

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**



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Application of California-American Water Company (U210W) for Authorization to increase its Revenues for Water Service by \$4,134,600 or 2.55% in the year 2011, by \$33,105,800 or 19.68% in the year 2012, by \$9,897,200 or 4.92% in the year 2013, and by \$10,874,600 or 5.16% in the year 2014.

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OPENING BRIEF OF CALIFORNIA-AMERICAN WATER COMPANY

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EXECUTIVE SUMMARY

This summary provides a high-level discussion of the litigated positions in this proceeding. California American Water fully discusses and thoroughly justifies each of its positions in the pages that follow.

PLANT: MONTEREY COUNTY DISTRICT

Special Request #19 – Recovery of Toro Arsenic Treatment Plant Costs

The \$1.9 million plant investment is a reasonable and prudent expenditure and is currently used and useful in serving customers. DRA's proposed alternative project is operationally impractical and would have higher maintenance costs.

Seaside Mains

The mains in Seaside have leak and break rates far in excess of other mains and need to be replaced. Replacement of these mains assists in reducing real water losses in a system where severe water production limitations are in place.

SCADA

The SCADA hardware has reached the end of its useful life in Monterey. To make the system more productive, all controls should be synchronized and based on the same technology.

Without updated controls on all facilities, water loss could be higher and water outages more frequent.

Special Request #32 - Monterey Billing System Modification Costs

All costs incurred were required to comply with Commission decisions and pre-rationing requirements. The Commission has not yet addressed or provided the opportunity for recovery of these costs.

INCOME TAX & TAX RELATED ISSUES

In addition to the specific income tax requests, California American Water also seeks a memorandum account to track the difference between the deferred taxes adopted in this proceeding and its actual deferred taxes.

Domestic Production Activities Deduction (“DPAD”)

California American Water is in a net operating loss position and will continue to be so for the foreseeable future. DPAD cannot be carried forward. The Commission has held that if a deduction cannot be taken for tax purposes it should not be used in the revenue requirement.

Repairs Deduction/ FIN 48

For purposes of a decision in this case, California American Water agrees that the currently estimated repairs deduction should be used in the determination of deferred taxes. Because California American Water inadvertently excluded the FIN 48 reserve in its application, California American Water will not reduce deferred taxes for rate making purposes in this case for the FIN 48 reserve.

Bonus Depreciation

California American Water agrees to project as part of the rate base the deferred tax related to the bonus depreciation for 2010 and 2012. California American Water will not take bonus depreciation in 2011. Since the Company will not be taking the bonus depreciation in 2011 it should not be recognized for ratemaking.

SPECIAL REQUESTS

Special Request #4 – Request for Rate of Return on Deferred Balances on Memorandum and Balancing Accounts

As of December 31, 2010, California American Water's deferred balances exceeded its short-term line of credit by approximately \$57 million and by December 31, 2011 will exceed it by over \$80 million. Applying a 90-day commercial paper rate return to all deferred balances ensures that California American Water will not have an opportunity to earn the authorized rate of return. California American Water requests that the interest on the deferred balances in excess of the short-term credit limit be set at its authorized rate of return.

Special Request #11 – Business Transformation Balancing Account

Projects of the magnitude and scope of American Water's Business Transformation Project are subject to some cost variability. Savings may be possible and will be captured if and when they exist to benefit customers. The current request is for a memorandum account to track revenue requirement differences and savings so that DRA and the Commission will have the opportunity to review.

Special Request #14 – Request for Recovery of Balances On Memorandum and Balancing Accounts (Limited to the Monterey Style Water Revenue Adjustment Mechanism (MSWRAM) Balancing Account and the Monterey Interim Rate True-Up (MIRTU) Memorandum Account)

MSWRAM balances are properly calculated as the difference between standard rates, using a 50% fixed cost service charge recovery, and actual billed rates under the conservation rate design. Leak adjustments are for the customer benefit and are appropriate to be included in the MSWRAM balance given the current rate design. DRA's proposal to change the already approved process for the MIRTU is retroactive ratemaking.

Special Request #18 – Contamination Proceeds

California American Water agrees that the net contamination proceeds for the Sacramento District related to non-MTBE proceeds should be used as a contribution in aid of contributions to offset rate base. California American Water agrees to file for recovery of the MTBE proceeds in a later proceeding.

Special Request #24 – Recovery of Toro Goodwill

The agreement for the \$408,000 purchase price of the Toro System did not exclude a later request to recover the actual purchase price plus total acquisition costs. The \$105,403 in “goodwill” costs were necessary and prudent for California American Water’s acquisition of this troubled system. True up to actual costs is a normal occurrence and should be recognized as prudent and reasonable in this case.

Special Request #34 –Amortize Balancing Accounts in Rates on an Annual Basis

California American Water’s request is similar to the process utilized by the natural gas utilities in California for more than a decade. Due to the size of its deferred balances, California American Water seeks comparable treatment, a treatment that reduces intergenerational inequities.

GENERAL OFFICE

Adjustment #1 – Labor and Labor-Related Expense

The actual annual 2010 labor and labor related costs were within 2% of the filed request in the case. This Commission should not sanction either the totally inappropriate one day “snapshot” short cut proposed by Overland nor its biased errors and flawed techniques to justify a huge, unwarranted and potentially disastrous reduction in the Service Company’s and California American Water’s general office labor costs.

Adjustment #2 – Pension Expense

DRA and Overland's recommendations do not reflect the actual practices of the Commission and the Company. The Commission should continue its practice of calculating the revenue requirement for pension expense based on actuarial projections of FAS 87 expense for Service Company and actuarial projections of ERISA contributions for California American Water and escalate the forecasts in accordance with the guidelines established in D.04-06-018.

Adjustment #11 – Group Insurance

The increase in group insurance expense, which includes a 20.3% increase to get from 2010 rates to 2011 actual rates currently in place, plus an 8% escalation factor to get from 2011 rates actually in place to the 2012 test year rates, is necessary in order cover current and forecast increases in program costs, which are consistent with industry trends. This request replaces California American Water's original request regarding group insurance expense, which included a 30% increase over 2010 rates.

Business Transformation

This Project will automate, update and modernize all aspects of the information technology platforms and business processes. No party in this proceeding disagrees that the replacement of the systems and processes are prudent and necessary. Capitalizing rather than expensing these costs is the proper regulatory approach fully supported by Commission precedent and ratebasing the Project costs rather than expensing them provides a major benefit to the ratepayers by spreading and leveling out the rate impact.

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Application No. 10-07-007
(Filed July 1, 2010)

OPENING BRIEF OF CALIFORNIA-AMERICAN WATER COMPANY

Pursuant to Article 13 of the Rules of Practice and Procedure of the California Public Utilities Commission (“Commission”), California-American Water Company (“California American Water” or “the Company”) respectfully submits its Opening Brief in the above-referenced proceeding.

I. INTRODUCTION

As discussed in more detail below, California American Water has provided ample justification for its requested rate increase. The record evidence in this proceeding overwhelmingly supports California American Water’s estimates and requests. By contrast, the proposals of the Division of Ratepayer Advocates (“DRA”), The Utility Reform Network (“TURN”) and others are based on speculation, are not supported by the record, contradict Commission regulations and decisions, and advocate radical deviations from established Commission policy. California American Water’s reasonable and well-supported rate increase represents an approach that balances the interests of customers and those of the utility in the short and long term. By contrast, the counter proposals represent short-term reductions based on ill-supported arguments and may in the long run work to the detriment of customers by destabilizing the long-term financial stability of California American Water, thereby producing less predictable rates in the future. The Commission should disregard these recommendations

and adopt California American Water's proposals.

California American Water and the DRA are continuing to work towards finalizing a settlement agreement on many of the contested issues in this general rate case. On May 19, 2011, DRA and California American Water served a stipulation on items that the parties agreed not to litigate. Subsequently, on June 7, 2011, TURN and California American Water served a stipulation on items that the parties agreed not to litigate. All intervenors were invited to participate in settlement negotiations. Most of the intervenors participated actively in settlement discussions and several intervenors achieved negotiated compromises with California American Water that are mutually acceptable to the settling parties and that will be covered in the settlement agreement. With the exception of rate design issues, which will be briefed later, the issues on which the parties were not able to reach agreement are the subject of this brief.

II. DISPUTED ITEMS

A. Plant: Monterey County District

1. Special Request #19 – Recovery of Toro Arsenic Treatment Plant Costs

In Special Request #19, California American Water seeks to include \$1,955,400 in rate base for the planning, permitting, and construction of improvements to the existing Toro arsenic treatment facility necessary to meet safe drinking water standards for arsenic. The arsenic treatment improvements, including a coagulation/filtration system by PureFlow, have been in service and providing water below the MCL (maximum contaminant level) for arsenic since March 1, 2010. The facility was granted a permit by the California Department of Public Health in May 2011.

DRA argues that the Commission should limit recovery for this project to \$685,000 based on its incorrect assumptions that (1) a Siemens adsorption system was a viable option for the Toro arsenic treatment facility and (2), that the annual operation and maintenance (“O & M”) costs for the Siemens adsorption system would be a fraction of its actual cost.¹ DRA

¹ DRA Exh. 9, *DRA Testimony on Utility Plant in Service of California American Water Company Monterey County*

admits that it would support California American Water’s use of the PureFlow system if it was determined that the combined annual cost inclusive of capital and operations and maintenance (“O&M”) costs was cheaper than the Siemens system.² DRA does not dispute that the Toro arsenic plant improvements were necessary or that the PureFlow system is currently in use and useful and is providing safe and reliable drinking water below the State and federal MCL for arsenic. The remaining dispute simply hinges on the true annual O&M cost for the Siemens adsorption system, which DRA claims is only \$91,500, but is in fact \$372,000.

Although the Siemens adsorption system was estimated to have lower initial capital costs as compared to the PureFlow coagulation/filtration system that was installed (\$685,000 versus \$1,955,400), California American Water determined that the combined annual cost inclusive of capital and O&M costs for the Siemens adsorption system would exceed that of the PureFlow system by an order of magnitude. This cost comparison is illustrated in the chart below. Based on this cost comparison, permitting concerns, California American Water’s staff’s experience in operation of similar installations, and a substantially superior delivery guarantee, California American Water decided to implement the PureFlow system over the Siemens adsorption system.³

	DRA Proposed Siemens Adsorption System	CAW Installed PureFlow System
Capital Cost	\$685,000	\$1,955,400
Pre-Tax Annual Revenue Requirement	\$77,131	\$220,178
Annual O&M Costs	\$372,000	\$18,660
Total Annual Cost	\$449,131	\$238,838
Annual Savings using PureFlow System	\$210,293	

The difference between California American Water and DRA’s estimated O&M expenses for Siemens adsorption system is based on a disagreement over the number of times per year that the filtration media would need to be replaced. DRA erroneously assumes that the

District and Toro Service Area, Including Special Requests 7, 15 and 19, dated January 21, 2011 (“DRA Exh. 9”), pp. 5-1 – 5-10.

² RT 1065:19-24 (Steingass/DRA).

³ See CAW Exh. 4, *Direct Testimony of Thomas F. Brunet*, dated July 1, 2010 (“Brunet Direct”), p. 15:12-22.

filtration media would only have to be changed-out once a year, based solely on the estimate contained in the bid of a company seeking to win a contract to install the Siemens system. By contrast, California American Water conducted a comprehensive evaluation of the water chemistry conditions, conducted detailed pilot testing of the various treatment systems, and reviewed studies published by the filtration media manufacturer in arriving at its determination that the Siemens filtration media would need to be changed out approximately four times per year.⁴ Accordingly, the correct annual O&M cost for the Siemens system is \$372,000 (at a cost of \$88,500 per change-out multiplied by four times a year). Contrary to DRA's claim that California American Water "prematurely dismissed" the adsorption system option, California American Water did in fact conduct a thorough investigation into the project options.

In addition to higher O&M cost of the Siemens adsorption system, California American Water ruled out this option because the Siemens system would have been operationally impractical due to excessive filtration media change-outs on an ongoing basis.⁵ The PureFlow system, by contrast, does not require media change-outs.

DRA also claims that California American Water purposefully increased the cost of the project by requiring an increased treatment system's peak capacity. DRA's allegation is unfounded and seeks to fault California American Water for its commendable work in restoring the Toro wells to original pumping capacity, which both eliminated the need to construct a backwash supply tank on site and enabled the Toro plant to deliver enough water to meet the Maximum Daily Demand with one filter out of service.⁶ It is counter-productive for DRA to suggest that California American Water's efforts to ensure safe, reliable drinking water for Toro

⁴ CAW Exh. 49, *Rebuttal Testimony of F. Mark Schubert, P.E.*, dated March 22, 2011 ("Schubert Rebuttal"), pp. 166-173.

⁵ Please see Section X.C. of Exh. 49, *Rebuttal Testimony of F. Mark Schubert* for a more detail explanation of the selection process California American Water used to arrive at the selection of the PureFlow coagulation/filtration system, the reasons why Siemens adsorption technology was ruled out in favor of PureFlow's coagulation/filtration system, what the actual annual costs to our customers would be had the Siemens adsorption system been implemented, how adsorption technology is operationally impractical for the Toro system; and how the arsenic removal upgrades are appropriately sized for production flows at the Toro.

⁶ See CAW Exh. 49, *Schubert Rebuttal*, p. 175.

customers are a convoluted attempt to increase costs. At the time it was purchased by California American Water, the Toro system was in receivership because the owners continuously failed to provide its customers with healthful drinking water in compliance with the Safe Drinking Water Act and there was an imminent potential of future violations.⁷ California American Water's acquisition of the system has resulted in compliance and is in keeping with the goals of the Commission's Water Action Plan. The Commission should support the prudent recovery of the capital investment associated with this project if it desires to have utilities remain committed to the Water Action Plan.

In summary, DRA's fundamental assumptions that the Siemens adsorption system is the lowest cost option and that the PureFlow coagulation/filtration system is the highest cost option are flatly wrong. In addition to being *more* costly on an annual basis, the Siemens proposal was not in any way a practical solution. The Toro arsenic treatment plant is in service, fully permitted and is successfully providing a consistent reduction of arsenic to a level below the State and federal MCLs. California American Water diligently pursued the least cost, best fit and economical alternative in its process selection. The arsenic removal system O&M costs are highly economical and sustainable over time. DRA's protest to the PureFlow system is based on incorrect assumptions and fails to take into consideration the total cost of the Siemens system. California American Water has clearly shown that its selection of the PureFlow system was prudent and reasonable. Therefore, the Commission should recognize and adopt this cost into rate base as originally presented by California American Water.

2. Seaside Mains

This investment project is a continuation of a highly successful small main replacement project wherein California American Water was able to replace almost twice the

⁷ D.07-11-034, *Application of California-American Water Company (U 210 W) and John W. Richardson & Associates, Court-Appointed Receiver for Toro Water Service, Inc., for an Order Authorizing the Sale and Conveyance of Certain Real Property and Utility Assets in Monterey County Pursuant to Public Utilities Code Section 851 and Authorizing an Increase in Revenues of \$ 105,332 or 31.7% on an Interim Basis in 2007, or \$ 208,467 or 63.5% (from Current Revenues) after Completion of Capital Improvements in 2007, and \$ 15,903 or 3.0% in 2008*, 2007 Cal. PUC LEXIS 658 ("D.07-11-034, 2007 Cal. PUC LEXIS 658"), *4.

projected amount of main within the budget approved for the 2009-2011 timeframe. California American Water is now requesting \$2,400,000 per year to continue this small main replacement project, for a total project cost of \$7,200,000 for the 2012-2014 general rate case cycle. The water distribution mains planned for replacement in the Seaside North area of the Monterey County District consist mainly of small diameter, thin walled, unlined steel pipelines. The Commission previously approved the first round of this Seaside main replacement project based on the Condition Based Assessment, which showed the rate of main breaks in Seaside North and Seaside South to be as high as 3.5 breaks/mile/year.⁸ In comparison, the Monterey County District system-wide average is 0.28 breaks/mile/year and the national average is 0.25 breaks/mile/year. Accordingly, this project is essential to help reduce non-revenue water in the Monterey County District.

