ATTACHMENT I

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MEMORANDUM

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DATE: September 6, 2012

TO: Gene Eckhardt, Assistant Director
Water and Transportation

FROM: Donald T. Trotter, Assistant Attorney General
Utilities & Transportation Division

SUBJECT: Sandy Point Improvement Company

You asked me whether there is a sufficient basis for Commission Staff to recommend the Commission initiate a classification proceeding pursuant to RCW 80.04.015, to determine whether Sandy Point Improvement Company (Sandy Point) is a water utility subject to Commission regulation under RCW 80.28, et al. For the reasons stated below, there is a sufficient basis for Staff to make that recommendation.

Facts

Sandy Point is a for-profit corporation that operates a water system near Ferndale, Washington. In addition to its water operations, Sandy Point operates recreational facilities: a club house, swimming pool and golf course.[1]

[1] I also considered the non-water related operations of Sandy Point. However, I understand that Sandy Point accounts for its water operations separately from its other endeavors. Absent further information indicating that water revenues are used to subsidize non-water activities, the existence of non-water operations does not change the outcome of the analysis.

Sandy Point's water customers generate average annual gross revenues per customer as follows[2]:

Class A shareholder/customers	$336.49
Class C shareholders/customers	$376.53
46 non-shareholders/customers	$451.73
All customers	$347.15

Sandy Point has 1148 shares of stock outstanding, in three classes, with 899 shareholders and 944 water customers:

	Shares	Shareholders	Water Customers
Class A stock	779	779	779
Class B stock	250	1	0[3]
Class C stock	119	119	119
Non-shareholders:	___	___	46
TOTALS:	1148	899	944

Each share has one vote. Thus, each Class A and C shareholder has one share and one vote, and the single Class B shareholder has 250 shares and 250 votes. Sandy Point's Class A shareholders have the right to membership in the club house, golf course and pool. The Class C shareholders do not. Each Class A and C share is appurtenant to the real property in the Sandy Point area that is owned by the shareholder. The Class A and C shares cannot be transferred except in the sale of that real property.[4]

Sandy Point's Articles of Incorporation state that Class C shareholders:

> may only vote for the election of the Board of Directors and on water service matters that are presented by the Board of Directors for a vote of the shareholders at any annual or special meeting called for that purpose. The holders of Class C stock shall have no vote on other matters presented at any meeting of the shareholders and shall not participate in any dividend of the corporation or in any distribution on liquidation of the corporation. Such share shall solely represent the right of the holder thereof to have water service provided by the corporation to real property owned by the shareholder in the vicinity of Sandy Point to which property such share shall be appurtenant ...[5]

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[2] Sandy Point's response to Staff Data Request 2. As I understand it, Staff has reviewed these figures and considers them reliable. WAC 480-110-255(3) sets forth the formula for calculating annual average revenues per customer.

[3] The Class B shareholder is not a Sandy Point water customer.

[4] Sandy Point Articles of Incorporation (dated December 29, 2011), Article V, Sections 1 and 3, respectively.

[5] *Id.*, Article V, Section 3. There appears to have been some dispute whether the Class C vote language quoted here was a legitimate change to the Articles of Incorporation. However, Staff has reviewed the minutes of a special shareholder meeting on May 19, 2012, which indicate a vote was taken and those voting rights were approved. In addition, Mr. Rehberger, counsel for Sandy Point, confirmed that we have the current version of the Sandy Point Articles of Incorporation. We therefore will assume the language in Article V, Section 3 of the Articles of Incorporation (quoted above and at the bottom of page 1 of this memo) accurately reflects the nature of the Class C voting rights.

For Class A and B shareholders, the Articles of Incorporation contain no such restrictions against dividends or distributions of assets upon liquidation.

We understand the Class B shareholder is a developer, though it is not clear what interest the 250 shares represent. According to the Articles of Incorporation, each Class B share "shall be fully transferable at the discretion of the holder thereof :.."[6] Thus, unlike the Class A and C shares, the Class B shares are not tied to specific parcels of real estate.

Issue and Brief Answer

Issue: Is Sandy Point, or any parts thereof, exempt from UTC regulation as a water company?

Brief Answer:

1. Subject to Conclusion 4 below, Sandy Point is not subject to UTC regulation as a water company to the extent it serves the 46 non-shareholder customers as a group, standing alone.

2. Sandy Point likely is subject to UTC jurisdiction as a water company to the extent it serves the 119 Class C shareholders/customers as a group, standing alone.

3. Sandy Point may or may not be subject to UTC jurisdiction as a water company to the extent it serves the 779 Class A shareholders/customers as a group, standing alone, depending on the legal impact of the single Class B non-customer shareholder, who has 250 votes.

4. If Sandy Point is ineligible for the entity exemption regarding its Class A or Class C shareholders/customers, then Sandy Point would also be subject to UTC regulation as to the 46 non-shareholder customers.

