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Decision 95-12-033 December 18, 1995

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SOUTHERN CALIFORNIA EDISON COMPANY (U 338-E) for Authority to Increase its Authorized Level of Base Rate Revenue Under the Electric Revenue Adjustment Mechanism for Service Rendered Beginning January 1, 1992 and to Reflect this Increase in Rates.

ORIGINAL

And Related Matters: (Filed December 18, 1989) (Filed February 21, 1991)

TWENTY-FIFTH INTERIM OPINION: PHASE 4 ISSUES

1. Summary The Commission closes Phase 4 of Southern California Edison Company's (Edison) test year 1992 general rate case (GRC) after reviewing recommendations contained in an independent Commission-ordered audit of transactions between Edison and its nonutility affiliates, as well as Edison's and the Division of Ratepayer Advocates' (DRA) comments in response to those recommendations, the Commission concludes that further action in Phase 4 is unnecessary.

2. Background On October 30, 1991, CACD announced the sale of Edison to MetLife and Associates (M&A). Pursuant to that authority, SCE Corp was formed as the sole owner of Edison and of a group of unregulated nonutility companies known as The Mission...

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Group. Edison's purpose in reorganizing was to more clearly separate its utility and nonutility operations and to better position itself to respond to the changing business environment in the electric utility industry. (Id. at 371, Finding of Fact 5.)

Addressing concerns that a holding company structure would reduce regulatory control, increase the risk of cross-subsidies, and subordinate utility management to the holding company, the Commission stated:

There is always the risk when affiliates and the utility do business together, holding company organization or not, that improper allocations will result in higher costs of service and, therefore, higher rates than necessary. But we believe the safeguards we will adopt through the guidelines which control intercorporate transactions under the holding company structure will provide the proper oversight." (Id. at 361-62.)

One of several conditions that the Commission attached to its authorization was that Edison undergo an outside audit of all transactions with its nonutility affiliates and submit a separate exhibit on the audit in its next GRC. (Id. at 375, Ordering Paragraph 1, Condition 5.e.) By D:91-05-020 dated May 8, 1991 (40 CPUC 2d 92), the Commission modified Condition 5.e in several respects. Among other things, it specified that the audit would be reviewed in a separate phase of this GRC. It also transferred joint responsibility for the audit from DRA to the Commission Advisory and Compliance Division (ACD).

2.2 The Audit Report

On October 30, 1991, ACD announced the selection of S. Metzler and Associates (M&A) to perform under ACD's oversight a coordinated financial and operational audit of transactions among SCE Corp., Edison, and the companies that make up The Mission Group that have occurred since July 1, 1988. M&A issued its report, "Affiliate Transactions Audit of SCE Corp., Southern California Edison Company and The Mission Group," Final Report (Audit Report)

in July 1992, CACD filed the Audit Report in Application 90-10-88.0 (A.) 87-05-007, the holding company docket, on July 28, 1992, and M&A evaluated three generic types of transactions among affiliates: power purchases, service-related charges, and purely financial transactions. M&A found that Edison has actively sought to establish a clear separation between utility and nonutility entities. M&A reported that steps taken by Edison include a comprehensive set of affiliate transactions policies and procedures, physical separation of nonutility subsidiaries, multiple levels of financial and credit separation, establishment of an Affiliate Officer, and other efforts. M&A noted that while the nonutility businesses could benefit from improperly priced direct transactions, unfair cost allocations, or certain indirect transactions, it found no material instances of such cross-subsidization. According to M&A, Edison's controls and procedures along with regulatory oversight have been largely successful in achieving ratepayer indifference to the existence and operations of the holding company and its nonutility subsidiaries. M&A concluded that "Edison's ratepayers have not been measurably affected by the formation or operation of the nonutility subsidiaries, nor are any negative impacts foreseen." (Audit Report, p. 12.)

However, M&A found that "there is still the need for the improvement of certain structures, processes, and procedures to further enhance and demonstrate separation of affiliated entities." (Audit Report, p. 9.) M&A made 20 recommendations to "strengthen key procedures, add needed documentation, and expand organizational separation." (Id. at p. 9.) According to M&A, these will "result in more equitable allocations of costs, improve assurance of arm's length transactions and ensure that maximum benefit is derived from the controls currently in place." (Id.)

### 2.3 Scope of this Review

The subject matter of this phase (phase 4) of Edison's Test Year 1992 GRC is the affiliate transactions audit ordered by

(Ordering Paragraph 6.)