DRA does not dispute that the Seaside mains are in disrepair. Rather, DRA spends an inordinate amount of time and effort discussing and suggesting various rehabilitation options. As in explained in great detail in its rebuttal testimony, California American Water strongly believes these options would not prove cost effective for the water main conditions in Seaside because these options are not appropriate due to the condition of the existing Seaside mains and surrounding soil composition, and could lead to other problems and higher operations and maintenance costs.⁹

For example, DRA suggests that California American Water install a cathodic protection system instead of replacing the Seaside mains. While California American Water agrees that “there are some situations where cathodic protection might be more cost-effective,” in the case of Seaside, “replacing a section of deteriorated main with a new main is going to be

⁸ D.09-07-021, *Application of California-American Water Company (U210W) for Authorization to Increase its Revenues for Water Service in its Monterey District by \$ 24,718,200 or 80.30% in the year 2009; \$ 6,503,900 or 11.72% in the year 2010; and \$ 7,598,300 or 12.25% in the year 2011 Under the Current Rate Design and to Increase its Revenues for Water Service in the Toro Service Area of its Monterey District by \$ 354,324 or 114.97% in the year 2009; \$ 25,000 or 3.77% in the year 2010; and \$ 46,500 or 6.76% in the year 2011 Under the Current Rate Design, And Related Matters*, 2009 Cal. PUC LEXIS 346 (“D.09-07-021, 2009 Cal. PUC LEXIS 346”), **54-55.

⁹ See CAW Exh. 49, Schubert Rebuttal, pp. 120-124.

much more cost-effective, especially if you end up getting good prices from a contractor” as California American Water has in Seaside.¹⁰ DRA’s analysis of the cathodic protection system failed to account for the operation and maintenance costs involved with having to inspect, monitor and replace the anodes, which dissolve over time. California American Water has emphasized that “these costs need to be balanced with what is going to be the best, most effective way of looking at pipe, whether it be replaced or rehabilitated.”¹¹ Contrary to DRA’s portrayal, the installation of a cathodic protection systems is not “simply putting an anode here, an anode there, an anode over here. There is the monitoring, the maintenance and the replacement of the sacrificial anode. The cost could end up actually being more than just outright pipe replacement.”¹² Therefore, contrary to DRA’s allegation that California American Water “failed to investigate a number of methods for rehabilitation and renewal of existing pipeline infrastructure in the Monterey District” California American Water conducted a thorough cost-benefit analysis of the options suggested by DRA in arriving at its conclusion that main replacement would be the most cost-effective for the Seaside area.

California American Water has proven that it can replace the mains in Seaside in a highly cost effective manner. In fact, over the 2009-2011 timeframe for this project, California American Water replaced 29,000 feet of main, 10,000 more feet than the 19,000 feet that was proposed within the same budget.¹³ Furthermore, disallowance for this investment project ignores the importance of reducing non-revenue water, which is contrary to DRA’s own testimony (as well as that of other parties) on the need to reduce non-revenue water in the Monterey County District.¹⁴

In summary, the Commission should recognize and approve the capital dollars as

¹⁰ RT 976:1-6 (Schubert/CAW).

¹¹ RT 973:24-25 (Schubert/CAW).

¹² RT 974:20-25 (Schubert/CAW).

¹³ RT 990:1-25 (Schubert/CAW).

¹⁴ DRA Exh. 9, pp. 4-2 – 4-3; MPWMD Exh. 3, *Direct Testimony of Andrew M. Bell*, dated February 4, 2011 (“Bell Direct”), p. 6; NRDC Exh. 1, *Testimony of the Natural Resources Defense Council On California American Water Company’s Proposed Rate Design, Water Conservation Rates, and Related Policy Issues*, dated February 4, 2011 (“NRDC Testimony”), p. 12.

originally presented by California American Water for this investment project (IP-0540-249 Seaside Main Replacement) in the total amount of \$7,200,000. Further, the Commission should allow these dollars to be included in rate base. It makes no sense to start with a logical and cost-effective investment project that will have long-term benefits to customers and then abruptly cancel it.

3. SCADA

California American Water has requested \$1,953,000 to address numerous deficiencies and issues with the outdated Supervisory Control and Data Acquisition (“SCADA”) system for the Monterey County District. With this investment project, California American Water will standardize the software, which is currently running three different programs, update remote site hardware that is beyond its useful life, and add SCADA capabilities to sites that currently do not have SCADA coverage. Like any other type of equipment, SCADA hardware and software have a finite life expectancy. In fact, best management practices dictate that SCADA hardware and software have a life expectancy of about five years. Considering that the first phase of the Monterey County District SCADA system was installed in 1998, the need to update and standardize the patchwork system is long overdue.

DRA’s proposed disallowance of this project is based on its unsupported claim that the Monterey County District has a complete SCADA system which is functioning properly and its disingenuous denial that the 400-500 monthly SCADA alarms constitutes a problem that needs to be resolved. Contrary to DRA’s claim that a complete SCADA system is in place and no additional investment is needed, California American Water’s capital investment workpapers demonstrate that 57% of the requested budget will be used to add SCADA capability to approximately twenty-five sites that currently do not have SCADA coverage and to replace and upgrade existing equipment that is beyond its useful life and is failing.

California American Water’s request to upgrade and standardize the Monterey County SCADA system is further supported by the 400-500 monthly SCADA alarms, many of which result from communication errors and transmitter failures. With regard to transmitter

failures, as this type of equipment ages (such as level and pressure transmitters), the tolerances of the signal drifts further from a true value. Transmitters that are out of tolerance will provide imprecise readings that can lead to false alarms and potential service disruptions. This proposed investment project will allow for the replacement of faulty and out of tolerance equipment. This investment project also includes a Radio Transmission Survey, which will identify communication sites that can be moved from an unreliable phone line to a radio frequency, and identify alternate data paths for data transmission. These improvements are anticipated to eliminate many of the errors related to broken communication.

As DRA has recognized,¹⁵ California American Water has to respond to the 400-500 SCADA alarms monthly, which consumes a significant amount of man-hours. In addition to the added personnel costs involved with responding to these alarms, failing transmitter signals contribute to increased amounts of non-revenue water. As explained in more detail in rebuttal testimony,¹⁶ a tank can overflow because the transmitter has failed open, giving a low level signal when the tank is in fact not only full, but also overflowing. These overflows waste water and contribute to non-revenue water, which California American Water is under significant pressure to reduce in the Monterey County District and which is a goal of the Commission's Water Action Plan.

Overall, California American Water has demonstrated that the current SCADA system in the Monterey County District has exceeded its useful life and needs to be upgraded, standardized, and expanded to include approximately twenty-five sites. Accordingly, this funding will allow for: 1) replacement of obsolete and worn equipment that is beyond its useful life, 2) equipping currently uncovered sites with SCADA coverage, 3) completing a Radio Transmission Survey that will address deficiencies and lead to improvements in communication, and 4) reprogramming of the SCADA interface needed as a result of finalizing the transfer from Wonderware to Iconics software. In addition, remote site hardware would be updated with

¹⁵ RT 1038:13-22 (Steingass/DRA).

¹⁶ See CAW Exh. 49, Schubert Rebuttal, pp. 118-119.

current technology, the SCADA architecture would be updated and computer systems would be made current. A reliable SCADA system is critical to reducing the excessive number of false alarms consuming significant personnel hours and to eliminate tank overflows, which is a high priority in the effort to meet the requirements of the Cease and Desist Order and Commission directives to reduce non-revenue water. Therefore, the Commission should recognize and approve the capital dollars as originally presented by California American Water for this investment project in the amount of \$1,953,000.

4. Special Request #32 - Monterey Billing System Modification Costs

In Special Request #32, California American Water requests authorization to include as plant in service all incurred costs related to the billing system modifications. California American Water is seeking to capitalize \$960,000 in billing system modification costs, which includes \$400,000 that it was authorized to track in the pre-rationing memorandum account and an additional \$560,000 related to the capital investment that it incurred to make further billing system changes the Commission required.¹⁷ The billing system modifications were necessary to comply with Commission decisions, support Commission policy and comply with Monterey Peninsula Water Management District (“MPWMD”) regulations. DRA’s various and contradictory arguments are all based on the mistaken belief that the Commission has already addressed or provided the opportunity for recovery of the billing system modification related costs. The Commission has not. DRA’s recommendation that the Commission disallow these amounts would penalize California American Water for making modifications that were necessary to comply with Commission orders and MPWMD regulations, and would result in financial harm to the Company.

California American Water first raised the issue of billing system modification costs in A.08-02-018, in which it sought authorization to modify its existing rationing memorandum account to include costs to modify its bill design and billing system to track

¹⁷ CAW Exh. 51, *Rebuttal Testimony of David P. Stephenson*, dated March 22, 2011 (“Stephenson Rebuttal”), p. 64.

customer consumption information, calculate the banked balance or excess usage on a monthly basis, and track flow restrictor installations and removals resulting from rationing. These requests were the result of the realization that California American Water would not be able to comply with MPWMD regulations in a timely manner without being fully prepared to go to rationing on short-term notice. The Commission approved this request in D.08-07-010 and directed the Company to coordinate its pre-rationing activities with California American Water's conservation proceeding (A.07-12-010) and its 2008 general rate case for its Monterey County District (A.08-01-027).¹⁸

In the conservation proceeding, the Commission issued a decision directing California American Water to provide water banking by December 31, 2010,¹⁹ as well as provide detailed customer information to MPWMD and to maintain and file comprehensive information related to implementation and results of the conservation program. In the 2008 general rate case proceeding, the Commission adopted a new conservation rate design for the Monterey County District.²⁰ California American Water had to modify its billing system in order to comply with these decisions. California American Water initiated the billing system modification process in May 2009 after it was certain that the new conservation rate design would be approved. The modifications were sufficiently in place by February 2010 to start billing customers under the new rate design. All modifications were completed in late Spring 2010.

The Commission had previously made it clear that California American Water had "full responsibility" to ensure that its total production remained under State Water Resource Control Board ("SWRCB") limitations and complied with the Seaside Groundwater Basin

¹⁸ D.08-07-010, *Application of California-American Water Company (U210W) To Modify Decision 03-02-030*, 2008 Cal. PUC LEXIS 274 ("D.08-07-010, 2008 Cal. PUC LEXIS 274"), **10-11, Conclusions of Law ¶¶ 1, 2, Ordering ¶¶ 1, 2.

¹⁹ D.09-07-023, *Application of California-American Water Company (U210W) for an Order Authorizing a Special Conservation Program and Modifications to its Rate Design in its Monterey District, and Authorization to Increase its Rates for Water Service in its Monterey District*, 2009 Cal. PUC LEXIS 331 ("D.09-07-023, 2009 Cal. PUC LEXIS 331"), *25, Ordering ¶ 2.

²⁰ D.09-07-021, 2009 Cal. PUC LEXIS 346, **196-197.

Adjudication Decision.²¹ In D.06-11-050, the Commission rejected California American Water's request for continuing a memorandum account to track fines imposed by the SWRCB stating that it had "the management tools necessary to operate its Monterey water system" and that California American Water should "assume full responsibility for managing water supply in compliance with the cutback requirement."²² The billing system modifications were necessary to take the additional necessary steps to ensure continued compliance with SWRCB and compliance with the Seaside Groundwater Basin Adjudication. The Commission later discussed the steps that created the need for the billing system modifications in a letter to the SWRCB in which it detailed California American Water's efforts to reduce consumption in Monterey.²³

The billing system modifications promote the Commission's conservation goals and benefit ratepayers by avoiding penalties and facilitating MPWMD rationing requirements to include water banking in an area subject to severe water restrictions. Had California American Water not made the billing system modification it "could have resulted in production that exceeded the State and Court ordered limitations, resulting in fines and penalties that customers may have had to pay, because the Company would not have been able to institute a billing structure to control customer usage."²⁴

DRA does not dispute that the Company was directed to upgrade its billing system and does not contest that California American Water reasonably and prudently incurred these costs. DRA also does not dispute that customers benefitted from these billing system

²¹ D.06-11-050, *In the Matter of the Application of California-American Water Company (U 210 W) for an Order Authorizing it to Increase its Rates for Water Service in its Monterey District to Increase Revenues by \$ 9,456,100 or 32.88% in the Year 2006; \$ 1,894,100 or 4.95% in the Year 2007; and \$ 1,574,600 or 3.92% in the Year 2008; and for an Order Authorizing Sixteen Special Requests with Revenue Requirements of \$ 3,815,900 in the Year 2006, \$ 5,622,300 in the Year 2007, and \$ 8,720,500 in the Year 2008; the Total Increase in Rates for Water Service Combined with the Sixteen Special Requests Could Increase Revenues by \$ 13,272,000 or 46.16% in the Year 2006; \$ 7,516,400 or 17.86% in the Year 2007; and \$ 10,295,100 or 20.73% in the Year 2008, In the Matter of the Application of California-American Water Company (U 210 W) for Authorization to Increase its Rates for Water Service in its Felton District to Increase Revenues by \$ 796,400 or 105.2% in the Year 2006; \$ 53,600 or 3.44% in the Year 2007; and \$ 16,600 or 1.03% in the Year 2008; and for an Order Authorizing two Special Requests, 2006 Cal. PUC LEXIS 479 ("D.06-11-050, 2006 Cal. PUC LEXIS 479"), *94.*

²² D.06-11-050, 2006 Cal. PUC LEXIS 479, *94.

²³ CAW Exh. 51, Stephenson Rebuttal, p. 63.

²⁴ CAW Exh. 51, Stephenson Rebuttal, p. 63.

modifications. Rather DRA argues (1) that California American Water did not track the billing system modification costs in the pre-rationing memorandum account, (2) that the billing system modification costs are administrative and general (“A&G”) expenses, not project costs to be capitalized, and (3) that the Commission has already addressed or provided for recovery of the billing system modification related costs. DRA is a wrong on all counts.

First, although California American Water did not charge the costs to a deferred regulatory asset on its balance sheet, that is not the same as tracking costs in a memorandum account. As Mr. Stephenson explained, California American Water included the \$400,000 as part in parcel to the balance of the memorandum account.²⁵ Indeed, when pressed, DRA failed to explain the relevance or significance of its assertion that there were no dollars recorded in the pre-rationing memorandum account.²⁶

Second, in its initial request for the memorandum account, California American Water did not request that the Commission treat the costs associated with billing system modification upgrades as expenses for ratemaking purposes, nor did the Commission impose such a requirement in its decision.²⁷ In fact, there is no discussion in D.08-07-010, the Commission’s decision in that proceeding, of the appropriate ratemaking treatment for the investment necessary to make the billing system modifications. D.08-07-010 merely authorizes the Company to track costs associated with pre-rationing procedures in a memorandum account.²⁸ The Commission was similarly silent on the ratemaking treatment of these costs in its decisions that created the need for the billing system modifications.²⁹ California American Water was not ordered to treat these costs as expenses and properly accounted for the billing system modifications as a capital investment.

Authorization to track costs in a memorandum account is not determinative of

²⁵ CAW Exh. 51, Stephenson Rebuttal, pp. 63-65.

²⁶ RT 721:7-23 (Cabrera, DRA).

²⁷ See generally D.08-07-010, 2008 Cal. PUC LEXIS 274.

²⁸ D.08-07-010, 2008 Cal. PUC LEXIS 274, *11, Ordering 2.

²⁹ See D.09-07-021, 2009 Cal. PUC LEXIS 346 and D.09-07-023, 2009 Cal. PUC LEXIS 331.

ratemaking treatment.³⁰ To the contrary, amounts recorded in a memorandum account are awaiting a determination of ratemaking treatment at some later date.³¹ As noted in Standard Practice U-27-W “[m]emo accounts track a) expenses, b) the carrying costs and depreciation on capital investments, and c) offsetting revenues, such as insurance proceeds, from the date of the account.”³² Furthermore, California American Water did not seek recovery of the costs of modifying the billing system as A&G expenses.

California American Water’s capitalization of billing system modification costs is in keeping with accounting standards. For example, the American Institute of Certified Public Accountants, the National Association of Regulatory Utility Commissioners, and the Financial Accounting Standards Board all state that costs associated with internal-use software, whether provided by a third party vendor or created internally, are to be capitalized.³³ Similarly, the Commission, in multiple decisions, has found that costs for billing system upgrades and software should be capitalized.³⁴

Third, contrary to DRA’s assertions, the Commission did not directly address recovery of these costs in D.09-07-021, as modified by D.10-11-006. In D.10-11-006, the Commission simply rejected a request by California American Water to add a term addressing these costs to the settlement agreement approved in D.09-07-021.³⁵ The basis of that rejection

³⁰ CAW Exh. 51, Stephenson Rebuttal, p. 65.

