonable financing, bankruptcy, financial rating downgrades, volatile commodity supply and demand, volatile pricing, and concern with the accuracy of corporate financial statements and reports. In this new environment, financings and transactions between regulated companies and their non-regulated affiliates and subsidiaries significantly impact utilities and, in turn, ratepayers. Establishing ongoing reporting requirements regarding financings and transactions between regulated companies and their non-regulated affiliates and subsidiaries will provide the Commission with more timely identification and disclosure of financial transactions that pose difficult regulatory issues.

The acquisition of Portland General Electric (PGE) by Enron and the subsequent financial difficulties experienced by Enron illustrate events that have enhanced Commission concern. Fortunately, when Enron acquired PGE, the Oregon Public Utility Commission imposed several restrictive conditions on Enron that insulated PGE from the Enron bankruptcy.

There have been a number of events in Washington State that signal the need for increased Commission awareness. Recent events include: (a) lack of notice provided to the Commission during a rate case concerning transactions with subsidiaries; (b) large cash dividends paid by regulated companies to its parent; (c) transfer of \$800,000,000 in cash from a regulated telecommunications company to its non-regulated subsidiaries; (d)

questions regarding the use of proceeds from financings; and (e) dependency upon a single supplier for an essential utility service. In recognition of these types of events, the Commission has directed a variety of provisions in transfer of property merger orders, rate orders and finance orders.

Commission Staff began a comprehensive review of the Commission's financial reporting rules focusing on the security and affiliated interest rules. The review has included several rounds of written comments from interested persons and three public workshops. Both written and oral comments have assisted in the development of rules that will provide the Commission with needed information without burdening the utilities.

The recommendation to shift the security and affiliated interest rules to each industry makes all financial reporting rules industry specific and readily accessible in one location.

The proposed rules will provide the Commission with the following information:

1. Report of the intent to issue securities five days before the issue date.
2. Report of planned large cash transfers to affiliates or subsidiaries five days before the transfer when the threshold is exceeded.
3. Annual report of transactions with subsidiaries.
4. Annual report by energy companies of essential utilities services contracts when the threshold is exceeded.

Substantive Comments

On July 16, 2004, comments were received from interested persons on the fourth discussion draft. Major issues include:

Exemptions from rules:

Qwest believes the cross reference to WAC 480-07-110 is confusing and unnecessary. PacifiCorp maintains referencing WAC 480-07-110 in the industry rule, and providing no independent authority within the industry rule, would limit the Commission's discretion to grant exemptions.

Staff suggests that the cross-reference to WAC 480-07-110 is appropriate and consistent with the standard that the Commission has always followed and intends to continue to follow. The Commission intends to consider additional exemption language for WAC 480-07-110 when it considers a tune-up of the rules in Chapter 480-07 WAC.

Definition of "Control" and "Subsidiary"

Qwest believes the inclusion of "or any other direct or indirect means" renders the definition of control vague, subjective and unenforceable. PacifiCorp also takes exception to references to an "indirect" ability to control management and references to a "power to direct or cause the direction of the management and policies of a company," making the standard open-ended, vague and impossible to administer.

Qwest comments that five percent is likely an inappropriate threshold.

Staff asserts that the threshold of five percent of voting securities set forth in the definition provides a clear standard paralleling the definition of an affiliate while giving the utility the opportunity to demonstrate it does not have control. The Commission proposes adopting the SEC definition of control. The definition of control provides the utilities with criteria upon which to base an assertion of no control.

Issuing Securities

Several companies submitted comments on this section. The comments took exception to the requirement to file certain general information five days before a utility issues securities. Concern was also expressed that sections (1)(b) and (2) are redundant. In summary, the comments maintain that the proposed rule exceeds Commission jurisdiction, is vague, is potentially in conflict with federal law and imposes impractical burdens and costs without any corresponding benefit.