D.88-01-063 as modified by D.91-05-020 and By D.93-01-024, dated on January 8, 1993 (47 CPUC2d 581), the Commission clarified the scope of Phase 4 and its intentions regarding additional uses of the Audit Report in Phase 5. As relevant here, the Commission provided that the following provisions shall apply:

"Phase 4 will examine Edison's implementation of the recommendations in the audit report; we intend to order reasonable management responses to the audit recommendations. Phase 4 is not meant to be a comprehensive review of all of Edison's affiliate transactions. Nor is it a reasonableness review, in which the parties have their only opportunity to comment on the conclusions in the audit report. We will not necessarily endorse or reject the general conclusions in the audit report. DRA may object to conclusions in the report in Phase 4, but it can rely on facts in the audit report to continue to oppose the report's conclusions in Phase 5 as it sees fit." (D.93-01-024, slip op. p.5.)

On March 10, 1993, by D.93-03-021 (48 CPUC2d 352), issued in A.88-02-016, et al., the Commission approved a settlement (Affiliate QF Settlement) between Edison and DRA which resolved DRA's claims concerning the reasonableness of, and allegations of self-dealing and/or anticompetitive favoritism with respect to, Edison's power purchases from 13 qualifying facilities (QFs) in which Edison affiliate Mission Energy Company holds a partial ownership interest. In so doing, the Commission further delineated the uses of the Audit Report:

"No disallowance, penalty, or sanction may be imposed based on any finding of the outside audit regarding relationships among Edison and its nonutility affiliates, provided for in Condition B-5 of D.88-01-063 (Edison's Holding Company Decision), and which is currently being conducted under the auspices of Commission Advisory and Compliance Division in so far as such finding involves the Affiliate QF Issues, compromised and settled by the Amended and Restated Settlement Agreement." (Id. at 373, Order Paragraph 6.)

This limitation on the uses of the Audit Report's findings is clarified in Section 16.6 of the Affiliate QF Settlement. It provides that:

DRA shall not recommend any disallowance, penalty, or sanction of any kind or in any amount whatsoever, or seek to impose any additional restrictions or requirements on Edison, which would have the effect of imposing such a disallowance, penalty, or sanction based on any finding of the outside audit, provided for in Decision No. 88-01-063 (Edison's Holding Company Decision) and which is currently being conducted under the auspices of the CACD, of transactions between Edison and its nonutility affiliates, insofar as such finding involves the Affiliate QF Issues compromised and settled by this Agreement. Recommended changes in administrative practices or bookkeeping methods based on any finding of the audit will not be considered to be a disallowance, penalty or sanction." (Id. at 385-86, Appendix B.)

In summary, Phase 4 is not a reasonableness review, and in particular the Commission will not impose a disallowance, penalty, or sanction related to defined affiliate QF issues covered by the Affiliate QF settlement. Instead, it is an examination of Edison's implementation of the recommendations in the Audit Report and a forum for determining whether we should order additional management responses to the Audit Report's recommendations. The Phase 4 review does encompass "recommended changes in administrative practices or bookkeeping methods," including those involving affiliate QFs.

**2.4 Procedural Matters**

Following the issuance of D.93-01-024, the Administrative Law Judge established procedures for comments on the Audit Report. Edison was directed to respond to each recommendation, identifying those which it had implemented, those which had yet to be implemented, and those to which it took exception. Only DRA

responded to Edison's comments. No other party has participated in Phase 4 of this proceeding.

As noted above, D.88-01-063 required Edison to submit the affiliate transactions audit as a separate exhibit in this GRC. Edison included with the application a proposed exhibit (SCE-17) which presented the results of an affiliate transactions audit conducted by Arthur Anderson & Company. According to Edison, it initiated the Arthur Anderson audit in part because the audit required by Condition 5.e. was not available at the time it filed A.90-12-018. However, there is no indication that Edison intended that its presentation of the Arthur Anderson audit represented full compliance with Condition 5.e. In any event, Edison withdrew its proposed Exhibit SCE-17 (Tr. 4119-20 and Tr. 4232-4233).

Clearly Edison was prevented from fully complying with Condition 5.e. by a circumstance beyond its control, namely the unavailability of the staff-coordinated Audit Report at the time it filed this application. Nevertheless, Edison has taken all steps within its control to fulfill its procedural obligations with respect to the affiliates audits, including the filing of comments on the Audit Report.