³¹ See D.09-07-021, 2009 Cal. PUC LEXIS 346, *141.

³² CAW Exh. 51, Stephenson Rebuttal, p. 64.

³³ CAW Exh. 51, Stephenson Rebuttal, p. 64.

³⁴ Id; See also Resolution T-17184, *Calaveras Telephone Company, Inc. (U-1004-C) General Rate Case Filing in Compliance with G.O. 96-A, Paragraph VI, and Decision Numbers 01-02-018 and 01-05-031*, dated January 29, 2009, p. 13 (“Calaveras revised plant-in-service budget to include \$250,000 for the billing system upgrade...[Communications Division] has reviewed its budget and found the investment is necessary and reasonable”); See also D.97-07-054, *Order Instituting Rulemaking to Review the Time Schedules for the Rate Case Plan and Fuel Offset Proceedings; In the Matter of the Application of Southern California Gas Company to Adopt Performance Based Regulation (“PBR”) for Base Rates to be Effective January 1, 1997*, 1997 Cal. PUC LEXIS 751 (“D.97-07-054, 1997 Cal. PUC LEXIS 751”), **142-143 (Directing capitalization of \$719,000 in “conversion costs associated with computer software.”); See also D.92-11-051, *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 Rate Adjustment Mechanism for Service Rendered Beginning January 1, 1992 and to Reflect this Increase in Rates; And Related Matters*, 1992 Cal. PUC LEXIS 802, **8-14 (Finding that software development costs should be capitalized as software is an asset providing significant benefits to ratepayers.)

³⁵ D.10-11-006, *Application of California-American Water Company (U210W) for Authorization to Increase its*

had *nothing* to do with the reasonableness of the billing system modification costs or the merits of California American Water's instant request. Instead, the Commission's decision was based on its finding that California American Water's request for unilateral modification of the settlement agreement would contravene Commission rules and practice.³⁶ DRA has pointed to nothing in these decisions, or any other decision, that would bar California American Water from seeking recovery here. For that matter, the decision does not preclude California American Water from seeking to recover the undepreciated value of the remaining cost that is in plant in service, exactly as it would for any other item of plant in service that was not specifically authorized in a prior decision.

Finally, capitalizing the billing system modification costs would not result in double recovery or retroactive ratemaking. As discussed above, the Commission has never addressed the ratemaking treatment of the \$400,000 of costs authorized in the memorandum account or the additional \$560,000 in any decision.³⁷ Furthermore, California American Water seeks only to ratebase the undepreciated value of the billing system modifications from 2012 forward.³⁸ DRA has failed to demonstrate or explain how such treatment amounts to retroactive ratemaking.

B. Income Tax & Tax Related Issues

California American Water discusses its positions regarding income tax and related issues below. In addition to the specific recommendations, California American Water also requests a memorandum account in which it can track the difference between the deferred taxes adopted in this case and its actual deferred taxes.

Revenues for Water Service in its Monterey District by \$ 24,718,200 or 80.30% in the year 2009; \$ 6,503,900 or 11.72% in the year 2010; and \$ 7,598,300 or 12.25% in the year 2011 Under the Current Rate Design and to Increase its Revenues for Water Service in the Toro Service Area of its Monterey District by \$ 354,324 or 114.97% in the year 2009; \$ 25,000 or 3.77% in the year 2010; and \$ 46,500 or 6.76% in the year 2011 Under the Current Rate Design, And Related Matters, 2010 Cal. PUC LEXIS 498 ("D.10-11-006, 2010 Cal. PUC LEXIS 498"), **4-5.

³⁶ D.10-11-006, 2010 Cal. PUC LEXIS 498, **4-5.

³⁷ CAW Exh. 51, Stephenson Rebuttal, p. 68.

³⁸ Id.

1. Domestic Production Activities Deduction (“DPAD”)

The Commission has recently held that if a deduction is not used, it should not be considered for ratemaking purposes.³⁹ In order to be considered for ratemaking, the tax benefits need to be available. If there are not actual tax benefits, then there is no need to recognize them in the revenue requirement.

California American Water generated an actual net operating loss of \$23,208,046 for 2010.⁴⁰ In addition, California American Water anticipates recording a tax net operating loss for 2011 as well as 2012.⁴¹ This tax loss position is due to accelerated depreciation, repairs and maintenance deductions, environmental remediation, and entries into the Water Revenue Adjustment Mechanism/Modified Cost Balancing Account that are forecast to exceed pre-tax income.⁴² The net operating loss position means that California American Water cannot utilize certain deductions, including the domestic production activities deduction (“DPAD”).

Accordingly, the Commission should adopt California American Water’s proposal regarding the DPAD, which takes the company’s current net operating loss position into account, and reject TURN’s and DRA’s proposals, which fail to do so.

DPAD applies to gross receipts from production activities, including water production.⁴³ The DPAD is a deduction and is not available if an entity experiences a net operating loss for tax purposes.⁴⁴ In addition, DPAD, which is recorded as a tax deduction and not as an expense, has no impact on deferred income taxes and cannot be carried back or forward to other tax years.⁴⁵ As Charles Lennox of Ernst & Young testified, the DPAD, “unlike other

³⁹ D.09-03-007, *Application of Suburban Water Systems (U339W) for Authority to Increase Rates Charged for Water Service by \$ 6,820,539 or 13.57% in 2009, \$ 1,698,004 or 2.97% in 2010, and \$ 1,250,644 or 2.12% in 2011*, 2009 Cal. PUC LEXIS 148 (“D.09-03-007, 2009 Cal. PUC LEXIS 148”), **24-26.

⁴⁰ CAW Exh. 45, *Rebuttal Testimony of Carl R. Meyers of American Water*, dated March 22, 2011 (“Meyers Rebuttal”), p. 2.

⁴¹ CAW Exh. 45, *Meyers Rebuttal*, p. 2.

⁴² CAW Exh. 45, *Meyers Rebuttal*, pp. 2-3.

⁴³ CAW Exh. 42, *Rebuttal Testimony of Charles A. Lennox*, dated March 22, 2011 (“Lennox Rebuttal”), p. 5.

⁴⁴ CAW Exh. 42, *Lennox Rebuttal*, p. 5.

⁴⁵ *Id.*; See also 26 U.S.C. § 172(d)(7) which addresses net operating loss carrybacks and carryovers and states: “The deduction under 199 shall not be allowed.”

sections of the code, is use it or lose it.”⁴⁶ Since California American Water has no taxable income for 2010 and forecasts no taxable income for 2011 and 2012, it will not be able to realize any tax benefit from DPAD.

DRA and TURN both propose attributing DPAD to California American Water for 2010-2012. TURN argues, “[t]he methodology for computing the Section 199 deduction that best accomplishes the minimization of the revenue requirement should be used for ratemaking purposes.”⁴⁷ DRA’s testimony does not take California American Water’s updated income forecasts and net operating loss position into account. DRA addresses only *how* to calculate DPAD, not whether it should be applied at all.⁴⁸ Similarly, TURN’s testimony on this issue only addresses how DPAD should be calculated, not whether it should be applied at all.⁴⁹ Neither DRA nor TURN explains why DPAD should be attributed to California American Water for ratemaking purposes when the utility is in fact not claiming DPAD for tax purposes. Since DRA and TURN fail to address DPAD in light of California American Water’s tax loss position, the Commission should disregard their testimony on this issue.

In addition, DRA and TURN’s proposals run contrary to Commission precedent.⁵⁰ In its 2008 general rate case, Suburban Water Systems (“Suburban”) did not adjust its revenue requirement for DPAD due to a net operating loss position.⁵¹ In granting Suburban’s request, the Commission found, “[i]t is unreasonable to direct Suburban to compute a DPAD as this deduction is non-existent.”⁵² In its Order Denying Rehearing of D.09-03-007, the Commission again rejected DRA’s proposal to compute DPAD for the utility separately from its parent

⁴⁶ RT 1143:13-14 (Lenns/CAW).

⁴⁷ TURN Exh. 1, *Direct Testimony of Ralph C. Smith on Behalf of The Utility Reform Network*, dated February 4, 2011 (“Smith Direct”), pp. 43-44.

⁴⁸ See DRA Exh. 5, *DRA Testimony On A&G Expenses, Depreciation, Taxes, Ratebase and Special Requests #S 4, 20, 22, 27, 33 and 34 of California American Water Company for Larkfield, Los Angeles County, Monterey County, Sacramento, San Diego County, and Ventura County Districts*, dated January 21, 2011 (“DRA Exh. 5”), pp. 42-44.

⁴⁹ TURN Exh. 1, Smith Direct, pp. 43-45.

⁵⁰ D.09-03-007, 2009 Cal. PUC LEXIS 148, **24-26.

⁵¹ *Id.*

⁵² D.09-03-007, 2009 Cal. PUC LEXIS 148, *53, Findings of Fact ¶ 11.

company and found that “Suburban did not realize any tax benefits associated with [DPAD].”⁵³

The Commission’s rationale in D.09-03-007 applies here as well. California American Water is in a net operating loss position and *cannot* benefit from DPAD. Accordingly, the Commission should not attribute DPAD to California American Water for ratemaking purposes. To hold otherwise would be to impute a credit to California American Water that it has not and does not intend to claim.

2. Repairs Deduction/ FIN 48

In general, if a company is not required to capitalize a tangible personal property expenditure, then it is deductible. Costs for incidental repairs and maintenance of property are not capital expenditures for tax purposes. The cost of incidental repairs necessary to maintain “ordinarily efficient operating condition” may be deducted as an expense.⁵⁴ If a repair meets the requirements of a valid deduction, the entire amount of the cost associated with that repair expense is treated as a current year tax deduction and not a capital asset.

Repairs accounting method changes are significant for water companies, and public utilities in general, because they are so capital intensive and a large portion of their assets consists of property, plant, and equipment. In general, income tax rules and regulations, which are not industry specific, allow for more costs to be treated as repair costs than the financial accounting and rate regulatory rules. For this reason, many utility companies, including water companies, filed accounting method changes to treat costs that previously they capitalized as property, plant, and equipment additions for income tax purposes as repair costs that are tax deductible in the year in which the costs are incurred. Under the current income tax rules, companies may claim tax deductions for current year repair costs, as well as “catch up” tax deductions for repair costs that were capitalized as property, plant and equipment additions in

⁵³ D.10-04-053, *Application of Suburban Water Systems (U339W) for Authority to Increase Rates Charged for Water Service by \$ 6,820,539 or 13.57% in 2009, \$ 1,698,004 or 2.97% in 2010, and \$ 1,250,644 or 2.12% in 2011*, 2010 Cal. PUC LEXIS 146 (“D.10-04-053, 2010 Cal. PUC LEXIS 146”), *6.

⁵⁴ CAW Exh. 42, Lennox Rebuttal, p. 14.

prior years, that should have been deducted as repair costs in prior years.⁵⁵ The Company filed its accounting method change on December 31, 2008, effective for the 2008 tax year. The Internal Revenue Service (“IRS”) approved the method change September 13, 2010, resulting in an adjustment of \$8,159,854.⁵⁶

Unfortunately, IRS approval of the method change does not guarantee that it will accept the Company’s calculation of its current year and “catch up” tax deductions for repairs. As Mr. Lenns explained, the IRS is overdue in publishing guidance on how exactly to determine what is deductible as a repair and what is not. “Accordingly, while there is no doubt that the Company is entitled to change its method of accounting for repair costs for income tax reporting purposes, the amount of its repairs deductions remain uncertain.”⁵⁷

California American Water will be taking the repairs deduction despite the uncertainty as to what the IRS will accept. Although FIN 48 would allow a company to reduce deferred income tax to reflect this uncertainty in this instance, California American Water did not include a FIN 48 reserve in its application. Given that it inadvertently excluded the FIN 48 reserve in its original application, California American Water elected not to update this issue.⁵⁸ As a result, California American Water will accept its full repairs deduction, which will increase deferred taxes.

3. Bonus Depreciation

The bonus depreciation provisions of the Economic Stimulus Act of 2008 (“2008 Act”) and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (“2010 Act”) allow a company to deduct “bonus” depreciation for investments in qualified property that it recently acquired and placed in service.⁵⁹ In effect, the 2010 Act extended the tax benefits of the 2008 Act and increased the deductible portion of depreciation from 50% to

⁵⁵ CAW Exh. 42, Lenns Rebuttal, p. 14.

⁵⁶ CAW Exh. 42, Lenns Rebuttal, p. 15.

⁵⁷ CAW Exh. 42, Lenns Rebuttal, p. 15.

⁵⁸ RT 1155-1556 (Lenns/CAW).

⁵⁹ See CAW Exh. 42, Lenns Rebuttal, p. 7.

100% for certain purchases in order to provide companies with a greater incentive to make purchases and invest in their businesses. The bonus depreciation deduction is elective and can be carried forward as a component of the deferred tax asset related to its net operating loss carryforward.⁶⁰ As part of the deferred tax asset, it should be utilized when it can provide the most benefit to the company.⁶¹

Although it has elected to take the bonus depreciation in 2010 and 2012, California American Water will not elect to take the bonus depreciation for 2011.⁶² DRA and TURN's recommendations regarding claiming bonus depreciation in 2011 and reducing ratebase by the deferred tax related to the election fail to reflect the fact that California American Water will not be taking the deduction. As discussed above, if a deduction is not used, it should not be considered for ratemaking purposes.⁶³

Mr. Lennox explained the factors that a utility considers in deciding whether to take the bonus depreciation:

The decision on whether or not to take bonus depreciation would need to be based on whether the company could benefit from the deduction for bonus depreciation in an appropriate time period. Based on currently available financial information provided by the Company, it appears that California American Water will be in a NOL position for 2011 and 2012. Accordingly, under these circumstances, and in accordance with the tax position of the company, it would not be an appropriate business decision to elect to take bonus depreciation in 2011.⁶⁴

TURN argues that because of recent changes to bonus tax depreciation rules “[t]here should be a substantial increase in the balance of Accumulated Deferred Income Taxes that offsets rate base, and thus a significant decrease to utility rate base.”⁶⁵ TURN proposes assuming approximately \$16 million for 2011. DRA similarly argues that the recent changes result in an “increase in the utilities (sic) deferred taxes, resulting in a corresponding decrease to

⁶⁰ CAW Exh. 42, Lennox Rebuttal, p. 12.

⁶¹ Id.

⁶² CAW Exh. 42, Lennox Rebuttal, p. 8.

⁶³ D.09-03-007, 2009 Cal. PUC LEXIS 148, **24-26.

⁶⁴ CAW Exh. 42, Lennox Rebuttal, p. 9.

⁶⁵ TURN Exh. 1, Smith Direct, p. 8.

the utilities (sic) ratebase.” Neither TURN nor DRA, however, base their recommendations on whether California American Water will actually realize the tax benefit in 2011. Therefore, the Commission should not attribute bonus depreciation in 2011 to California American Water for ratemaking purposes. To do so would be to attribute a benefit to California American Water that it does not intend to claim.

Furthermore, as discussed at the evidentiary hearing, the bonus depreciation calculations supplied in this case were, by necessity, preliminary. Mr. Lenns explained that “bonus depreciation is a relatively new concept”⁶⁶ and that there has been a lot of activity recently regarding the correct way to calculate it. In September 2010, bonus depreciation (at 50%) was extended to cover 2010 additions. In December 2010, another law was passed to allow 100% bonus depreciation for assets placed into service between September 8, 2010 and December 31, 2010. Therefore, if a company placed an asset in service between January 1 and September 2010, the bonus depreciation was 50% and if it placed the asset into service between September 8, 2010 and December 31, 2010, the bonus depreciation was 100%.⁶⁷ For a non-utility company, the determination as to whether the bonus depreciation was 50% or 100% was relatively straightforward, “because a normal company goes out and buys an asset and places it in service.”⁶⁸ As Mr. Lenns explained, however, for a utility company the determination is more complicated:

But for a utility company, it’s difficult to determine where the assets fit in those dates because most of their assets are self-constructed. And so oftentimes construction will begin, say, in 2008 or 2009, and the asset won’t be placed in service until sometime in 2010. And so as late as the end of this year, there was uncertainty as to whether an asset that was placed in service after September 8, 2010, but where construction began before that date, whether it was entitled to 100 percent or a 50 percent bonus.⁶⁹

It was not until March 2011 that the IRS published additional guidance that

⁶⁶ RT 1161:13-14 (Lenns/CAW).

