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08-CRI-1
DATE MAR 13 2009
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**STATE OF CALIFORNIA**

**ENERGY RESOURCES CONSERVATION**

**AND DEVELOPMENT COMMISSION**

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| CALIFORNIA LIVING & ENERGY (a division of William Lilly & Associates, Inc.) and DUCT TESTERS, INC.,<br><br>Complainants,<br><br>vs.<br><br>MASCO CORPORATION and ENERGYSENSE, INC.,<br><br>Respondents. | Docket Number 08-CRI-01<br><br>**PRE-HEARING BRIEF OF RESPONDENTS MASCO CORPORATION AND ENERGYSENSE, INC.**<br><br>Date: March 17-19, 2009<br>Time: 9:00 a.m.<br>Place: California Energy Commission<br>1516 Ninth Street<br>First Floor, Hearing Room A<br>Sacramento, California |

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Respondents Masco Corporation and EnergySense, Inc. ("Masco" and "EnergySense," or collectively, "Respondents") respectfully submit their pre-hearing brief in advance of the March 17-19, 2009 hearing on the complaints filed by California Living & Energy and Duct Testers Inc. ("Complainants").

## INTRODUCTION

The Complainants allege that Respondents are violating the California Home Energy Rating System ("HERS") conflict of interest proscriptions set forth in Title 20, Section 1673(i)(2) of the California Code of Regulations.[1] According to Complainants, EnergySense, a wholly-owned Masco subsidiary that employs certified "raters" who conduct Title 24 HERS testing, has a purported "conflict of interest" because EnergySense is allegedly not an entity independent from the builders or installers of energy efficiency improvements, whose work is verified or tested by EnergySense's employed raters. Complainants are wrong. The HERS raters EnergySense employs (as well as EnergySense itself) operate in full compliance with the HERS conflict of interest requirements. Indeed, the record shows that Masco and EnergySense acted conscientiously and in accord with guidance received from the certified HERS "provider," California Home Energy Efficiency Rating Service ("CHEERS"), and the knowledge and awareness of the staff of the California Energy Commission (the "Commission") in ensuring that the HERS raters EnergySense employed operated in accordance with Title 20 requirements. For these reasons, as more fully explained below, Complainants cannot prevail. Thus, their Complaints should be dismissed.

## ARGUMENT

### I. COMPLAINANTS CANNOT SATISFY THEIR BURDEN OF PROOF.

Complainants bear the burden of proving by a preponderance of the evidence that the HERS raters employed by EnergySense are violating the applicable Title 20 conflict of interest requirements. *See Patterson Flying Service v. Department of Pesticide Regulation*, 161 Cal. App.

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[1] Subsequent references to section numbers are to those in Title 20 or Title 24 of the California Code of Regulations unless otherwise noted.

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4th 411, 426 (2008) (applying preponderance of the evidence standard in administrative proceedings). The Complainants cannot satisfy their burden.

In their June 5, 2008 Complaint (served pursuant to the Efficiency Committee's August 5, 2008 Order) and in the other documents produced to date, Complainants have not shown that the HERS raters employed by EnergySense have violated any of the conflict of interest requirements. Those materials, which consist of irrelevant and incendiary diatribes against, and misrepresentations about Respondents, illustrate that Complainants have ignored, or have a fundamental misunderstanding of, the plain and unambiguous language of the conflict of interest regulation at issue in this proceeding. Instead, Complainants, who are two of EnergySense's competitors in the California HERS testing market, have improperly attempted to use their unfounded complaints to bolster their competitive positions and undermine EnergySense's market position and Masco's and EnergySense's business reputations.[2]