**3. Comments**

**3.1 Edison**

Edison concurs with or does not dispute most of the 20 Audit Report recommendations. It has implemented many of them, and it has developed plans for implementing others. In particular, Edison has implemented or has taken steps to implement, in whole or in part, M&A's recommendations that it:

1. Continue with plans to communicate the affiliate transactions policies and procedures to all of the Mission Companies' employees.
2. Require that invoices for interaffiliate transactions state that balances are due thirty days from the date of the invoice.

3. Formalize the work request process for intercompany transactions.
4. Provide more formal documentation and structure for the periodic determination of the shared officer allocation rate.
5. Revise budgeting procedures and the policies and Guidelines for Affiliated Company Transactions (PGACT) manual to include the Mission Group's provision of data on the annual budget for directly requested services to Edison's Affiliate Officers.
6. Modify procedures to allocate to the Mission Group an appropriate portion of the cost of internal audit activities indirectly benefiting it.
7. Restructure the reporting relationships of SCEcorp's chairman and Edison's president to provide greater separation of work related to the regulated and nonregulated businesses.
8. Expand the Mission Group's board to include both internal and outside directors.
9. Develop an external audit process which will be a credible evaluation of any preferential treatment among the affiliated entities and nonaffiliated O&S.
10. Review control over nonutility affiliates, electronic access to Edison systems and databases, and improve as necessary.
11. Expand the PGACT manual to specifically include policies dealing with transfers of business opportunities.
12. Modify the PGACT manual to require that nonutility affiliates institute and document relationship checks as part of their due diligence process of investing, and avoid investments in which Edison has established a significant business relationship.
13. Continue to evaluate the effects of increased separation of services.

- 14. Implement improvements that give SCE greater oversight of the unregulated business activities.
- 15. Develop additional policies regarding the transfer of senior executive personnel.
- 16. Review the policies regarding rotational transfers of employees between Edison and Mission Companies, and either modify or reaffirm those policies accordingly.

Edison has not implemented or finds constraints preventing implementation or other problems with the following Audit Report recommendations:

- 1. Continue with the planned increase in the level of Internal Audits Department involvement regarding the affiliate relationships, as shown in the Internal Audit 1992 plan. Edison concurs with most aspects of this recommendation, but does not agree with a specific recommendation that it complete all affiliate transaction audits planned for a given year. Edison believes that it needs flexibility to adjust auditing priorities in light of changing workload, transaction volumes, etc.
- 2. Expand the scope of the audits performed by the internal audit function to review and compare the terms and prices of Edison's fuel contracts with those of Mission Energy's projects. Edison finds this recommendation troubling in several respects. Edison's fuel contracts are already routinely reviewed in Energy Cost Adjustment Clause proceedings. According to Edison, its fuel contracts are likely to be significantly different than those utilized by Mission Energy projects. Edison contends that the comparison would be burdensome, yet yield little valuable information. Finally, Edison notes that the comparison would facilitate the flow of information between the utility and nonutility affiliates, a result it has tried to avoid.

Continue to evaluate the effects of increased separation of services.



3.3. Strive for recognition of ultimate QF ownership

and implement reviews to guarantee against reciprocal dealmaking. Edison notes that its ability to implement this recommendation, including such activities as requiring disclosure statements from QFs, is constrained by ongoing efforts to develop uniform contractual terms and conditions for utility/QF contracts. Edison notes these concerns are being addressed in the Commission's QF-related proceedings.

4. Develop procedures which distinguish between ratepayer-supported asset transfers and nonratepayer-supported transfers, seek Commission approval of the procedures, and incorporate them in the PG&CT manual.

Edison largely concurs with this recommendation. However, it does not see any need for additional Commission approval of policies and procedures. Edison notes that Public Utilities Code § 851 already requires approval of transfers of utility property.

3.2. DRA

DRA notes that the Audit Report does not address and could not have addressed the substantial impact on Edison and the electric industry of the Energy Policy Act of 1992 (EPAct). DRA contends the report is thus largely obsolete. DRA finds other faults with the Audit Report. Significantly, DRA criticizes the audit for failing to investigate the possibility of unrecorded or unreported transactions among affiliates. DRA finds the report is inadequate to address the procedures, controls, and structural changes needed to protect ratepayers from excessively risky financial structures, self-dealing potential, cross-subsidization, and reporting deficiencies under the emerging Edison structure. DRA concludes that the Audit Report cannot be used as a basis for future policy decisions regarding Edison's affiliate relations.

2 "Order instituting rulemaking on the Commission's own motion to adopt reporting requirements for electric gas, telephone utilities regarding their affiliate transactions," filed August 11, 1992. Public L.102-486 (1992), 106 Stat. 2776.