⁶⁷ RT 1162:14-20 (Lenns/CAW).

⁶⁸ RT 1162:9-10 (Lenns/CAW).

⁶⁹ RT 1162:21-1163:6 (Lenns/CAW).

explained that for a utility company whose asset is self-constructed, and construction began before September 8, 2010, the company is only allowed 50% bonus depreciation on that asset.⁷⁰ Now that the issue has been clarified, the Commission's decision should reflect the proper percentage of bonus depreciation as well as the fact that California American Water will not take the bonus depreciation deduction in 2011.

C. Special Requests

1. Special Request #4 – Request for Rate of Return on Deferred Balances on Memorandum and Balancing Accounts

California American Water's Special Request #4 requests that the Commission provide the Company the opportunity to recover the actual carrying costs it incurs on the balances in its memorandum and balancing accounts.⁷¹ The inability to recover just and reasonable costs in a timely manner through the Commission's regulatory process has already placed California American Water in an untenable situation as it continues to fund a large portion of its deferred balances with long-term debt and equity, while it is able to recover only a fraction of its actual carrying cost related to these balances. In this case, California American Water seeks the opportunity to recover its actual carry costs. Allowing California American Water to recover its authorized rate of return, or currently 8.04%, reflects the source of funds used to finance these regulatory assets and is consistent with the utility's constitutional right to have the opportunity to earn a reasonable return on its investment.

The 90-day commercial paper rate that DRA advocates may be appropriate in certain typical situations. However, this is not a typical situation, nor it is an expected situation as contemplated by Standard Practice U-27-W. The Commission has recognized that short-term

⁷⁰ RT 1163:13-21 (Lenns/CAW).

⁷¹ *E.g.*, The rate of return that the Commission authorized for the interest rate on the Memorandum Account in D.06-12-040 is set at the 90-day commercial paper rate and does not reflect California American Water's Commission-authorized rate of return. D.06-12-040, *In the Matter of the Application of California-American Water Company for a Certificate of Public Convenience and Necessity to Construct and Operate its Coastal Water Project to Resolve the Long-Term Water Supply Deficit in its Monterey District and to Recover All Present and Future Costs in Connection Therewith in Rates*, (U 210 W), 2006 Cal. PUC LEXIS 422 ("D.06-12-040, 2006 Cal. PUC LEXIS 422"), **38-39.

debt is typically the appropriate vehicle to fund deferred balances.⁷² The Commission has routinely recognized the use of short-term debt to fund balancing account under-collections for energy utilities. For instance, in D.06-05-029, the Commission authorized San Diego Gas & Electric Company to issue short-term debt in order to finance under-collections of balancing accounts.⁷³ The Commission's frequent use of the 90-day commercial paper rate reflects the short-term nature of the balances, the idea that these are average sum-total zero balances and their funding is normally covered by short-term debt since the cumulative balance is small averages near zero. Standard Practice U-27-W, upon which DRA relies so heavily, is also in keeping with the short-term financing of many deferred balances.⁷⁴ While this standard practice may provide helpful guidance for certain deferred balance accounts, it does not in any way limit the Commission's ability to modify it to fit non-standard circumstances. Indeed, the Commission did so in D.08-05-036, in which it recognized that it should "decide the interest rate treatment based upon the circumstances at hand" and "the type of financing" being used.⁷⁵

In the case of California American Water, the deferred balance far exceeds the Company's short-term debt limit. In fact, the reality is these deferred balances are not short-term and will not be fully recovered in rates for a number of years. As described in the testimony of

⁷² See D.85-12-107, *Application of the Southern California Edison Company for (1) Authority to Change Its Rates Effective September 1, 1985, by Increasing Its Energy Cost Adjustment Billing Factors, Increasing Its annual Energy Rate, Decreasing Its Electric Revenue Adjustment Billing Factor, and Decreasing Its Steel Surcharge Adjustment Billing Factor; (2) Authority, at Some Future Date, to Reduce Its Energy Cost Adjustment Clause Rates to Reflect Fuel and Energy Cost Savings Attributable to Palo Verde Nuclear Generating Station Unit 1 Coincident With Implementation of the Major Additions Adjustment Clause Rates; and (3) Review of the Reasonableness of Edison's Operations During the Period from December 1, 1983, through November 30, 1984*, 1985 Cal. PUC LEXIS 1129, *3 (discussing the Energy Cost Adjustment Clause (ECAC) balancing accounts and noting that "any change in the inventory value due to price was tracked in the balancing account and financed with short-term debt."); D.05-05-047, *Application of San Diego Gas & Electric (U 902 M) for Authority to Increase Its Short-Term Borrowing Authorization to an Aggregate Amount Not to Exceed \$400,000,000 in Addition to that Amount Otherwise Authorized by Public Utilities Code Section 823(c), and to Simultaneously Extend the Term of Such Authorization Through December 31, 2010*, mimeo, 2005 Cal. PUC LEXIS 192, *20, Ordering ¶ 2.

⁷³ D.06-05-029, *Application of San Diego Gas & Electric Company (U-902-M) for Authority to Increase its Short-Term Borrowing Authorization to an Aggregate Amount not to Exceed \$ 550,000,000 in Addition to that Amount Otherwise Authorized Application 05-12-026 by Public Utilities Code Section 823(c)*, 2006 Cal. PUC LEXIS 195, mimeo, **3-4.

⁷⁴ DRA Exh. 5, pp. 129-131.

⁷⁵ D.08-05-036, *In the Matter of the Application of California-American Water Company (U210W) for an Interest Rate of 8.33% for Allowance for Funds Used During Construction (AFUDC) for its San Clemente Dam Memorandum*, 2008 Cal. PUC LEXIS 182, **15-16.

Mr. Jeffrey Linam, as of December 31, 2010, the deferred balances earning 90-day commercial paper have grown to \$90 million and could easily approach \$120 million by the end of 2011.⁷⁶ California American Water's short-term debt limit for 2010 was **\$33 million**.⁷⁷ This means that California American Water must fund the difference – approximately \$57 million to \$87 million – with long-term debt and equity.⁷⁸

Using a 90-day commercial paper rate for these deferred balances creates an automatic shortfall because California American Water recovers only a fraction of the carry cost it pays on these deferred balances. As such, California American Water is denied the opportunity to ever earn its authorized return. The current authorized weighted average cost of capital is 8.04%, whereas the current 90-day commercial paper rate, upon which California American Water earns on these deferred balances, is 0.24%, a historic low.⁷⁹ The deferred balances, which are typically viewed as short-term but are actually long-term in nature, have continued to grow between 2005 and 2010 at a compound annual growth rate of **70%**.

The shortfall is significant. Mr. Linam explained the severity of the situation:

It's to recover a shortfall that in my testimony I have calculated at \$7.3 million, which, like I said, was equivalent to us having to lay off a quarter of our staff in California in order to make up that shortfall. That's how significant this issue is to the company. We would have no opportunity to make our authorized return if we don't get relief on this issue. It's equivalent to 340 basis points of our return on equity.⁸⁰

California American Water has requested an average rate base of \$421 million for test year 2012.⁸¹ These deferred balances represent over 20% of the company's total projected rate base. To require these assets be covered by commercial paper rates would be sending a very negative message to investors that they are responsible for regulatory assets that the Commission has approved to be held on the books, but for which the Commission refuses to recognize a

⁷⁶ CAW Exh. 43, *Rebuttal Testimony of Jeffrey T. Linam*, dated March 22, 2011 ("Linam Rebuttal"), p. 2.

⁷⁷ CAW Exh. 43, Linam Rebuttal, p. 2, Attachment 1.

⁷⁸ CAW Exh. 43, Linam Rebuttal, pp. 2, 4.

⁷⁹ Based on the Federal Reserve Statistical Release (H15), 3-Month Financial Commercial Paper Rate for January 2011.

⁸⁰ RT 553:3-13 (Linam/CAW).

⁸¹ A.10-07-007, Exhibit A, Chapter 2.

return on them commensurate with the costs actually supporting those assets. As Mr. Linam explained, “This is not a “perceived” risk as DRA suggests but a *real* risk and a *real* cost to California American Water of compliance with Commission orders and directives.”⁸² As such, it is critical that the Commission authorize California American Water to recover its actual carrying costs at its full, weighted average cost of capital, to further avoid affecting its ability to earn a fair return and ensure that it is able to attract capital at reasonable rates for its customers. Denying California American Water the opportunity to recover its actual carrying cost of its investments will have the unintended consequences of increasing the cost of capital for California American Water and its customers.⁸³

Allowing California American Water the opportunity to recover its weighted average cost of capital on its deferred balances that are financed with long-term debt and equity is consistent with the regulatory compact between the Commission and the utility.⁸⁴ Even DRA agrees that California American Water should be compensated for carrying costs associated with long-term debt that is necessary to fund prudent and reasonable costs.⁸⁵ DRA’s proposal to maintain the status quo (of a 90-day commercial paper rate applied under the Commission’s standard practice), however, fails to recognize the unique circumstances that California American Water faces, despite the fact that California American Water has acted responsibly to minimize the amount of deferred balances and seeks more timely relief and recovery of costs. For example, California American Water has filed Special Request #34 seeking a more timely process of amortizing balancing accounts in rates.

California American Water cannot later recoup lost carrying costs of its investment. Under the Commission’s standard ratemaking practices, if California American Water cannot book its carrying costs for the regulatory assets in its memorandum and balancing

⁸² CAW Exh. 43, Linam Rebuttal, p. 2.

⁸³ CAW Exh. 43, Linam Rebuttal, p. 3.

⁸⁴ *Federal Power Comm’n v. Hope Natural Gas Company*, 320 U.S. 591, 603 (1944); *Bluefield Water Works & Improvement Co. v. West Virginia Public Service Comm’n*, 262 U.S. 679, 690, 692-93 (1923).

⁸⁵ RT 664:5-19 (Rauschmeier/DRA).

accounts, California American Water cannot later recoup such costs. If the Commission denies California American Water the opportunity to accrue interest at the full rate of return, its actual carrying cost, it is effectively denying California American Water the opportunity to earn a reasonable return on all of its investments and full recovery of prudent expenses. Practically speaking, such an action would be the same as disallowing reasonable and necessary costs.

Moreover, there is no guarantee to this rate of recovery even if California American Water books an appropriate rate, as that action only preserves the *opportunity* to earn a compensatory rate of return. By contrast, maintaining the status quo (keeping the 90-day commercial paper rate) will keep the rate preemptively low, and thus deny California American Water the opportunity to earn its authorized rate of return because the shortfall that is created cannot later be made up.

Furthermore, contrary to DRA's claim, the Commission's authorization of Special Request #4 would not create far-reaching precedent. In fact, California American Water's request is tailored to address its own unique situation. DRA cites the Commission's modification to Southern California Edison's deferred balance accounts in D.04-01-048 as support for its position because the change was noted as "temporary" and not "precedent setting."⁸⁶ California American Water's request is no different. As base rates are better aligned with customer demand, issues are addressed in the Monterey County District and deferred balances are amortized in rates, the adjustment under Special Request #4 will ultimately be eliminated. The recovery requested would only operate when the deferred balances exceed the short-term debt limit. If these unusually large balances are somehow reduced below the short-term debt limit, thereby resolving this longstanding issue, the adjustment requested in Special Request #4 is eliminated.

⁸⁶ DRA Exh. 5, p. 119, citing D.04-01-048, *Application of Southern California Edison Company (U 338-E) For Approval of its 2003 Revenue Requirement and related Estimates Under the Energy Resource Recovery Account (ERRA); For Approval of its 2003 AB57 Trigger and Threshold Amounts; and For Approval of a Proposed Scope and Schedule for ERRA Proceedings*, 2003 Cal. PUC LEXIS 649, **32-33, Ordering ¶ 4.

2. Special Request #11 – Business Transformation Memorandum Account

California American Water discusses Business Transformation in Section II.D.4 below.

3. Special Request #14 – Request for Recovery of Balances On Memorandum and Balancing Accounts (Limited to the Monterey-Style Water Revenue Adjustment Mechanism (MSWRAM) Balancing Account and the Monterey Interim Rate True-Up (MIRTU) Memorandum Account)

In Special Request #14, California American Water requests recovery of outstanding balances on all current memorandum and balancing accounts.⁸⁷ Currently, only the Monterey-Style Water Revenue Adjustment Mechanism (“MSWRAM”) and the Monterey Interim Rate True-Up (“MIRTU”) Memorandum Account are disputed. The issue of the proper definition and calculation of “standard rates” link these items. The recovery of the balances therein, however, are two separate and distinct issues and arise out of different Commission decisions. DRA’s attempt to combine the recovery of these separate accounts is merely an attempt to circumvent the prohibition against retroactive ratemaking.

a. MSWRAM

The MSWRAM is the WRAM that was in effect until recently. It tracked the difference between revenues that California American Water would have collected under the Commission’s standard rate design and what it collected based on tiered conservation rates, at the same level of consumption. In its decision on California American Water’s 2008 general rate case, the Commission approved a change from the MSWRAM to full decoupling WRAM and modified cost balancing account (“MCBA”). The full decoupling WRAM tracks differences between forecasted and actual consumption, not just differences between standard and conservation rate design.

The Commission should authorize California American Water to recover the MSWRAM balance as filed, which includes billing adjustments provided to customers for water

⁸⁷ See CAW Exh. 39, *Rebuttal Testimony of Sherrene P. Chew*, dated March 22, 2011 (“Chew Rebuttal”).

unintentionally consumed due to leaks, and is based on a calculation which considers the Commission's previously approved definition and calculation of "standard rates." The Commission should reject DRA's proposal that California American Water shareholders pay billing adjustments provided to customers and its attempts to retroactively redefine "standard rates" to use a 37% fixed cost factor. DRA's proposals are inconsistent with Commission precedent, contrary to the purposes of the MSWRAM, and would result in harm to the customers and the company.

(1) Billing Adjustments

When customers in the Monterey County District experience large increases in water bills due to a leak on their property that results in charges in the upper tiers of the very inverted conservation rate, they at times request a billing adjustment after they have repaired the leak.⁸⁸ In calculating the billing adjustment, California Water American simply applies the second-tier of the conservation rate to the quantities of water that were in excess of historical usage.⁸⁹ California American Water does not adjust the quantity of water billed.⁹⁰ Providing these billing adjustments, therefore, is in the interest of ratepayers, who would otherwise have to pay extremely high rates for water they did not intend to use or even know they were using.

DRA unreasonably maintains that California American Water improperly included billing adjustments due to customer leaks in the MSWRAM.⁹¹ At the evidentiary hearing, the DRA witness was either unable or unwilling to articulate a rationale for DRA's position, and refused to acknowledge that customers benefit from billing adjustments.⁹² DRA instead repeatedly asserts, without any justification or explanation, that granting billing adjustments to customers is within the discretion of the utility and that these adjustments should

⁸⁸ CAW Exh. 39, Chew Rebuttal, p. 17.

⁸⁹ Id.

⁹⁰ Id.

⁹¹ DRA Exh. 14, *Audit Report of DRA Audit of Balances in Memorandum and Balancing Accounts of California American Water Company Larkfield, Los Angeles County, Monterey County, Monterey Wastewater, Sacramento, San Diego County, and Ventura County Districts*, dated January 21, 2011 ("DRA Exh. 14"), p. 163.

⁹² RT 1081-1089 (Montero/DRA).

be “shouldered by the stockholders.”⁹³ Such a resolution would be nonsensical, unjust, inconsistent with Commission precedent and inconsistent with the purpose of the MSWRAM balancing account.