Analysis

1. Applicable Law: Statutes, Rules and Judicial Precedent

The UTC regulates water companies under RCW 80.28. Under the statutory definitions, as pertinent here, "water company" "includes every corporation ... controlling, operating, or managing any water system for hire within this state." RCW 80,04.010(30)(a). However, a company meeting this definition is not necessarily subject to UTC jurisdiction, because there are two exemptions potentially applicable here.

The first exemption I call the "statutory exemption". The statutory exemption is found in RCW 80.04.010(30)(b), which excludes from the definition of "water company" any water system meeting both of the following conditions: 1) the company serves 99 or fewer

[6] *Id.* Article V, Section 2.

customers; and 2) the company's average annual gross revenue per customer is $557 or less.[7]

The second exemption I call the "entity exemption". The entity exemption applies to companies that meet the literal definition of "water company" in the statutes, but do not have the indicia of a public service company, i.e., they do not hold themselves out to the serve the public. This exemption may arise from RCW 80.04.010(23), which classifies each water company as a "public service company". In any event, this exemption is recognized by the courts of this state.

There are three court cases from Washington that provide guidance on this entity exemption. The first case is *State ex rel. Addy v. Department of Public Works*, 158 Wash. 462 (1930), which involved The Fruitdale-on-the-Sound Water Company (Fruitdale Company). The Fruitdale Company was a for-profit corporation that operated a water utility serving customers on property located within a plat called "Fruitdale-on-the-Sound". Fruitdale Company also served customers on property outside, but in the vicinity of, that plat.

The court ruled that the Fruitdale Company was a water company subject to regulation by the UTC's predecessor agency. The court rejected the Fruitdale Company's claim that it was not a public utility because each customer it served had a separate, private contract with the company. The court reasoned that the Fruitdale Company fell within the statutory definition of "water company", and it could not alter that status by private contract. 158 Wash. at 466.

The second case is *Inland Empire Rural Electrification, Inc. v. Department of Public Service*, 199 Wash. 527 (1939). That case involved Inland Empire Rural Electrification, Inc. (Inland Empire), a non-profit mutual corporation that operated electrical facilities to provide electricity to its members only. The court noted that while Inland Empire met the literal definition of "electrical company" in the statutes of the UTC's predecessor agency, that did not make Inland Empire a "public service corporation" subject to state regulation. 199 Wash. at 535. The court identified the applicable legal test as follows:

> A corporation becomes a public service corporation subject to regulation by [the UTC's predecessor agency] only when, and to the extent that, its business is dedicated or devoted to public use. The test to be applied is whether or not the corporation holds itself out, expressly or impliedly, to supply its service or product for use either by the public as a class or that portion of it that can be served by the utility; or whether, on the contrary, it merely offers to serve only particular customers of its own selection.

Id. at 537 (citations omitted). The court emphasized that "[w]hat it does is the important thing, not what it, or the state, says that it is." *Id.* at 538.

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[7] The version of WAC 480-110-255(1)(b) in effect on the date of this memo increased the annual revenue per customer exemption maximum from the initial $300 level in the statute to $471, per the authorization in RCW 80.04.010(30)(b). The Commission recently approved a rule amendment that increases the exemption level for average annual gross revenue per customer to $557 or less. That rule change is effective September 9, 2012. I will use the $557 figure in my analysis, but the analysis would not be different had I used the $471 figure.

The court went on to conclude that Inland Empire was not a public service company subject to state regulation because it was not "engaged in business for profit for itself at the expense of a consuming public that has no voice in the management of its affairs and no interest in the financial returns", and thus its customers did not require protection of the public service laws. *Id.* at 539. The court emphasized that Inland Empire served only its members, at cost, and any surplus funds were returned to those members ratably each year. Id at 540[8]. The court specifically noted the "complete identity of interest between the corporate agency supplying the service and the persons who are being served. It is a league of individuals associated together in corporate form for the sole purpose of producing and procuring for themselves a needed service at cost." *Id.*

Note that the legal test enunciated by the court in *Inland Empire* qualified the application of the public service laws "to the extent" that the company dedicated its property to public use. This means, for example, that had Inland Empire served non-members, it would be a regulated water company, but only "to the extent" it served those non-members. This is consistent with the court's underlying rationale that non-member customers need the protection of the public service laws.

The third court case from this state on this subject is *West Valley Land Company, Inc. v. Nob Hill Water Association,* 107 Wn.2d 359 (1986). This case involved the Nob Hill Water Association (Nob Hill); a non-profit cooperative that provided water service only to its members, at cost. The court observed that while Nob Hill met the literal definition of "water company" in RCW 80.04.010, that did not end the inquiry. The court quoted and applied the legal test stated in the *Inland Empire* case, which is set forth in the block-indent above.