With respect to the Audit Report recommendations, DRA states it is pleased to the extent that Edison is willing to adopt them. While DRA is more concerned with the inadequacies of the report and the limited scope of the recommendations, DRA does not find the recommendations to be harmful, although some it finds meaningless. DRA notes that issues of Commission oversight of utility/affiliate relationships are better addressed in other proceedings, including R.92-08-008<sup>2</sup> and other policy forums.

#### 4. Discussion

We note DRA's concerns regarding the methodology and scope of the audit, the currency of its findings, in light of the EPAct (as well as this Commission's initiatives regarding industry restructuring), and the significant areas of omission in the audit. As noted above however, the focus of Phase 4 is Edison's response to the Audit Report's recommendations, not the shortcomings of the audit or the Audit Report's findings and conclusions.

These recommendations do not represent sweeping reform of Edison's affiliate transactions policies and procedures. Instead, they constitute an incremental improvement in ratepayer protection by providing for greater separation of Edison's operations and those of its nonutility affiliates. Edison has implemented in whole or in part most of them, and in its comments has provided adequate justification for not implementing those which are problematic. DRA does not oppose any of the 20 recommendations or Edison's responses to them. In view of Edison's responses to date, the significant industry and regulatory developments that have occurred since the recommendations were proffered by M&A, and the availability of our generic rulemaking proceeding dealing with

DRA concludes that the Audit Report cannot be used as a basis for future policy decisions regarding Edison's affiliate relations.

<sup>2</sup> "Order instituting rulemaking on the Commission's own motion to adopt reporting requirements for electric, gas, telephone utilities regarding their affiliate transactions," filed August 11, 1992.

affiliate transactions, we find no need for further action in Phase 4 of this proceeding. We take no further action with the following caveats: First, while we accept Edison's stated need for flexibility to adjust auditing priorities, we do not anticipate or condone material reductions in completed audits; Second, because Edison is obligated by the terms of the Affiliate QF Settlement to limit purchases from any generating project in which SCEcorp, or any subsidiary of SCEcorp, has an ownership interest, Edison cannot disclaim knowledge of the identity of such affiliated QFs. We will assume that Edison, within the context of efforts to develop uniform contractual terms and conditions, will exercise its contractual opportunities to reasonably approve requests for assignment of QF contracts, or take other reasonable steps, in order to apprise itself of possible SCEcorp ownership interests.

#### Findings of Fact

1. Edison has complied with its procedural obligations with respect to the affiliate transactions audit ordered in Condition 5.e. of D.88-01-063.
2. The focus of Phase 4 is Edison's response to the Audit Report's recommendations.
3. Edison has implemented in whole or in part most of the Audit Report's recommendations, and has provided adequate justification for not implementing those which are problematic.
4. DRA does not oppose any of the 20 recommendations or Edison's response to them.

#### Conclusion of Law

As there is no basis for further action, Phase 4 should be closed.

affiliated transaction in **TWENTY-FIFTH INTERIM ORDER** in Phase 4 of this proceeding. We take no further action with the following **IT IS ORDERED** that Phase 4 of this consolidated proceeding is concluded by adjusting priorities, adjusting priorities to adjust auditing priorities, adjusting auditing priorities to adjust auditing priorities. This order becomes effective 30 days from today. Dated December 18, 1995 at San Francisco, California. Edison has an ownership interest in SCE Corp, or any subsidiary of SCE Corp, has an ownership interest in SCE Corp, or any subsidiary of SCE Corp, has an ownership interest in SCE Corp, or any subsidiary of SCE Corp. We will disclose the identity of such affiliated persons. We will assume that the context of efforts to develop uniform conditions, will exercise the contractual responsibility to approve requests for assignment of contracts, or take other reasonable steps, in order to apprise itself of possible SCE Corp ownership interests.

**DANIEL W. FESSLER**  
President

**P. GREGORY CONLON**

**JESSIE J. KNIGHT, JR.**

**HENRY M. DUQUE**

**JOSIAH L. NEEPER**

Commissioners

- Findings of Fact
1. Edison has complied with its procedural obligations with respect to the affiliate transactions audit ordered in Condition 2.6 of D.88-01-063.
  2. The focus of Phase 4 in Edison's response to the Audit Report's recommendations.
  3. Edison has implemented in whole or in part most of the Audit Report's recommendations, and has provided adequate justification for not implementing those which are problematic.
  4. ERA does not oppose any of the 20 recommendations or Edison's response to them.

Conclusion of Law

As there is no basis for further action, Phase 4 should be closed.