DRA argues that the MSWRAM tracks differences in rate design only and that only differences caused by the design should accrue to the MSWRAM account while differences in consumption should not.⁹⁴ DRA contends that the billing adjustments California American Water provides to ratepayers that had leaks on their property are “differences due to consumption.”⁹⁵ As discussed above, however, at the evidentiary hearing, DRA’s witness was unwilling or unable to articulate a rationale to support this position. DRA ignores the correlation between the billing adjustments and the MSWRAM, specifically that the adjustments are largely the result of the conservation rate design.

These types of large adjustments would not occur in other districts; they are the result of the very inverted rates in the Monterey County District. In fact, in all other districts, leak adjustments are provided by reducing the customer’s billed usage to a more normal amount. Reducing the billed usage to a more normal amount results in lower billed revenues and higher non-revenue water. The company is compensated for these adjustments in other districts by the increased non-revenue water amount. DRA has never raised any concern as to this recovery method in other districts, a method that does allocate the cost of the adjustments to customers, not shareholders. Moreover, DRA concedes that despite having an opportunity to do so, it has not conducted an in-depth review of the billing adjustments.⁹⁶

As California American Water explained, DRA’s position fails to take into account the differences between the Monterey County District and other California American Water districts.⁹⁷ In the Monterey County District, billing adjustments are rate adjustments, not

⁹³ RT 1083:15 – 1084:13 (Montero/DRA).

⁹⁴ RT 1096:11-27 (Montero/DRA).

⁹⁵ Id.

⁹⁶ RT 1101:20-22 (Montero/DRA).

⁹⁷ CAW Exh. 39, Chew Rebuttal, p. 16.

consumption adjustments. This is because, due to the unique conservation rate design in the Monterey County District, California American Water bills customers for every unit of water used, even if it makes a billing adjustment for the customer.⁹⁸ Put as simply as can be stated, where a customer has shown that a monthly bill that was out of step with historical usage was due to a leak and has repaired that leak, California American Water *still makes the customer pay for the water that was lost*, albeit at a lesser rate.

In the Monterey County District, the billing adjustment is a rate adjustment that re-allocates excess usage from the fifth tier to the second tier. Sherrene Chew described an actual adjustment California American Water provided to a residential customer in June 2010. In this example, the customer was billed \$4,620 in quantity charges for 1,812 units of water compared to the \$244 they were billed for 370 units in June 2009. With the exception of the July 2010 outlier, this customer's historical consumption between June 2009 and December 2010 ranged from 185 to 461 units, equating to \$153 to \$895. Using the 370 units as a guide, California American Water adjusted the customer's June 2010 bill by taking 370 of the 1,812 units and billing them as they would normally be billed under the conservation rate design. The remaining 1,442 units were billed at the second tier rate of \$0.4007 instead of the fifth tier rate of \$2.8051. The final quantity charge owed by the customer came to \$1,153, an adjustment of \$3,467. The level of consumption billed remained at the 1,812 units.⁹⁹

The dispute between California American Water and DRA is how to treat this credit of \$3,467. California American Water contends that the final \$1,153 billed to the customer should be booked to the MSWRAM as recorded revenue since it represents the final, true amount billed to the customer. DRA's position is that these adjustments should be excluded from the MSWRAM and the total original bill of \$4,260 should be included as recorded revenue in the MSWRAM because the adjustments are not related to the rate design, but as clearly shown, these are *entirely* related to rate design issues. However, the sharp impact to the

⁹⁸ CAW Exh. 39, Chew Rebuttal, p. 16.

⁹⁹ CAW Exh. 39, Chew Rebuttal, pp. 16-17.

customer's bill is the direct result of the conservation rate design – exactly what the MSWRAM was meant to track.

Under a standard rate design, the customer would have paid a single rate for all consumption. Instead, the customer unintentionally incurred charges for a much higher usage – not because the customer was a chronic high-end user, but because of a leak. If the Commission denies the allowance of these bill adjustments, California American Water would need to enforce a strict no adjustment policy going forward or risk the loss of additional revenue it will not recover. DRA has not even attempted to demonstrate or explain how making customers pay exorbitant conservation rates for water lost through leaks is in the interest of ratepayers. To the contrary, not providing billing adjustments for water leaks would *harm* ratepayers because they would be paying top-tier conservation rates for water they did not intend to use or know they were using.

The intent of the conservation rate design was to reduce the consumption of those who continually use water in excess of their allotment; the exclusion of billing adjustments would have the unintended consequences of penalizing those who inadvertently had high usage due to an isolated event. California American Water is not requesting more revenue – it is merely asking for the revenue it would have received under a standard rate design in accordance with the parameters of the MSWRAM.

The goal of the MSWRAM is to balance the interests of customers and the Company. The Commission can only accomplish this if it includes billing adjustments in the MSWRAM. Otherwise, California American Water is penalized by extending the adjustment to the customer and refunding the same dollars through an unadjusted MSWRAM.¹⁰⁰ DRA's logic to exclude adjustments from the MSWRAM is therefore flawed and results in a loss to California American Water and an end to future leak adjustments. The most appropriate treatment is the one already exercised and put forth by California American Water – that is to 1) grant bill

¹⁰⁰ CAW Exh. 39, Chew Rebuttal, pp. 18-19.

adjustments directly to customers affected by a leak and 2) account for these adjustments in the MSWRAM.

(2) Standard Rate Design

In contradiction to its testimony elsewhere, in the context of the MSWRAM, DRA argues that the rates billed to customers also constitute standard rates. In fact, standard rates are completely different from the conservation rates actually billed to customers. It is this difference that first created the need for a MSWRAM.

The Commission first approved the MSWRAM in 1996, in the same decision in which it approved “experimental” conservation rates.¹⁰¹ The original MSWRAM balancing account was established to track the under or over collection of revenues due to the differences between the conservation rate design and the Commission standard rate design. The mechanism’s purpose was to ensure that California American Water was not adversely impacted if billed revenues under conservation rates were less than the revenues that would have been generated under standard rates. Conversely, the MSWRAM would also protect customers from overpaying in the event billed revenues came in higher than those that would have been generated under standard rates. The Commission reaffirmed this MSWRAM in multiple Monterey rate case decisions,¹⁰² until 2009, when the Commission adopted a full decoupling WRAM with a MCBA for the Monterey County District.¹⁰³

The MSWRAM tracks the difference between revenues that California American Water would have collected under the Commission’s “standard rate design” at the actual customer consumption level and the revenues that California American Water actually collected

¹⁰¹ D.96-12-005, *In the Matter of the Application of California-American Water Company for an Order Authorizing it to Increase its Rates for Water Service in its Monterey District*, 1996 Cal. PUC LEXIS 1066 (“D.96-12-005, 1996 Cal. PUC LEXIS 1066”),*33, Ordering ¶ 8.

¹⁰² D.03-02-030, *In the Matter of the Application of the California-American Water Company (U210W) for an Order Authorizing it to Increase its Rates for Water Service in its Monterey Division to Increase Revenues by \$ 5,725,300 or 22.47% in the Year 2003; \$ 1,772,100 or 6.94% in the Year 2004; and \$ 996,500 or 3.02% in the Year 2005*, 2003 Cal. PUC LEXIS 121, **55-56; D.06-11-050, 2006 Cal. PUC LEXIS 479, **96-97.

¹⁰³ See D.09-07-021, 2009 Cal. PUC LEXIS 346, Appendix A, *Settlement Agreement Between the Division of Ratepayer Advocates and California-American Water Company on Conservation Rate Design Issues*, *240.

under the conservation rate design.¹⁰⁴ The MSWRAM was intended to address revenue shortfalls that would occur as utilities moved from standard rates to conservation rates, in which a greater percentage of fixed costs are moved from the meter charge to the quantity charge,¹⁰⁵ as well as the implementation of an inverted tier rate structure. By ensuring California American Water revenues it would have earned pursuant to standard rates, the MSWRAM removes some of the financial disincentive to promote sales over conservation.

The “standard rate” serves as the measuring stick for the revenues that California American Water would have collected but for the implementation of conservation rates. The Commission has long recognized that standard rates are based on a 50% allocation of fixed costs to the meter charge.¹⁰⁶ In D.03-02-030, the Commission adopted California American Water’s standard rate design calculation, which used a 50% fixed cost factor for the meter charge to recover the 2003 MSWRAM balance.¹⁰⁷ The Commission continued this same ratio in its reauthorization of the MSWRAM in D.06-11-050.¹⁰⁸ Furthermore, this ratio is memorialized in Standard Practice U-7-W, which provides that the “[s]ervice charges shall be set to allow utilities to recover up to 50% of their fixed costs.”¹⁰⁹

DRA ignores this precedent and recommends that the Commission redefine “standard rate” by assigning only 37% of fixed costs to the service charge component, citing the Commission’s 2006 Monterey general rate case decision for support.¹¹⁰ DRA asserts that D.06-11-050 authorized a standard rate design based on a 37% fixed cost factor. This is incorrect. The 37% fixed cost factor was used to simply determine the meter and second block quantity rates actually billed customers under the conservation rate design. The fixed cost factor was set

¹⁰⁴ CAW Exh. 7, *Direct Testimony of Sherrene P. Chew*, dated July 1, 2010 (“Chew Direct”), p. 27.

¹⁰⁵ D.08-11-023, *Application of California-American Water Company (U210W) to Decrease Revenues for Water Service in its Coronado District by (\$ 73,100) or (0.46%) in 2008, and Increase Revenues by \$ 266,200 or 1.67% in 2009, and \$ 260,900 or 1.61% in 2010, and Related Matters*, 2008 Cal. PUC LEXIS 456, **16-18.

¹⁰⁶ See D.86-05-064, *Order Instituting Investigation (Rulemaking) into Water Rate Design Policy*, 1986 Cal. PUC LEXIS 972, *23, Ordering ¶ 2.

¹⁰⁷ D.03-02-030, 2003 Cal. PUC LEXIS 121, *117, Findings of Fact ¶ 11.

¹⁰⁸ D.06-11-050, 2006 Cal. PUC LEXIS 479, **96-101.

¹⁰⁹ Standard Practice U-7-W, p. 3.

¹¹⁰ DRA Exh. 14, p. 155.

at 37% in order to ensure that the majority of the rate increase adopted in D.06-11-050 was shifted into the conservation rate volumetric charge to encourage customers to conserve water and offer greater opportunity to control their bills. The adoption of the 37% cost factor was not intended to also serve as standard rates. DRA's position blurs the line between standard and conservation rates. To consider these rates as both the standard rate and conservation rate would render the MSWRAM, which was meant to track differences between the two designs, moot.

DRA's inability to recognize the distinct characteristics of the two rate designs is further highlighted by its claim that D.09-07-021 adopted a new "standard" rate design based on a 15% fixed cost factor.¹¹¹ Actually, D.09-07-021 authorized a new WRAM that would replace the MSWRAM once the new rate design was implemented in Monterey. This new WRAM is identical to the WRAMs in effect in other California American Water districts and tracks the difference between adopted and recorded quantity revenues instead of differences between rate designs as previously done under the MSWRAM. Thus, nowhere in D.09-07-021, or in the settlement agreement that it approved, is there any requirement that the fixed cost factor for standard rates be limited to 15% for the purposes of the WRAM. The only time the 15% fixed cost factor is discussed is as a component of conservation rates under the new pilot program in the settlement adopted in D.09-07-021.¹¹²

By modifying the "standard rate design" to shift a greater portion of the fixed costs to the quantity charge, DRA is turning the "standard rate" into a conservation rate. However, DRA's testimony on the WRAM and MCBA applied in other districts makes a clear distinction between standard and conservation rate design. DRA states:

Under standard rate design, the fixed cost component of the revenue requirement is divided in half. One half of the fixed costs are then recovered through service charges. The other half of the fixed cost component is added to the variable costs and recovered through volumetric charges.... The quantity charge revenues – one half of fixed costs plus all variable costs – are distributed across

¹¹¹ DRA Exh. 14, p. 155.

¹¹² D.09-07-021, 2009 Cal. PUC LEXIS 346, Appendix A, *Settlement Agreement Between the Division of Ratepayer Advocates and California-American Water Company on Conservation Rate Design Issues*, *250, Section IV.B.

the customer classes based on the expected water sales in each customer class... There are two key differences between Standard Rate Design and Conservation Rate Design. First, an additional portion of the fixed costs is shifted from the service charges to the volumetric charges. This is described in the California Urban Water Conservation Council's (CUWCC) Best Management Practice (BMP) 1.4. It is intended to send a stronger conservation signal to the customer, since water use and charges will be more closely aligned. . . . Second, tiered rates, where the volumetric charge increases with increased consumption, are developed for some customer classes – usually just the residential class...¹¹³

Therefore, by DRA's own admission, a standard rate design and conservation rate design are two discrete approaches to recovering a revenue requirement. Moreover, according to DRA's own testimony, under the standard rate design, 50% of fixed costs are recovered through service charges. Therefore, DRA's proposal, if adopted, would contradict its own testimony and the basic purpose of the MSWRAM, which is to ensure that the Company recovers the revenues it would have earned but for conservation rate design and to remove only a limited portion of the disincentive for the Company to promote sales over conservation.

b. Monterey Interim Rate True Up ("MIRTU") Memorandum Account

The Monterey Interim Rate True Up ("MIRTU") Memorandum Account tracks the difference between interim rates and final rates granted in D.09-07-021.¹¹⁴ On January 26, 2010, California American Water filed Advice Letter 826 to recover the balance tracked in the MIRTU and implement the new rate design adopted in D.09-07-021. In an effort to minimize the number of rate changes made during the year, in Advice Letter 826 California American Water proposed to implement the interim rate true up in two phases. Phase I took effect on February 1, 2010 and was designed to recover the undercollected balance of \$6,474,700 in the MIRTU for the period from May 11, 2009 through December 31, 2009. California American Water proposed that Phase II would be part of the 2011 step rate filing and would be to recover or refund any costs in the MIRTU for the period from January 1, 2010 through January 31,

¹¹³ DRA Exhibit 10, *DRA Testimony on Rate Design and Special Requests #s 5, 6, 10, 28 and 29 Of California American Water Company For Larkfield, Toro Service Area in Monterey, Los Angeles County, San Diego County, Ventura County Districts*, dated January 21, 2011 ("DRA Exh. 10"), pp. 6-15 – 6-16.

¹¹⁴ CAW Exh. 7, Chew Direct, p. 18.

2010.¹¹⁵ California American proposed that the updated surcharge or surcredit would become effective at the same time as the 2011 step increase.¹¹⁶ In its advice letter filing with the Commission's Division of Water & Audits ("DWA") California American Water included Excel spreadsheets that showed how the Company calculated the MIRTU balance. Both the new rate design adopted in D.09-07-021 and California American Water's proposed recovery of the MIRTU were approved effective February 1, 2010.¹¹⁷ Since DWA had already approved California American Water's calculation and recovery method in Advice Letter 826, California American Water included the MIRTU in this rate case merely to report on the balance – not to seek any approval as part of this general rate case.

DRA recommends that the Commission retroactively change the methodology for calculating the MIRTU balance. Not only is DRA's proposed methodology incorrect, it is inappropriate for procedural and policy reasons. California American Water served DRA with the advice letter. DRA had the opportunity to protest the advice letter, but chose not to. Now, in this general rate case, DRA is trying to take another bite at the apple by combining the MIRTU recovery with the MSWRAM recovery. Furthermore, changing the calculation methodology *after* it has been approved by DWA and *after* California American Water has begun recovering the MIRTU constitutes retroactive ratemaking.

DRA based its retroactive adjustments to this account on the same flawed calculation of standard rates it applies to the MSWRAM on the standard rate design. As previously discussed, the standard rate design should be defined as a 50% fixed cost allocation to the meter charge – not the 15% DRA recommends. The rates created from this approach would be compared against the rates of the conservation rate design to determine the appropriate WRAM and true-up balances.

Furthermore, DRA's interim rate calculation incorrectly interchanges parameters

¹¹⁵ The January 2010 balance in the MIRTU is an approximate under-collection of \$750k, not including interest.

¹¹⁶ California American Water has not yet made its 2011 step rate filing.

¹¹⁷ CAW Exh. 7, Chew Direct, p. 18.

between the new rate design adopted in D.09-07-021 with the prior rate design. DRA states it calculated the interim rate true-up by taking the difference between revenues that California American Water would have received under the final conservation rates and the revenues California American Water actually billed under the interim conservation rates.¹¹⁸ However, DRA fails to recognize that the allotments and block widths in effect during the interim rate period are different from those used to calculate rates under the new rate design.