## II. HERS RATERS EMPLOYED BY ENERGYSENSE COMPLY WITH TITLE 20 CONFLICT OF INTEREST REQUIREMENTS.

In relevant part, Section 1673(i)(2) provides that HERS raters, who perform Title 24 field verification and testing, "shall be independent entities from the builder and from the subcontractor installer of energy efficiency improvements field verified or diagnostically tested." Under Section 1671, the "Definitions" section of the Title 20 HERS regulations, "Independent Entity means having no financial interest in, and not advocating or recommending the use of any product or service as a means of gaining increased business with" the builder or installer of energy efficient improvements. That same definitions section states that "Financial Interest means an ownership interest, debt agreement, or employer/employee relationship" with the builder or installer of the energy efficient improvement that the individual HERS rater field tests

[2] For example, in May 2007, Complainant California Living & Energy improperly and erroneously communicated to numerous builders throughout California that the Commission had determined that EnergySense was operating in violation of HERS conflict of interest requirements.



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or verifies.[3]

Together, these regulations narrowly define what a "conflict of interest" is between an individual HERS rater and a builder or installer of energy efficient improvements that are subject to the rater's Title 24 field verification and testing. Specifically, the plain language of the conflict of interest regulation bars an individual HERS rater from (a) having an ownership interest in a builder or installer of energy efficiency improvements that he or she field tests or verifies, (b) having a debt agreement with such a builder or installer, or (c) having an employer/employee relationship with such a builder or installer. As shown below, the HERS raters employed by EnergySense have no ownership interest in, debt agreements with, or employer/employee relationships with the builders or installers of the energy efficient improvements that they have field tested or verified under Title 24.

### A. The HERS Conflict Of Interest Regulations Apply Exclusively To Individual Raters, Not To Their Employers.

Complainants have erroneously focused on the relationship between EnergySense and the installation companies whose work is tested by the HERS raters employed by EnergySense. That focus is misguided because the plain language of the regulation makes it clear that the HERS conflict of interest prohibitions apply only to the individual raters, not to the companies that employ them. *See Southern Cal. Edison v. Public Utilities Com.*, 85 Cal. App. 4th 1086, 1105-06 (2000) (agency's interpretation of a regulation is controlled by the plain and unambiguous language of the provision); *see also Park Medical Pharmacy v. San Diego Orthopedic Associates Medical Group, Inc.*, 99 Cal. App. 4th 247, 258-59 (2002) (litigants may not re-write a statute to encompass a conflict of interest where the words of the statute do not reflect one).

For example, in Section 1671, a "rater" is defined as "a **person** performing the site inspection and data collection required to produce a home energy rating or the field verification and diagnostic testing required for demonstrating compliance with the Title 24 energy

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[3] Section 1671 also provides that "[f]inancial interest does not include ownership of less than 5% of the outstanding equity securities of a publicly traded corporation."



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performance standards, who is listed on a registry in compliance with Section 1673(c)." (emphasis added).

Furthermore, the term "rater" is used throughout Title 20 without any mention of the entity that may employ the rater, except to prohibit a rater from having an employer/employee relationship with a builder or installer of the energy efficient improvements that the rater field tests or verifies. The consistent usage of the term "rater" to refer to persons or individuals, and not to corporations who may employ raters (*e.g.,* in the context of certification, testing and registration) further underscores that the HERS conflict of interest prohibitions apply only to the individual raters EnergySense employs, not to EnergySense itself.

Section 7.9 of the 2005 Residential HERS Field Verification and Diagnostic Testing Regulations (CEC-400-2005-044) confirms that a HERS rater is a person, not a corporation:

> HERS Rater means **a person certified by a Commission approved HERS Provider** to perform the field verification and diagnostic testing required for demonstrating compliance with the standards. (Emphasis added.)

Moreover, the Commission's Energy Efficiency Division has previously acknowledged that the conflict of interest prohibitions apply only to individual HERS raters:

> By law, HERS raters must be independent from the builder or subcontractor installer of the energy efficient features being tested and verified. They can have no financial interest in the installation of improvements. HERS raters can not be employees of the builder or subcontractor whose work they are verifying. Also, HERS raters cannot have a financial interest in the builder's or contractor's business, nor can they advocate or recommend the use of any product or service that they are verifying. (Blue Print, Summer/Fall 2001, #66, Energy Efficiency Division, California Energy Commission, p. 1.)