In applying the legal test from *Inland Empire*, the court emphasized that Nob Hill "did not conduct its operations for gain to itself, or for the profit of investing stockholders, but functions entirely on a cooperative basis." 107 Wn.2d at 367. Nob Hill served only its shareholder members, all of which "have a 'voice' in the management of its affairs." 107 Wn.2d at 368. The court contrasted Nob Hill with a corporation "engaged in business for itself at the expense of a consuming public which has no voice in the management of its affairs and no interest in its financial returns." 107 Wn.2d at 368.

At the same time, the court noted that some water users did not literally have a vote because they were served via a landlord or condominium association that was the water customer and co-op member. However, these tenants "receive the same benefit as other members and are not charged an additional amount for their water nor are they treated differently as a class." *Id.* at 369. Because the tenants had the same interest as their landlord or condominium association, they could not be "exploited". The court said "[e]quality of representation is not required by *Inland* Empire; all that is requisite is a voice in the cooperative". *Id.*[9]

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[8] The court did not explain what it meant by "ratably".

[9] Because the facts are sketchy, it is not clear why the *Nob Hill* court deemed the tenants to be an important consideration, because the landlord was Nob Hill's water customer. If the court was concerned about the plight of the tenants regarding water service, it should have analyzed whether the landlord was a public service company vis a vis the tenants, because as between the two, the landlord was the water provider.

The court also noted that, unlike Inland Empire, Nob Hill retained its net income rather than paying it out ratably to its shareholders. However, the court did not find this distinction meaningful, because "a reasonable retention of profits for future liquidity and working capital is permissible". *Id.*

The UTC has codified the entity exemption in WAC 480-110-255(2)(e), which exempts from UTC regulation "homeowner associations, cooperatives and mutual corporations, or similar entities that provide service only to their owners or members". The rules go on to state that this exemption does not apply to the extent such entities serve more than 99 non-owners or non-members, or the average annual gross revenue related to those non-owners or non-members exceed $557 per customer. WAC 480-110-255(2)(f), as amended (see footnote 4). I conclude that these rules reasonably implement the statute and the principles of the court decisions I located and discussed above, and should be applied in light of that statute and those decisions.

2. *Applying the Law to the Facts*

As a starting point, there is no question Sandy Point meets the statutory definition of "water company" because Sandy Point literally is a "corporation ... controlling, operating, or managing any water system for hire within this state." RCW 80.04.010(30)(a).

However, Sandy Point may be eligible for the statutory exemption or the entity exemption I discuss above. Also, because the *Inland Empire* court adopted a legal test to determine "the extent" to which a company would be subject to UTC regulation, I analyze these exemptions with regard to the separate various customer/shareholder groups Sandy Point serves.

The 46 Non-Shareholder Customers.

Sandy Point's 46 non-shareholder customers are not members, owners or shareholders of Sandy Point. Therefore, they must be analyzed under the statutory exemption, because the entity exemption does not apply to them.

These 46 non-shareholder water customers qualify for the customer number part of the statutory exemption (i.e., 46 is within the 99 customer number exemption maximum), and, because they have average annual gross revenues per customer of $451.73, they also qualify for the average annual gross revenue per customer part of the statutory exemption (i.e., $451.73 is within the $557 average annual gross revenue per customer exemption maximum). Therefore, Sandy Point is not subject to UTC jurisdiction as a water company to the extent Sandy Point provides water service to those 46 non-shareholder customers.

However, it is important to point out that if it turns out that Sandy Point is not eligible for the entity exemption for its Class A or Class C shareholders/customers, then Sandy Point would be subject to UTC jurisdiction to the extent it serves the 46 non-shareholder customers, because in that circumstance, Sandy Point would then exceed the statutory customer number exemption maximum of 99 customers.

The Class A Shareholders/Customers.

The next issue is whether Sandy Point is eligible for the entity exemption to the extent it serves the Class A shareholders/customers.

Sandy Point is a for-profit corporation, like the company the court found to be subject to regulation in *Addy*, and unlike the companies the court found not subject to regulation in *Inland Empire* and *Nob Hill*. If the court intended all profit-seeking corporations to be ineligible for the entity exemption, Sandy Point would be subject to UTC regulation because it would exceed the maximum customer number exemption of 99 customers[10].

However, as I described in the "Facts" section above, each of Sandy Point's 779 Class A shareholders/customers have one vote and, apparently, have a right to any dividends Sandy Point may declare, plus a claim to any assets remaining when Sandy Point dissolves. These facts likely render inapplicable the court's concern about for-profit corporations "engaged in business for profit for itself at the expense of a consuming public that has no voice in the management of its affairs and no interest in the financial returns".[11] Therefore, I tentatively conclude Sandy Point is not subject to UTC regulation to the extent it serves the Class A shareholders/customers.