For example, a residential three-person household on a 3/8 acre lot was previously allowed 70 units of water in each block. In the new rate design, the same customer would be allowed 45 units of water in the first two blocks, with an additional allowance for outdoor use in the higher blocks during summer months. During the interim rate period, if the customer used 70 units of water, all their usage would fall within the first block and be charged the first block rate. Under the new rate design, only 45 units would fall into the first block. The remainder would tip into the second block and be charged the second block rate. DRA's analysis takes the decision-authorized first block rate and charges all 70 units of water at that rate, without any consideration for the difference in usage distribution and what California American Water would truly bill. In other words, DRA did not properly apply the rate design parameters the Commission adopted in D.09-07-021 and did not reallocate the 25 units of the customer usage into the block as required by that rate design. By only applying the decision-authorized rates and not the final rate design parameters, DRA has understated what California American Water would have billed under the decision-authorized rates. Moreover, if DRA's position is that the new rates and rate design should be retroactive back to May 11, 2009, then the new WRAM and MCBA would also have to be made effective May 11, 2009 as components to the new rate design.

DRA's proposal for the MIRTU fails to take into account the effect of the MSWRAM. The MSWRAM – which was in effect until February 1, 2010 – was designed to allow the Company the revenue it would have received under the standard rate design.

¹¹⁸ DRA Exh. 14, p. 160

Therefore, regardless of the revenues billed under conservation rates, California American Water's final interim revenues are those based on the standard rate design.¹¹⁹

When the Commission issued D.09-07-021, it adopted a final revenue requirement for the Test Year 2009. In accordance with Advice Letter 750-B, California American Water was allowed to calculate an interim rate true-up going back to the May 11, 2009 effective date of interim rates. Under normal circumstances, the interim rate true up would be calculated by taking the difference between the final authorized rates and the interim rates customers were billed. However, the MSWRAM was also effective during the interim period and its impact must be considered. As discussed above, the MSWRAM tracks the difference between the revenues that would have been generated if standard rates had been billed and the actual revenues that resulted from conservation rates. Thus, when the Commission adopted interim rates in Advice Letter 750-B, the standard rates effectively became the interim standard rates. In effect, until a final decision was rendered and a new standard rate could be calculated based on the newly adopted revenue requirement, the current standard rate would be the interim standard rate. Thus, from May 11, 2009 through January 31, 2010 – the effective period of interim rates - the MSWRAM was tracking the difference between an interim standard rate and the conservation rates.

With the final revenue requirement in D.09-07-021, a final standard rate was determined and applied to the effective period of interim rates to calculate the interim rate true up. However, the nuance is once again the MSWRAM. By its very nature, the MSWRAM has already adjusted revenues to the level they would have been had customers been billed under interim standard rates. In other words, if the Commission accepted the MSWRAM balance as calculated, California American Water would be allowed to recover revenues equal to the revenues it would have received had customers been billed under the interim standard rate design. If the Commission grants this revenue level as tracked in the MSWRAM, it only makes

¹¹⁹ CAW Exh. 39, Chew Rebuttal, p. 20.

sense that the interim rate true-up calculate the difference between the revenues California American Water would have received under the final standard rate design (as calculated based on the final revenue requirement) and the revenues California American Water has received under the interim standard rate design used in the MSWRAM. The revenue generated using the final standard rate and actual consumption and customer counts is the revenue California American Water would have been allowed to collect if the final rates had been implemented as originally scheduled. The interim rate true up is therefore the difference between the revenue calculated under the final adopted standard rate and the revenue calculated under the interim standard rate.

The mechanism to make California American Water whole is thus a two-step process. The first step occurs through the MSWRAM, which brings California American Water's revenues up to the level of revenues it would have received under the interim standard rate. The second step brings California American Water from the revenues under the interim standard rate to the revenues it would have received under the final standard rate based on the final revenue requirement granted in D.09-07-021. If one only compared what was billed to customers without consideration for the mechanics of the MSWRAM, as DRA has done, the actual recovery would be overstated. In order to arrive at the correct interim rate true-up amount, dollars accrued to the WRAM must be incorporated into the overall picture.¹²⁰

The interim rate true up that DWA approved in Advice Letter 826 showed the difference between the revenue calculated under the final adopted standard rate and the revenue calculated under the interim standard rate. There is no justification for retroactively modifying this methodology, as DRA proposes in this general rate case.

4. Special Request #18 – Contamination Proceeds

California American Water agrees that it will abide by the ruling of the Administrative Law Judge in this proceeding that the (non-MTBE) contamination proceeds from Aerojet and the U.S. Air Force for specific sites in the Suburban service area of the Sacramento

¹²⁰ CAW Exh. 39, Chew Rebuttal, p. 20.

District, amounting to net proceeds of \$1,879,556, should be recorded as a contribution in aid of construction to offset plant investment to remediate contamination issues. The net MTBE proceeds will remain on the balance sheet of California American Water and disposition of these proceeds will be addressed in a future application.

5. Special Request #19 – Recovery of Toro Arsenic Treatment Plant Costs

California American Water discusses this issue in Section II.A.1 above.

6. Special Request #24 – Recovery of Toro Goodwill

The Commission should authorize California American Water to recover 100% of Toro Goodwill, totaling \$260,000.¹²¹ DRA maintains that, pursuant to the settlement approved in D.07-11-034, California American Water is only entitled to recover \$105,000.¹²² DRA’s proposal excludes post acquisition costs, and is therefore unreasonable.

Due to the timing of the Toro acquisition, which occurred in 2007, California American Water did not include the acquisition premium in the 2008 Monterey County District rate case.¹²³ With the purchases of a business, direct transaction costs need to be factored into goodwill.¹²⁴ These sorts of costs are not always known at the time of acquisition.¹²⁵ DRA does not dispute accounting for such costs in goodwill.¹²⁶

DRA asserts, however, that California American Water “assumed the risk of any misstatement of the numbers and failing to not include (sic) any other costs when it settled on the purchase price of \$408,000 and to recover only \$105,403 in goodwill.”¹²⁷ Contrary to DRA’s assertions, however, the settlement agreement approved in D.07-11-034 simply provides that the parties agreed “that it would be reasonable, consistent with the law, and in the public interest for

¹²¹ CAW Exh. 40, p. 5

¹²² DRA Exh. 13, *DRA Testimony on Special Request Nos. 3, 11, 12, 24, 25, 26, and 32 of California American Water Company Larkfield, Los Angeles County, Monterey County, Monterey Wastewater, Sacramento, San Diego County, and Ventura County Districts*, dated January 21, 2011 (“DRA Exh. 13”), p. 4-1.

¹²³ CAW Exh. 9, Direct Testimony of Jeffrey M. Dana, dated July 1, 2010 (“Dana Direct”), p. 29.

¹²⁴ CAW Exh. 9, Dana Direct, p. 29.

¹²⁵ CAW Exh. 40, *Rebuttal Testimony of Jeffrey M. Dana*, dated March 22, 2011 (“Dana Rebuttal”), p. 5.

¹²⁶ DRA Exh. 13, p. 4-1.

¹²⁷ DRA Exh. 13, p. 4-5.

[California American Water] to include the purchase price of \$408,000...in the rate base for the Toro Water System...”¹²⁸ Nothing in the settlement agreement, or the decision approving it, prohibits California American Water from seeking future recovery of other related costs. In addition, the settlement does not refer to “goodwill.”

Furthermore, the plain language of the settlement agreement makes clear that DRA and California American Water agreed only that California American Water would request and DRA would support recovery of \$408,000 in the 2008 general rate case. Nowhere does the settlement agreement cap recovery at that amount or preclude California American Water from seeking recovery of post-acquisition transaction costs. In addition the settlement agreement specifically provides that “no Party has relied or presently relies upon any statement, promise or representation by any other Party...except as specifically set forth” and further provides that “[the settlement agreement] constitutes the parties entire settlement...”¹²⁹ Accordingly, DRA cannot rely on inferences drawn from the settlement agreement in support of its argument that Toro goodwill was capped at \$105,403.

Finally, as stated by Mr. Dana, true ups and adjustments are common and appropriate so long as the cost overages are reasonable and prudent.¹³⁰ DRA has not even tried to argue that any of the additional \$155,000 of goodwill was not prudently or reasonably incurred. Therefore, the Commission should allow the full and true cost of the acquisition in rates.

7. Special Request #32 – Monterey Billing System Modification Costs

California American Water discusses this issue in Section II.A.4 above.

8. Special Request #34 –Amortize Balancing Accounts in Rates on an Annual Basis

Due to the magnitude of the deferred balances discussed above, in Special Request #34 California American Water requests permission to amortize the account balances

¹²⁸ D.07-11-034, 2007 Cal. PUC LEXIS 658, Attachment A, *Settlement Between the California-American Water Company and Division of Ratepayer Advocates*, *22, ¶ 2.2.

¹²⁹ D.07-11-034, 2007 Cal. PUC LEXIS 658, Attachment A, *Settlement Between the California-American Water Company and Division of Ratepayer Advocates*, **19-20, ¶¶ 1.9, 1.6.

¹³⁰ CAW Exh. 40, Dana Rebuttal, p. 5.

for all of its balancing accounts annually to minimize the effect on customers and shareholders. This approach is similar to that utilized by the natural gas utilities in California for more than a decade.¹³¹ Due to the size of its deferred balances, California American Water seeks comparable treatment, a treatment that reduces intergenerational inequities.

Mr. Linam addresses the annual true-up process in his direct testimony.¹³² For example, Pacific Gas and Electric (PG&E) has an “Annual Gas True-up of Balancing Accounts” process. The process updates rates to recover all gas transportation-related balancing and memorandum account balances for costs that the Commission has authorized to be recovered in rates on an annual basis. PG&E must file a Tier 2 advice letter 45 days before the end of each calendar year for rates effective January 1.¹³³ This annual amortization process is similar to those in place for Southern California Gas Company and San Diego Gas and Electric.¹³⁴ Following this model, California American Water proposes filing a Tier 2 advice letter on October 15th of each year to include the most recent recorded balancing account balances plus a forecast through December 31st. The company proposes working closely with the Commission’s Division of Water & Audits to establish criteria for forecasting costs and revenues associated with its balancing accounts.

An amortization of balancing accounts would benefit customers and the Company. It would reduce the number of rate changes by consolidating changes that result from large over or under-collected balances. Frequent rates changes confuse customers, particularly when the Company and the Commission are urging them to conserve. Annual amortization of balancing accounts would allow customers to better budget their annual water costs. Annual amortization is also in keeping with Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) Issue Paper 92-07 and Accounting Standards Codification (ASC) 980-

¹³¹ One difference for gas utilities in California is that commodity costs are amortized in rates on a monthly basis. California American Water requests that both its commodity and non-commodity costs be amortized on an annual basis. CAW Exh. 43, Linam Rebuttal, p. 11.

¹³² CAW Exh. 15, *Direct Testimony of Jeffrey T. Linam*, dated July 1, 2010 (“Linam Direct”), pp. 11-13.

¹³³ CAW Exh. 15, Linam Direct, p. 12., Attachment 3.

¹³⁴ CAW Exh. 15, Linam Direct, p. 12, Attachments 4 and 5.

065-25, which requires such mechanisms to collect revenue from customers within 24 months of the end of the period for which the revenue is recognized.¹³⁵

A timely, annual process to review and approve the recovery of balancing accounts would also further the Water Action Plan goal of streamlining regulation. Ultimately, annual recovery of balancing account amounts lower rates to customers by shortening the period that accounts accrue interest. There are also ratepayer equity considerations in avoiding delay in recovery of costs in rates for the customers of record.¹³⁶ The principle of intergenerational equity for customers favors timely recovery of balancing account amounts.

DRA has argued that the Commission cannot grant California American Water's Special Request #34 because of potential overlap with A.10-09-017, which addresses the recovery of WRAM/MCBA balances.¹³⁷ This argument has no merit. California American Water made the decision to join the four other Class A water utilities in filing an expedited application (A.10-09-017) out of an abundance of caution and because at the time of the filing it appeared likely that a Commission decision could be issued by the end of 2010.¹³⁸ It is important to note that there is no evidentiary record (based on written testimony, live testimony evidentiary hearings, or briefs) in that proceeding. Furthermore, on June 23, 2011, California American Water filed a motion to withdraw from that proceeding. As California American Water explained in detail in its motion, the expanded scope, the refusal to address the immediate need for relief as requested, and the timing of a decision in that proceeding rendered California American Water's involvement ineffective and in conflict with requests it previously made in its general rate case application.

This issue is critically important to California American Water due to the substantial deferred balances being funded by both long-term debt and equity. Although the

¹³⁵ CAW Exh. 15, Linam Direct, pp. 13-14, Attachment 6.

¹³⁶ CAW Exh. 15, Linam Direct, p. 13.

¹³⁷ DRA Exh. 5, pp. 129-131.

¹³⁸ Although the amortization period for recovery for balances in excess of 5% of revenues was not to exceed 18 months, the opportunity to obtain a timely decision and prevent possible write offs under GAAP, was deemed a reasonable outcome.

other large Class A water utilities have deferred balances earning commercial paper rates, it appears that none are as large as California American Water. As Mr. Linam explained in his rebuttal testimony, California American Water's regulatory assets as a percentage of total capitalization is 35% versus 16% for Golden State Water Company, 9% for California Water Company and 3% for San Jose Water Company.¹³⁹ These deferred balances are so large and contribute to California American Water's recent net operating losses that they need to be addressed in a timely fashion more quickly than the other Commission proceeding will allow. Moreover, DRA does not oppose the parties' proposal in that proceeding for an 18-month amortization period. DRA seems to recognize the need to address the timely recovery of these costs in rates. California American Water is willing to accept the position of parties and DRA to limit this Special Request to just the WRAM/MCBA accounts and to adopt an 18-month amortization period rather than the 12-month period originally requested.¹⁴⁰ However, California American Water respectfully requests that this issue be resolved in a timely fashion in *this* proceeding.

D. General Office

The report that Overland Consulting, Inc. ("Overland") prepared for DRA is titled "Regulatory Audit of California American Water Company's General Office Expense."¹⁴¹ This title, however, is misleading. In general, use of the word "audit" implies that the preparer used an unbiased, objective, independent approach to evaluate California American Water's general office request. This is certainly not the case with Overland, a Kansas-based consulting firm.

An important principle in ratemaking and accounting is consistency. Overland, however, has not been consistent from one recommended adjustment to another. For example, rather than stick to adjustments all based on actual data or all based on budget data, Overland's

¹³⁹ CAW Exh. 43, Linam Rebuttal, pp. 11-12.

¹⁴⁰ CAW Exh. 43, Linam Rebuttal, pp. 12-13.

¹⁴¹ See DRA Exh. 31C, *Overland Consulting Regulatory Audit of California American Water Company's General Office Expense*, dated May 24, 2011 ("DRA Exh. 31C").

recommendations instead generally selects the lower figure, whether actual or budgeted.¹⁴² Overland ignored, purposely omitted, or misconstrued crucial relevant information provided by California American Water. Overland's methods are inconsistent. These tactics led to adjustments that are out of line with current costs. Overland uses the base year 2010 to estimate Service Company expenses and escalates that amount to the test year 2012. But nowhere in Overland's report is a true comparison of total 2010 estimated Service Company expenses vs. 2010 actual Service Company expenses.

Pursuant to the Scoping Memo and Ruling in this case, the last date for a final update was October 11, 2010. The DRA Report was due January 24, 2011.¹⁴³ By mutual agreement, necessitated by delays in the state budget that hampered the timing of DRA's contract with Overland, the filing date for the Overland Report was moved to February 18, 2011. It was then further extended to March 14, 2011 pursuant to the Revised Scoping Memo issued March 4, 2011. The October 11, 2010 update deadline was *not* extended by these changes in the timing of the Overland Report.¹⁴⁴

In violation of the October 11, 2010 update cutoff deadline, Overland served data requests relating to California American Water and Service Company 2010 year-end operating results and 2011 budgets. Operating results are obviously not available until year-end and in the Company's case not until after audited financial statements are available late in the first quarter of the *next* year. Similarly, the 2011 operating budgets were not available until very late in 2010. "Both [of] these items are definitely not available until months after the [Rate Case] filing date of July 1, 2010 and months after the required utility update which is due 100 days after filing, in this case October 11, 2010."¹⁴⁵

The Rate Case Plan allows for specific updates on a proper motion and showing.