### B. HERS Raters Employed By EnergySense Do Not Have A "Financial Interest" In The Installers Of Energy Efficient Improvements That They Have Verified Or Tested Under Title 24.

It is undisputed that HERS raters employed by EnergySense have performed Title 24 testing of High Quality Installation of Insulation ("HQII") that has been installed by separate Masco installation subsidiaries, including Western Insulation, LP, Coast Insulation Contractors, Inc., Sacramento Insulation Contractors and Masco Contractor Services of California, Inc. In fact, of the several energy efficiency improvements that can be subject to Title 24 testing by a HERS

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rater, HQII is the only one performed by any Masco subsidiary. Title 24 testing of such installations by HERS raters employed by EnergySense is plainly permissible under the Title 20 conflict of interest regulations.

The HERS raters employed by EnergySense (as well as EnergySense itself) do not have any "financial interest" in the separate Masco installation subsidiaries whose HQII work the raters have field tested or verified under Title 24.[4] First, the HERS raters employed by EnergySense have no "ownership interest" in any of those Masco installation subsidiaries, and EnergySense itself owns no stock and has no ownership interest in those subsidiaries either.[5] Likewise, the HERS raters employed by EnergySense (as well as EnergySense itself) do not have any "debt agreements" with any Masco installation subsidiary whose work they have tested or verified under Title 24.

Finally, the HERS raters employed by EnergySense do not have an "employer/employee relationship" with any builder or installer of energy efficient improvements that they test under Title 24, including any Masco installation subsidiary. Those HERS raters are exclusively employees of EnergySense. Similarly, EnergySense does not employ anyone who is also employed by a builder or installer whose work is tested by EnergySense's HERS raters.

In short, because the HERS raters employed by EnergySense do not have an "ownership interest" in, debt agreements with, or an employee/employer relationship with, any person or company whose work they field test and verify, they simply do not have a "financial interest" that is barred by Title 20.

Yet, it appears that Complainants are of the mistaken view that because two corporations

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[4] The HERS raters employed by EnergySense do not perform any HERS verification and testing for EnergySense's parent, Masco Corporation. Masco is a public holding company that provides administrative and high-level corporate governance support to more than 200 subsidiary companies, including EnergySense.

[5] It is possible that some raters employed by EnergySense might own a small amount of Masco Corporation stock (*e.g.,* as part of a stock ownership program). However, even if the Commission ignored the fact that Masco Corporation and each of its subsidiaries are legally separate entities and equated ownership of Masco stock with ownership of stock in the Masco installing subsidiaries, the ownership interest the raters employed by EnergySense may have would fall far below the five percent threshold set forth in Section 1671.

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(for example, EnergySense and Masco Contractor Services of California, Inc.) are related through a common parent (Masco Corporation), this establishes the requisite prohibited "financial interest" — essentially treating the parent corporation and its subsidiaries as a single legal entity. However, that interpretation is contrary to well-settled precedent holding that a parent corporation and its respective subsidiaries are legally separate entities. *See, e.g.*, *Westinghouse Electric Corp. v. Superior Court of Alameda County*, 549 P.2d 129, 139 (Cal. 1976) (absent bad faith, a parent company and its subsidiary are separate corporate entities); *Luis v. Orcutt Town Water Co.*, 204 Cal. App. 2d 433, 443 (1962) (a wholly-owned subsidiary is not the same entity as its parent corporation).

More importantly, however, the plain and unambiguous language of the Title 20 conflict of interest prohibitions do not apply to corporations, or to corporations related through common ownership; on their face, they apply only to an individual HERS rater in carefully circumscribed circumstances (*i.e.,* barring the rater from having an ownership interest in, debt agreement with, or employer/employee relationship with the builder or installer of improvements that the rater field tests or verifies under Title 24).