The reason this conclusion is "tentative" is because of the impact the Class B shareholder has on the analysis. Recall that the Class B shareholder is not a water customer, yet holds 250 shares, and thus has 250 votes. With regard to voting rights, the *Nob Hill* court stated that "all that is requisite is a voice", and Sandy Point's Class A shareholders/customers literally have "a voice" (i.e., they have a vote). However, the court made that statement in the context of shareholders/customers with one vote each, with any non-voting water users having an identity of interest with those shareholders/customers.

Here, by contrast, the 250 vote Class B block is not held by a Sandy Point water customer, and 250 shares in one shareholder diminishes substantially the "one customer, one vote" situation that applied in *Inland Empire* and *Nob Hill*. Moreover, we are lacking information regarding whether the 250 shares represent a proportionate interest in Sandy Point's operations, or whether the Class B shareholder has an identity of interest with the Class A and C shareholders.

In this regard, I considered a recent decision by the Utah supreme court,[12] *Bear Hollow Restoration, LLC v. Public Service Commission of Utah*, 274 P.3d 956 (2012), in which the court affirmed the Utah commission's determination that a non-profit mutual water company was not subject to regulation as a public service company. The crux of the case was the fact that two shareholders formed a partnership that held more than 50 percent of all outstanding shares. The court acknowledged that the partnership "exerts considerable influence over [the water cooperative's] affairs". 274 P.3d at 959. However, the court concluded that

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[10] Because Sandy Point would exceed the customer number exemption maximum, the annual gross revenue per customer threshold becomes irrelevant.
[11] *Inland Empire*, 199 Wash. at 539.
[12] This case was referred to me by counsel for Sandy Point.

partnership's interests "are aligned with those of other shareholders to provide adequate service at affordable rates", and the partnership was voting "only its proportionate interest". 274 P.3d at 963.[13]

It is not clear at present whether Sandy Point's Class B shareholder's interests are aligned with other ratepayers and that the Class B shares represent a "proportionate interest" in Sandy Point's operations. Absent more, the facts do not clearly exempt Sandy Point from UTC jurisdiction to the extent it serves the Class A shareholders/customers.

The Class C Shareholders/Customers.

Sandy Point's Class C shareholders/customers stand in a position similar to the Class A shareholders/customers, but there is an important difference. Under the Sandy Point Articles of Incorporation[14], the Class C shareholders/customers are denied participation in any dividend the corporation may declare and any distribution on corporate dissolution. As the Articles summarize, the Class C shares "solely represent the right of the holder thereof to have water service provided by [Sandy Point]." The Class A shareholders/customers are not subject to these limitations.

Recall again the *Inland Empire* court's concern about companies "engaged in business for profit for itself at the expense of a consuming public that has no voice in the management of its affairs *and no interest in the financial returns*" (emphasis added). 199 Wash. at 539. The *Nob Hill* court reiterated this point. 107 Wn.2d at 368. Even assuming the Class C shareholders/customers have a sufficient "voice"[15], it is apparent they have no legal interest in Sandy Point's "financial returns". Therefore, the entity exemption likely does not apply to the extent Sandy Point serves the Class C customers.

I conclude that even assuming the Class C shareholders'/customers' vote constituted a sufficient "voice" under *Inland Empire*, Sandy Point likely is subject to UTC jurisdiction as a water company to the extent it serves the Class C shareholders/customers, because the entity exemption does not apply, and the Class C shareholders/customers are 119 in number, which exceeds the statutory customer number exemption maximum of 99 customers.

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[13] The Utah court does not explicitly follow the test enunciated in *Inland Emptre*. In Utah, the analysis evaluates, among other things, whether the entity at issue has "monopolistic incentives" or presents a risk of "monopolistic coercion". 274 P.3d at 962 and 963. In the *Bear Hollow* case, the court noted that for a cooperative, such concerns typically are not at issue because if rates are too low, the consumer-members must either "accept curtailed service or contribute to the cooperative to improve service. On the other hand, if rates are too high, the collected surplus is returned to the consumer-members pro rata." *Id.* at 962-63, citing *Garkane Power Co. v. Public Service Commission*, 100 P.2d 571 (1940). The court also referred to the consumer-members "power to elect other directors and demand certain changes." *Id.* at 963, quoting *Garkane*, 100 P.2d at 573.

Sandy Point does not simulate this situation because the Class C shareholders cannot share in a surplus. Under the Sandy Point Articles of Incorporation provisions discussed earlier, Class C shareholders are not entitled to a dividend or any share of the funds that remain upon dissolution of the corporation.

[14] I quoted the pertinent language in the Facts section above.

[15] The same issue I raised for Class A shareholders/customers regarding the impact of the Class B shareholders' 250 shares applies to the Class C shareholders/customers. See my discussion of Class A shareholders/customers in this regard.