¹⁴² CAW Exh. 54, Dana Rebuttal, pp. 8-9.

¹⁴³ *Scoping Memo and Ruling of the Assigned Commissioner and assigned Administrative Law Judge*, issued on September 24, 2010.

¹⁴⁴ CAW Exh. 56, *Rebuttal Testimony of David P. Stephenson on General Office Issues*, dated April 25, 2011 ("Stephenson GO Rebuttal"), pp 6-7.

¹⁴⁵ CAW Exh. 56, Stephenson GO Rebuttal, p 5.

Those exceptions do not apply here. As Mr. Stephenson testified:

Almost all the data requested by Overland falls well outside the allowances made in the [Revised Rate Case Plan] decision [D.09-05-062]. Overland's audit cannot be hampered by the later production of data that is not even allowed to be included in the case. If data is not allowed to be included in a case, how can the delayed provision of such data as the result of an explicitly allowed [discovery] dispute process be a rationale for the [delay] claims espoused by Overland?¹⁴⁶

DRA and its consultants should be reminded to abide by the discovery and update rules and guidelines in the Rate Case Plan or the sound policy and procedural reasons for those rules will be subverted.¹⁴⁷ Overland's report relies heavily on 2010 year-end expenses and 2010-end-of-year headcount. The recently filed Joint Motion ... to Strike certain portions of Mr. Stephenson's Rate Design Rebuttal Testimony filed by DRA and others reflects an understanding of these rules but obviously intends that these rules apply only against the Company.¹⁴⁸ DRA must recognize those rules are a two-way street.

1. Adjustment #1 – Labor and Labor-Related Expense

a. Methodology

California American Water filed its request in this case for its test year 2012 general office labor and labor-related costs based on its 2010 budget. Notwithstanding vacancies, significant reorganization and other changes at the Service Company in 2010, actual labor and labor-related charges to California-American for full year 2010 *were within two percent of that budget figure*. DRA and Overland ignore this critical fact and instead rely on a one-day snapshot of the employee list at December 31, 2010 (a point in time well past the 100-day update period). The “snapshot” approach is misleading, provides no legitimate basis for forecasting labor and labor-related expenditures, and in fact should not even be considered since it is beyond the 100-day update period. The Commission should reject the DRA and Overland

¹⁴⁶ CAW Exh. 56, Stephenson GO Rebuttal, p 6.

¹⁴⁷ CAW Exh. 56, Stephenson GO Rebuttal, pp 7-9.

¹⁴⁸ See *Joint Motion of the Division of Ratepayer Advocates to Strike Portions of the Rebuttal Testimony of David P. Stephenson on the Rate Design Joint Proposal*, dated June 24, 2011, Section III, p. 7.

Adjustment #1 and adopt the Company's projected test year Service Company labor costs of \$127,711,286, of which \$16,883,638 is to be allocated to California American Water.

California American Water based its 2010 Service Company labor and labor-related estimate on the 2010 Service Company budget, which was prepared in early 2009 for use in part as an operational tool. While history is used as a basis to project certain business situations, budgets also identify expected future business conditions for that upcoming period and the costs to operate under those conditions for that time. The Service Company generally incorporates known and measurable conditions into the budget, but omits plans and or situations where the impact or timing is uncertain. The Service Company then uses the budgets to monitor how well the business is performing and to highlight when differences arise in business conditions. While the Service Company makes every attempt to develop budgets that reflect expected operations, the budget may differ from actual results for a variety of reasons.¹⁴⁹

Doneen Hobbs, Vice President of Shared Services for American Water Works Service Company, explained:

Management is diligent in developing budgets that reflect expected operations and attempt to operate to those plans, but it is a sign of good management when managers take advantage of implementing opportunities to reduce costs when they arise even if it will result in variances below their budgeted costs. Service Company management personnel continually try to identify these opportunities (even if they are not budgeted) that will reduce overall costs to the Company and ultimately to our customers.¹⁵⁰

As a check of the reasonableness of the proposed labor and labor related expenses in the Application, the Service Company compared the twelve-month actual labor and labor related charges to California American Water for a recent period. As noted above, the Service Company actual labor and labor-related charges to California American Water for full year 2010 were within two percent of the budget figure requested in this case. By contrast, the difference between the Service Company's actual experienced 2010 labor and labor related expense and

¹⁴⁹ CAW Exh. 55, *Rebuttal Testimony of Doneen Hobbs on General Office Issues*, dated April 25, 2011 - Without Confidential Attachment 3 ("Hobbs Public GO Rebuttal"), pp. 20-21.

¹⁵⁰ CAW Exh. 55, *Hobbs Public GO Rebuttal*, p. 21.

Overland's amount is more than \$11.7 million overall and \$1.1 million of charges to California American Water.¹⁵¹ This amounts to a proposed disallowance of 19% of the Service Company's 2010 actual costs.

Remarkably, Overland does not recommend an adjustment to California American Water's corporate office ("CalCorp") base period labor and related expenses "because CalCorp's 2010 *budgeted* and end-of-year *actual* employees are in close alignment, and an adjustment would therefore be immaterial."¹⁵² Yet Overland recommends a double-digit percentage reduction for the Service Company labor expense despite the fact that its 2010 actual costs come to 98% of the 2010 requested amount. Such inconsistency by Overland is startling.

In contrast to the Service Company's meticulous and detailed approach to develop its budget, Overland used a single day snapshot to justify a substantial disallowance. What is Overland's "analysis"? ***There is no analysis.*** Instead, Overland adopts a simplistic and distorting one-day snapshot – using the December 31, 2010 employee roster, which excluded, among others, both forty-six Service Company employees moved to the Business Transformation Project *and* their replacements as well as costs for twenty-two positions where the work is being performed by consultants. Based on this arbitrary one-day snapshot Overland recommends recovery of only 83% of the 2010 actual costs. Overland then uses that distorted figure to project its 2012 test year general office labor recommendation.¹⁵³

Overland's approach is easy, but it is wrong. Overland violates the basic tenets of statistical analysis that requires maximum data points. It also violates common sense and would be comparable, as Doneen Hobbs testified, "to setting expected revenues by taking one day's power usage to represent the need for all the days' power needs throughout a year without analyzing whether other circumstances should be considered."¹⁵⁴ It ignores a mountain of data supplied to Overland by California American Water, including the fundamental approach of the

¹⁵¹ CAW Exh. 55, Hobbs Public GO Rebuttal, pp. 3-5, 20.

¹⁵² DRA Exh. 31C, p. 2-3 (emphasis added); see also CAW Exh. 54, Dana GO Rebuttal, pp. 6-8.

¹⁵³ DRA Exh. 31C, p. 2-2.

¹⁵⁴ CAW Exh. 54, Dana GO Rebuttal, pp. 12-13.

Service Company and California American Water that fully budgets for each position and does not separately budget for overtime, temporary help or outsourcing to cover for vacant positions.¹⁵⁵

Overland's use of a December 31, 2010 employee list for its labor estimate ignores forty-six Service Company employees transferred to the Business Transformation Project in 2010 (mostly in December 2010) and, for payroll accounting reasons, all on or before December 27, 2010.¹⁵⁶ If, instead of December 31, Overland had picked December 26, or any earlier date, forty-six additional and actual Service Company employees would have been on that list. Service Company used December 27, 2010 for payroll accounting reasons.

Overland also failed to take into account that every business – and particularly a complex business organization such as the Service Company – always has some level of vacancies in its employee ranks. For example, employees go on leave, get sick or disabled, quit, die, are transferred. Seasonality and business reorganizations can also have significant impacts on vacancies at any given point in time.¹⁵⁷ A more appropriate way to look at the employment and vacancy rates is on all annualized average basis, not a point in time. As discussed above, California American Water and Service Company budget positions on an annual basis and do not budget for temporary help or outsourcing that are used in the event of a vacancy. Here, the Service Company's actual 2010 labor expense was within 2% of its proposed amount charged to California American. That totally belies Overland's projected 8-10% claimed vacancy rate factor that has no support in the record.¹⁵⁸

b. Positions

Overland improperly eliminated from the general office labor pool the replacements at the Service Company of sixty-eight positions transferred to other functions, including forty-six to the Business Transformation Project and ten income tax positions that were

¹⁵⁵ *E.g.*, RT 798:4-24 (Hobbs/CAW); CAW Exh. 55, Hobbs Public GO Rebuttal, pp. 11-13.

¹⁵⁶ CAW Exh. 54, Dana GO Rebuttal, p. 9; RT 783:16-784:10 (Hobbs/CAW).

¹⁵⁷ RT 795:3-12, 796:3-9 (Hobbs/CAW).

¹⁵⁸ *See* CAW Exh. 55, Hobbs Public GO Rebuttal, p. 6.

outsourced.¹⁵⁹ If adopted, the effect of this reformulation on California American Water would be devastating. The Business Transformation Project is a 2010-2014 add-on to the Service Company labor pool. The costs of those Business Transformation Project personnel will be capitalized rather than expensed. Their replacements at their old jobs at the Service Company will be expensed as before. Overland recommends total elimination of the Business Transformation Project expenses, including labor, from this rate case (discussed elsewhere in this brief) and makes zero accommodation for the need to refill their positions at the Service Company. The services that these transferred employees were providing are services that were provided and will continue to be provided. Similarly, the ten income tax positions that Service Company outsourced did not eliminate the cost; the cost was simply moved from internal payroll to the service provider – a real cost that was paid for but was not provided for in the budget or expense request in this case.¹⁶⁰ The same is true of eight IT positions that were outsourced and five Shared Service Center positions where contract or temporary employees were used.¹⁶¹

As a result of Overland ignoring these facts, sixty-eight employee positions disappear from Overland’s recommended labor costs for the Service Company. That despite the fact that virtually all of those sixty-eight positions in the Service Company have been or are being refilled to enable the Service Company to continue to perform as required.¹⁶² The result of Overland’s recommendation is an \$11.7 million difference in labor costs at the Service Company level (the Company proposed amount of \$127,711,286 vs. \$116,169,911 recommended by Overland) and a \$1,106,190 difference at the California American Water level.¹⁶³ Yet the adjustments to Overland’s proposal offered by the Company result in a figure of \$127,711,286, which compares favorably to the 2010 actual Service Company labor costs of \$127,905,371, a minor difference of \$194,085 in Company proposed costs vs. actual costs.¹⁶⁴

¹⁵⁹ CAW Exh. 55, Hobbs Public GO Rebuttal, p. 18.

¹⁶⁰ CAW Exh. 55, Hobbs Public GO Rebuttal, pp. 15-16.

¹⁶¹ CAW Exh. 55, Hobbs Public GO Rebuttal, pp. 16-19.

¹⁶² See RT 791:16-28, 792:19-26, 793:13-16 (Hobbs/CAW).

¹⁶³ CAW Exh. 55, Hobbs Public GO Rebuttal, pp. 4-5.

¹⁶⁴ CAW Exh. 55, Hobbs Public GO Rebuttal, p. 20.

In fact, due to the Business Transformation Project, forty-six Service Company employees shifted to that four-plus year project have been and are being replaced – their old jobs still have to be done. The Service Company has not “lost” forty-six employees – it has transferred them to the Business Transformation Project as capitalized expense and must replace them in the Service Company in order to keep all of the usual Service Company functions going. The Service Company is replacing those transferred employees with new hires, by temporary outsourcing and by using temporary help. California is *not* requesting recovery of the costs of that outsourcing and temporary help in this case. California American Water is requesting the cost of the budgeted positions that must be replaced with these new replacement personnel, whether permanent or temporary.¹⁶⁵

In her rebuttal testimony, Ms. Hobbs describes this situation in great detail. She summarizes as follows:

Overland’s approach assumes that the [68] vacant positions at December 31, 2010 were vacant for the entire year. In fact, at least 49 of the 68 vacancies [at the December 31, 2010 Overland “snapshot” date] existed for only a few weeks in December. Overland also fails to account for situations where the Service Company reduced staff but replaced them with consultants or contract labor, which accounts for another 18 employees that Overland did not factor into the calculations under the one-day snapshot approach.¹⁶⁶

Ms. Hobbs further explained the sixty-eight employees “eliminated” by Overland have not, in fact, been eliminated:

There are actually 4 components that make up the 68 employees [eliminated in the Overland recommendation]. The first one is a transfer of employees to the Business Transformation Project (BT). Overland ignored information by the Company that at least forty-six of the positions, which they had identified as vacant at December 31, 2010, were not permanent vacancies. As of now [April 25, 2011], twenty-four of the vacant positions due to the employee transfers to the Business Transformation project have been replaced with consultant or contract labor and thirteen... have been replaced with full time employees. Second, services provided

¹⁶⁵ RT 791:22-28, 793:13-16 (Hobbs/CAW).

¹⁶⁶ CAW Exh. 55, Hobbs Public GO Rebuttal, pp. 4; 7 (emphasis added); see also RT 791:16-28, 792:19-26, 793:13-16 (Hobbs/CAW).

by employees, in ten positions vacant at December 31, 2010 in the Corporate Finance Income Tax function are being provided by an outside service provider. Third, services provided by eight positions vacant at December 31, 2010 in the Information Technology Service (ITS) function are being provided by an outside service provider. These three actions make up 64 of the 68 employees [eliminated by Overland].¹⁶⁷

Of the Service Company employees transferred to the Business Transformation Project in late 2010, forty-nine were on the Service Company payroll most of that year but not on Overland's self-serving December 31, 2010 "snapshot" date. The Service Company either already has filled or intends to fill forty-six of those positions that were transferred to the Business Transformation Project as the services they were performing must continue to be performed, whether by permanent hires, by temporary help, or by outsourcing.¹⁶⁸ Overland was made aware of all of these facts.¹⁶⁹

Any employee of California American Water or any Service Company employee who has been transferred to and is billing time to the Business Transformation Project will record their time to the Business Transformation Project capital account. That employee's time will not be charged as an expense to the Service Company or to the California American Water (or other operating utility) payroll. Instead, only the costs for the positions to be filled by replacement employees or consultants hired by the Service Company to provide the needed services will be billed to the appropriate operating units. There is in short, no double billing.¹⁷⁰

The employees transferred to the Business Transformation Project remain Service Company employees but their expenses, like all of the Business Transformation Project-related costs, are being capitalized. That does not eliminate the Service Company's need to incur the expense to replace all but one of those employees to perform the same functions that had been performed by the employees who were transferred to the Business Transformation Project and

¹⁶⁷ CAW Exh. 55, Hobbs Public GO Rebuttal, pp. 11-12 (emphasis added); *see also* RT 780:18-22, 791:4-784:10 (Hobbs/CAW).

¹⁶⁸ CAW Exh. 55, Hobbs Public GO Rebuttal, p. 14.

¹⁶⁹ *Id.*

¹⁷⁰ CAW Exh. 56, Stephenson GO Rebuttal, pp. 90-91.

whose costs are being capitalized.¹⁷¹

Additionally, the December 31, 2010 “snapshot” headcount was further reduced by a group of ten employees whose Corporate Income Tax function were outsourced due to a need for a higher level of expertise. Again, the function continued and the positions are in the Service Company budget, there is no separately amount budgeted or sought here for those contract services, and Overland’s “analysis” does not anywhere account for them.¹⁷²

Similarly in 2010 eight positions were outsourced in the Service Company’s IT function and the outsourcing costs are not budgeted for by the Service Company other than as regular employees nor are they taken into account by Overland in any fashion (either in headcount or as an outsource expense).¹⁷³

Overland’s Adjustment #1 recommends elimination of sixty-eight positions. If adopted, it will result in an \$8,659,910 shortfall in Service Company labor expense or a 14% reduction from California American Water’s request.¹⁷⁴ Ms. Hobbs, in her rebuttal testimony, explained those adjustments and summarized them in a chart in her rebuttal testimony.

c. Salary

Overland based part of its Adjustment #1 on assumed labor expenses for at least sixty-three newly hired Service Company employees. Overland assigned the lowest possible salary from a given range or similar position instead of using an average or actual salary for numerous employees.¹⁷⁵ Overland failed to disclose or explain this in its report, and did not provide this information in its workpapers. Indeed, California American Water had to specifically request the documentation from Overland after DRA served all of its workpapers in order to track down these misleading assumptions.¹⁷⁶ There were several instances where Overland’s salary assumptions led to inaccurate results. Although some resulted in

¹⁷¹ CAW Exh. 55, Hobbs Public GO Rebuttal, p. 15; CAW Exh. 56, Stephenson GO Rebuttal, pp. 91-92.