### C. HERS Raters Employed By EnergySense Do Not Advocate Or Recommend The Use Of Any Product Or Service As A Means Of Gaining Increased Business From The Installers Of Energy Efficiency Improvements That They Test Under Title 24.

Under the Title 20 conflict of interest regulations, individual HERS raters are also prohibited from advocating or recommending the products or services of builders or installers whose work is tested under Title 24, as a means of gaining increased business from them. The HERS raters employed by EnergySense (as well as EnergySense itself) comply fully with this prohibition. Notably, the marketing efforts of the HERS raters and EnergySense focus exclusively on advocating their testing services, not the products or services sold by builders or

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installers, including Masco's separate installation subsidiaries.[6]

## III. MASCO AND ENERGYSENSE HAVE ACTED IN CONFORMITY WITH THE GUIDANCE RECEIVED FROM CHEERS AND WITH THE AWARENESS OF THE COMMISSION'S STAFF TO ENSURE THAT THE RATERS EMPLOYED BY ENERGYSENSE COMPLY WITH TITLE 20 CONFLICT OF INTEREST REQUIREMENTS.

Prior to October 1, 2005, the effective date of the amendments to Title 24 that added HQII as one of the measures that could be field tested by HERS raters, the Title 20 conflict of interest prohibitions did not cause Masco or its subsidiaries any concern because the other types of improvements subject to HERS testing were not installed by any Masco subsidiary. However, with the addition of HQII to the list of improvements that could be tested by HERS raters, Masco recognized that the conflict of interest prohibitions posed a potential issue because certain Masco insulation installing subsidiaries also employed HERS raters. Accordingly, Masco and its installation subsidiaries began exploring various options to ensure compliance with the Title 20 conflict of interest requirements, including formation of a separate Masco subsidiary that would employ HERS raters to perform Title 24 testing.

### A. EnergySense Was Structured Based On Guidance Received From CHEERS.

In January 2006, representatives of Masco and certain of its installation subsidiaries operating in California approached CHEERS' Executive Director, Tom Hamilton, for guidance in complying with the conflict of interest requirements. In a series of meetings with Hamilton, Masco received reassurance that its proposed plan to consolidate and transfer HERS raters from the installing subsidiaries (where they had been employed) to a new, separate wholly-owned Masco subsidiary (to be named EnergySense, Inc.) would meet HERS requirements. Significantly, Hamilton expressed CHEERS' view that EnergySense's proposed structure,

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[6] Nothing in the Title 20 regulations prohibits builders or installers of energy efficient improvements from advocating or recommending the use of HERS raters employed by EnergySense, EnergySense or others for testing services. Indeed, that is fully consistent with the language in Example 2-7 of the 2005 Residential Compliance Manual, which expressly acknowledges that installation and testing services may be sold to builders as a package by installation companies.

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including having HERS raters employed by EnergySense conduct field verification and diagnostic testing of HQII work performed by separate Masco installation subsidiaries, would be consistent with Title 20 conflict of interest requirements, particularly in light of the fact that the regulations on their face apply only to individual HERS raters, and not to their employer.[7]

In those discussions, Hamilton also suggested that, as an extra precaution, firewalls be put in place between EnergySense and the Masco installation subsidiaries. Following Hamilton's advice, Masco began the lengthy process of forming EnergySense as a new, wholly-owned subsidiary, while Masco's insulation installing subsidiaries took steps to modify their structure and procedures to ensure the separateness and independence of their previously employed HERS raters.