The language of the rule is taken from RCW Chapter 80.08.040 except the rule

requires the filing of certain general information five days before issuance. Subsection (1)(b) requires the “estimated” terms of financing five days before issuance whereas subsection (2) repeats the statutory language requiring the “terms of the financing” before issuance. The rule permits filing in person, by mail, telefacsimile, or electronic mail message.

RCW 80.08.040 provides that a public service company issuing securities shall file certain information with the Commission” before such issuance”. If the pre-filing requirement is to be meaningful such information must be filed with the Commission in sufficient time to permit the Commission to review and react to the information. Five days in advance balances the ability of the utility to provide the information with the Commission’s needed time for meaningful review. It is reasonable to presume the Legislature intended the pre-filing requirement to be meaningful.

From 1933 to 1994, when legislation was enacted removing the pre-approval requirement, Commission rules required public service companies to submit a completed application to the Commission 15 days prior to the date of the Commission order for authorization to issue securities stating the amount, character, terms and purpose of each issue. Public service companies did comply with the pre-1994 requirements of the statute. It is unclear what has changed in the financial markets to make it “an impractical burden” for the utilities to provide the information required by the statute.

Transferring cash or assuming obligation.

Qwest opposing the rule “as it is both unlawful and deeply flawed,” raised the following issues:

(1) The language establishing the second trigger once the cumulative trigger is satisfied should be clarified.

(2) The threshold has been reduced from 5% of prior year gross operating revenue to 2%.

(3) The cumulative trigger lumps together all non-exempt cash transfers between a utility and all of its subsidiaries and affiliates as opposed to with each subsidiary or affiliate.

PacifiCorp objects to the inclusion of transactions between a “subsidiary of an electric utility” and other subsidiaries or affiliates.

The threshold for telecommunications companies was reduced from 5% of prior year gross operating revenue to 2% in error. The current draft establishes the threshold at 5% of prior year gross operating revenue, clarifies the language regarding the second trigger, and makes clear that the threshold applies to transactions with each subsidiary or affiliate.

RCW 80.04.080 grants the Commission authority to require reports from public service companies. Transactions between a subsidiary of a utility and other subsidiaries or affiliates appear on the books of the utility, thereby directly affecting the utility’s financial viability.

Affiliated interest and subsidiary transactions report.

Verizon believes there has been no demonstrated need for the reporting requirement for subsidiaries of telecommunications companies and further if such a rule is adopted, the rule should specifically exempt subsidiaries that are local exchange companies.

Subsidiary accounts are incorporated into the books of the parent company and therefore, activities of the subsidiary directly impact the financial viability of the parent. Cost shifting can occur among regulated parents, subsidiaries, and affiliates, thereby affecting the results of operations of the various entities.

Small Business Impact Statement (SBEIS).

The Commission received a response from PSE to its SBEIS questions. PSE indicated that the cost of the securities and essential services contracts report could be substantial but could not predict what the cost might be to the company. No other responses were received. It appears an SBEIS is not required.

Conclusion:

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The draft rules reflect a balance of the Commission's need to be informed of the regulated companies financial activities without unduly burdening the regulated companies.

Staff recommends that the Commission direct the Secretary to file a Notice of Proposed Rulemaking (CR-102) with the office of the Code Reviser in Docket A-021178 proposing revisions to Chapters 480-70 WAC (Solid Waste Collection Companies), 480-90 WAC (Gas Companies), 480-92 WAC (Low Level Radioactive Waste), 480-100 WAC (Electric Companies), 480-110 WAC (Water Companies), 480-120 WAC (Telephone Companies), and 480-121 WAC (Registration, Competitive Classification and Price Lists of Telecommunications Companies), and repeal of Chapter 480-145 WAC (Commission General-Securities, Liens, Affiliated Interests, Refunding of Notes, Lease of Utility Facilities).

Staff recommends that the Commission direct the Secretary to file a Notice of Proposed Rulemaking (CR 102) with the office of the Code Reviser in Docket TO-030288 proposing establishing Chapter 480-73 WAC (Pipeline Companies).

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