One of the measures central to that effort was EnergySense's entry into contracts with the Masco installation subsidiaries. Those contracts establish that the raters employed by EnergySense are independent contractors who are directly accountable to the installation companies' customers — the builders — for the testing services they provide. The contracts are non-exclusive — they do not obligate Masco's subsidiaries to use EnergySense's raters for testing services, nor do they obligate EnergySense's raters to perform testing referred by those companies. Indeed, under those contracts, EnergySense is free to market the testing services provided by its HERS raters directly to builders or rely upon bids prepared by Masco's installation subsidiaries. Under the contracts, EnergySense retains exclusive control over the prices charged to builders for the verification and testing services provided by its HERS raters, and it does not vary its pricing based upon the identity of the installation company whose work is tested.

In exchange for the opportunity to offer builders a more comprehensive set of services, Masco's installation subsidiaries act as conduits for builder orders and payments to EnergySense for the testing services provided by its HERS raters on a pass-through basis without any markup or administrative fees charged by the installation subsidiary. Moreover, bids submitted to a

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[7] Hamilton reiterated this position in his videotaped deposition taken on February 26, 2009.



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builder for installation and testing services are evaluated separately by the builder on a standalone basis, enabling the builder to select from among the services offered. If, in response to those bids, a builder elects HERS testing services, EnergySense is responsible for scheduling the testing by its HERS raters and reporting the test results to the builder and CHEERS, not the installation subsidiary. That contractual arrangement is functionally equivalent to the permissible "three-party contracts" described in Example 2-7 in Section 2 of the 2005 Residential Compliance Manual.[8]

### B. Respondents Consulted With The Commission's Staff About EnergySense's Structure And Operations.

In October 2006, in response to an inquiry from Commission staff member Tav Cummins, EnergySense's president, David Bell, provided a written explanation of EnergySense's corporate ownership, structure and operations. Several months later, in May 2007, Commission attorney William Staack requested additional information about EnergySense's governance and operations. In response, Masco and EnergySense compiled the requested information and communicated that information (through counsel) to staff members Staack, Cummins, and William Pennington in a telephone conference call in early August 2007. During conference, the Commission's staff voiced no objections to EnergySense's structure or operations. The staff closed the call with assurances that the Commission would contact EnergySense if it needed any additional information.

However, prior to the current complaint proceeding being opened twelve months later (in August 2008), Masco and EnergySense never received any further communications or guidance

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[8] The contracts between EnergySense and Masco's installation subsidiaries reinforce the independence of the HERS raters employed by EnergySense. Moreover, a review of the quality assurance audits of EnergySense raters conducted by CHEERS shows that the raters employed by EnergySense have performed their jobs as required by the HERS regulations. Indeed, EnergySense is unaware of any issues that CHEERS has identified involving the quality or integrity of the work performed by any raters employed by EnergySense. Further illustrating the independence of those HERS raters are the instances where those raters have failed installation work performed by Masco's installation subsidiaries. Although such HERS test failures are not routine, they still confirm the independence and objectivity of the HERS raters EnergySense employs.

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from the Commission staff, reinforcing Respondents' belief that the HERS raters employed by EnergySense complied with Title 20 conflict of interest requirements.

### C. Masco and EnergySense Reasonably Relied Upon the Guidance Provided By CHEERS And The Awareness Of The Commission's Staff.

More than three years have transpired since Masco first sought and received CHEERS' guidance regarding compliance with Title 20 conflict of interest requirements, and nearly two and a half years since EnergySense first provided to the Commission's staff information about its operations and about the compliance of its HERS raters with Title 20 conflict of interest requirements. Throughout that period, Masco and EnergySense have taken extraordinary steps to maintain the independence of the HERS raters EnergySense employs to ensure that they comply with those plain and unambiguous requirements. The Commission can require nothing more.

## CONCLUSION

For the foregoing reasons, the Commission should find that the HERS raters employed by EnergySense are operating in accord with Title 20 conflict of interest requirements, and dismiss the Complaints.

Respectfully submitted,

Dated: March 13, 2008

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**PROOF OF SERVICE**

*California Living & Energy v. MASCO Corporation*
ERCDC Docket No. 08-CRI-01

I, Diane Donner, hereby declare:

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