¹⁷² CAW Exh. 55, Hobbs Public GO Rebuttal, pp. 15-17.

¹⁷³ CAW Exh. 55, Hobbs Public GO Rebuttal, pp. 16-17.

¹⁷⁴ CAW Exh. 55, Hobbs Public GO Rebuttal, pp. 18-19.

¹⁷⁵ CAW Exh. 55, Hobbs Public GO Rebuttal, p. 16; CAW Exh. 54, Dana GO Rebuttal Exhibit, p. 9, Attachment 2.

¹⁷⁶ CAW Exh. 54, Dana GO Rebuttal, p. 9, Attachment 2.

overstatements and some resulted in understatements, in total, Overland's salary assumptions produce an unwarranted downward bias.¹⁷⁷

For example, for newly hired Call Center employees, Overland used the average salary of similar job titles to calculate costs, despite using the lowest possible salary in the range for the employees described above – yet another example of Overland's rampant inconsistency. This involved 351 employees, resulting in Overland overstating projected labor and labor related costs by approximately \$95,251. In situations where a business unit added a new position that was not in the Work Force Planning Model, but was in actual headcount at December 31, 2010, Overland used a similar job title from another business unit and assumed the same salary for the individuals. Overland did this for three different employees, which resulted in a \$30,076 overstatement of projected labor and labor-related costs. When the employee in a particular position changed since the budget was prepared, Overland used the lowest costs for the position within that business unit. Overland used this method for sixty-three positions, resulting in a \$329,059 understatement projected labor and labor related costs by approximately. Overland also used the incorrect position and costs for thirty-nine other employees, resulting in Overland understating projected labor and labor related costs by approximately \$1,403,078. Finally, Overland made errors regarding the salary for twenty-nine additional employees. Unlike the previous employees, Overland had the correct job title, but still changed the salary to the lowest possible salary for that position. This resulted in Overland understating projected labor and labor related costs by approximately \$132,822.¹⁷⁸ The net result of these Overland's errors is that Overland improperly recommends a \$2,881,465 reduction in Service Company labor and labor-related costs. These errors also, obviously, reflect rather poorly on Overland's methodology, biases and, ultimately, its recommendations.

d. Summary

The Commission should reject Overland's proposed Adjustment #1. This

¹⁷⁷ CAW Exh. 55, Hobbs Public GO Rebuttal, pp. 9-11.

¹⁷⁸ CAW Exh. 55, Hobbs Public GO Rebuttal, pp. 9-11.

Commission should not sanction either the totally inappropriate one day “snapshot” short cut proposed by Overland nor its biased errors and flawed techniques to justify a huge, unwarranted and potentially disastrous reduction in the Service Company’s and California American Water’s general office labor costs. The Commission should also reject Overland’s reliance on data from well beyond the Rate Case Plan’s 100-day update period. A single day snapshot of a highly complex organization’s employee list is simply inappropriate. That inappropriate and inept approach combined with Overland’s other mistakes severely distorts reality and violates both common sense and an extensive record to the contrary. California American Water has fully demonstrated how the Service Company’s 2010 requested and actual labor costs were in fact so closely aligned. After correcting Overland’s analysis for the items mentioned above, California American Water has proposed a downward adjustment of \$140,910 for Service Company labor expense instead of Overland’s \$1,300,929 adjustment in the 2012 test year.¹⁷⁹

Allowance of those requests would restore \$11,541,375 of Overland’s proposed Adjustment #1 reductions.¹⁸⁰ The result would be to allow Service Company labor costs of \$127,711,286, of which \$6,883,653 would be allocated to California American Water.¹⁸¹ That \$127,711,286 compares remarkably favorably to the Service Company’s *actual* 2010 labor costs of \$127,905,371, which contrasts starkly with Overland’s proposed \$116,169,911 – a net difference of \$11.7 million to the Service Company and \$1,106,190 to California American Water.¹⁸²

2. Adjustment #2 – Pension Expense

In this general rate case, California American Water simply requested that the Commission continue its practice of calculating the revenue requirement for pension expense based on actuarial projections of FAS 87 expense for Service Company and actuarial projections of ERISA contributions for California American Water. Specifically, California American

¹⁷⁹ CAW Exh. 54-E, Dana GO Rebuttal, pp. 12-27.

¹⁸⁰ CAW Exh. 55, Hobbs Public GO Rebuttal, p. 19.

¹⁸¹ CAW Exh. 55, Hobbs Public GO Rebuttal, pp. 4-5.

¹⁸² CAW Exh. 55, Hobbs Public GO Rebuttal, pp. 8-9, 20.

Water requests the Commission: (1) base the pension expense for the Service Company on FAS 87 actuarial forecasts as provided by Towers/Watson for test year 2012, (2) base the pension expense for California American Water on ERISA actuarial forecasts as provided by Towers/Watson for test year 2012, and (3) authorize the Company to continue track in the previously authorized pension balancing account (D.10-06-038) the difference between the ERISA expense authorized in this case for the test year and the actual amount incurred (net of capitalized amounts). Furthermore, California American Water requests that the forecasts for the Service Company and California American Water be escalated in accordance with the guidelines established in D.04-06-018.¹⁸³

The allegations and arguments of DRA and Overland regarding pension expense are flawed. The key incorrect assumption that underlies their claims is that California American Water's record pension expense under Accounting Standards Codification (ASC) 715-30 (formerly FAS 87). As Mr. Stephenson explains, "this is clearly incorrect as California American Water has never recorded pension expense for ratemaking purposes under FAS 87 and as recently as in July 2010 has been ordered by the Commission to continue to track costs under ERISA."¹⁸⁴ The determination of pension expense related to Service Company and California American Water is all based on the same pension plan, but the ratemaking treatment is different between the two. Furthermore, contrary to the assertions of DRA and Overland, California American Water's request in this case is not 95% higher than actual expenses incurred in 2010. Besides all the tables and assertions of differences between comparative cost increases for Service Company and California American Water, Overland has also misstated the actual costs as recorded by California American Water for 2010.

For Service Company pension expense, it has been recorded and expensed in accordance with FAS 87 for many years and as noted in this case, Overland has agreed with this

¹⁸³ CAW Exh. 56, Stephenson GO Rebuttal, pp. 43-44.

¹⁸⁴ CAW Exh. 56, Stephenson GO Rebuttal, p. 42.

methodology.¹⁸⁵ For California American Water, in D.10-06-038, the Commission stated, “Cal Am’s recovery for ratemaking purposes is capped at the minimum level of Benefit Plan expense calculated according to the Employee Retirement Income Security Act (ERISA) minimum funding levels.”¹⁸⁶ Additionally in D.10-06-038, the Commission adopted a balancing account for pension costs of California American Water.¹⁸⁷

Regarding Overland’s assertion of costs that are 95% higher, it does not reflect the balancing account the Commission authorized in 2010. Mr. Stephenson explained:

California American Water was authorized a pension expense balancing account in 2010. The amounts that get recorded as expense on the books and record of California American Water are those that are authorized in the rate case decision. The actual amounts were substantially higher and in accordance with balancing account procedures are not recorded as an expense, but are recorded to a deferred asset account for later recovery. The amount recorded to the memorandum/balancing accounts in 2010 was \$1,982,248. This amount, when added to the reported actual expense amount by Overland of \$1,690,971 for the California districts and \$292,499 for Cal Corp, produces a total expense amount for 2010 of \$3,965,718. This makes the comparisons on Overland’s Table 6-67 more meaningful and then clearly shows that the 2010 actual amount is in line with the 2010 base period request and the forecasts for 2011 and 2012.¹⁸⁸

Since DRA and Overland’s recommendations do not reflect that actual practice of the Commission and the Company, they should be disregarded and the Commission should adopt California American Water’s pension estimates.

3. Adjustment #11 – Group Insurance

The Commission should approve California American Water’s updated request for group insurance expense, as described in the General Office Rebuttal Testimony of Jeffrey

¹⁸⁵ DRA Exh. 31C, p. 6-1.

¹⁸⁶ D.10-06-038, *Application of California-American Water Company (U210W) for Authorization to Increase its Revenues for Water Service in its Larkfield District by \$ 648,100 or 23.38% in the year 2010; and by \$ 140,200 or 4.07% in the year 2011 and to Increase its Revenues for Water Service in its Los Angeles District by \$ 7,886,200 or 41.29% in the year 2010; and \$ 1,100,000 or 4.09% in the year 2011 and to Increase its Revenues for Water Service in its Sacramento District by \$ 17,537,800 or 51.29% in the year 2010; and \$ 5,339,800 or 10.25% in the year 2011, and Related Matters*, 2010 Cal. PUC LEXIS 224 (“D.10-06-038, 2010 Cal. PUC LEXIS 224”), **17-18.

¹⁸⁷ D.10-06-038, 2010 Cal. PUC LEXIS 224, **17-19.

¹⁸⁸ CAW Exh. 56, Stephenson GO Rebuttal, p. 43.

Dana.¹⁸⁹ The increase in group insurance expense, which includes a 20.3% increase to get from 2010 rates to 2011 actual rates currently in pace, plus an 8% escalation factor to get from 2011 rates actually in place to the 2012 test year rates, is necessary in order cover current and forecast increases in program costs, which are consistent with industry trends. This request replaces California American Water's original request regarding group insurance expense, which included a 30% increase over 2010 rates. While California American Water based its original request on the information that was available at the time that it filed the application, it amended its request in response to changing circumstances and forecasts,¹⁹⁰ as allowed under the Commission's rate case plan.¹⁹¹ The Commission should reject Overland's recommended adjustments, which would reduce authorized group insurance expense by more than \$1 million dollars annually for 2011-2013.¹⁹²

Group insurance expense is a general office expense that includes California American Water's contributions to employee life insurance, medical, dental, prescription drug, vision, accidental death and dismemberment insurance, long-term disability insurance, and short-term managed disability insurance.¹⁹³ Despite facing increasing health care costs, California American Water had not increased the expenses paid for group insurance costs per employee between 2007 and 2011.¹⁹⁴ California American Water management kept costs down by, among other things, conducting an employee dependent audit in 2007 and ensuring that the plan administrator has a robust claims review process to prevent payment of any non-covered claims.¹⁹⁵ California further reduced costs in 2010 by decreasing the number of plan options available to employees; increasing employee co-pays; increasing the cap on annual out-of-pocket expenses per employee; and increasing employee payroll contributions to the voluntary

¹⁸⁹ CAW Exh. 54, Hobbs GO Rebuttal, pp. 17-18.

¹⁹⁰ CAW Exh. 54, Hobbs GO Rebuttal, p. 18.

¹⁹¹ D.07-05-062, *Order Instituting Rulemaking to Consider Revisions to the General Rate Case Plan For Class A Water Companies*, 2007 Cal. PUC LEXIS 226 ("D.07-05-062, 2007 Cal. PUC LEXIS 226"), **62-63.

¹⁹² CAW Exh. 54, Dana GO Rebuttal, p. 18.

¹⁹³ CAW Exh. 9, Dana Direct, p. 27.

¹⁹⁴ See CAW Exh. 9, Dana Direct, p. 25; See also CAW Exh. 54, Dana GO Rebuttal, p. 17.

¹⁹⁵ CAW Exh. 9, Dana Direct, p. 26.

employees' beneficiary association (VEBA) trust.¹⁹⁶ As Mr. Dana explained during hearings:

[The updated request] wasn't as high as the [original estimated expense increase] of 30% for the four year period. It was only 20 percent, which as I mentioned earlier, that's an annual rate of 5 percent increase, which was lower than the trend. It reflects that the company has been doing a lot of things to keep the group insurance low.¹⁹⁷

Despite these efforts, California American Water is paying 20.3% more per month in 2011 than it was in 2010.¹⁹⁸ These increases are due, in part, to increased contributions to the VEBA trust balance consistent with current health care costs, a new legislative requirement for mental health parity, health care reform related costs, and the addition of same-sex dependent coverage.¹⁹⁹ In addition, Hewitt Associates forecasts an increase of 8.2% for medical/prescription costs and of 6% for dental/vision costs in 2012, which when combined equates to a weighted average trend of 8.0% per year.

Overland recommends that the Commission limit increases in group insurance expense to normal composite inflation as provided in D.04-06-018 and reject the Hewitt industry trend escalation estimates offered by California American Water.²⁰⁰ Overland argues that to the degree that California American Water's instant request is needed to "replenish" the VEBA trust balance for expenses recorded in 2009 and 2010 it is improperly shifting such costs to ratepayers in future years.²⁰¹ Overland further argues that the 2010 base period used by California American Water includes insurance expense for "budgeted" employees who were not on California American Water's payroll in 2010.²⁰²

Overland's recommendation that the Commission adjust California American Water's group insurance expense estimates by applying the escalation rates and weighting methods published in DRA/Water Division letters pursuant to D.04-06-018, instead of Hewitt's

¹⁹⁶ CAW Exh. 54, Dana GO Rebuttal, p. 16.

¹⁹⁷ RT 767:28-768:7 (Dana/CAW)

¹⁹⁸ CAW Exh. 54, Dana GO Rebuttal, p. 16.

¹⁹⁹ CAW Exh. 9, Dana Direct, p. 26.

²⁰⁰ DRA Exh. 31C, p. 7-3.

²⁰¹ DRA Exh. 31C, p. 7-4.

²⁰² DRA Exh. 31C, p. 7-2.

forecasted industry cost trend rates used by California American Water, is unreasonable and inconsistent with Commission precedent, including D.04-06-018. Overland asserts that the “problem with CalAm’s procedure is that it raises the effective composite inflation rate...above the approved inflation rate contained in DRA/Water Division escalation letters.”²⁰³ Nothing in D.04-06-018, however, restricts utilities from proposing alternative escalation factors for general office expenses before 2013. In fact, D.04-06-018, the same case relied on by Overland, explicitly states that pre-2013 “[f]or district and general office expenses, excluding water production related expenses, the utilities and ORA may forecast using traditional estimating methodologies (historical averages, trends, and specific test year estimates).”²⁰⁴ The Commission later reaffirmed this policy statement in D.07-05-062.²⁰⁵ As Mr. Stephenson explained:

[i]t is clear that the estimates of test year expense are not driven by the [DRA/Water Division] escalation memos. California American Water is free to use any method available to forecast its Test Year (2012). For 2013 and beyond, D.04-06-018 does set a formulaic methodology to estimate cost in the escalation year (2013) and the attrition year (2014). California American Water has used those formulas to estimate the revenue requirement in this case.²⁰⁶

If Overland’s proposed escalation rate was correct and utilities were bound by the approximately 3% annual composite escalation rate dictated by the DRA escalation memos to forecast the test year, when medical costs are increasing by 8% annually, all California utilities would be under recovering group insurance costs significantly. Accordingly, Overland’s proposed escalation rate for 2012, which it based on the consumer price index and bears no relation to actual increased group insurance costs, should be rejected.

Overland’s assertion that the Company’s group insurance expense is inflated due

²⁰³ DRA Exh. 31C, p. 7-7.

²⁰⁴ D.04-06-018, *Parties Of Record In Rulemaking 03-09-005; Order Instituting Rulemaking on the Commission's Own Motion to Evaluate Existing Practices and Policies for Processing General Rate Cases and to Revise the General Rate Case Plan for Class A Water Companies*, 2004 Cal. PUC LEXIS 276, *58.

²⁰⁵ D.07-05-062, 2007 Cal. PUC LEXIS 226, Appendix A, fn 11, *98.

²⁰⁶ CAW Exh. 56, Stephenson GO Rebuttal, pp. 35-36.

to the inclusion of coverage of “budgeted” employees who were not on California American’s payroll in 2010 is based on a one-day snapshot of the Service Company’s payroll.²⁰⁷ As discussed above, Overland’s methodology and conclusions with regards to the numbers of vacant positions at California American Water are unreasonable and based on faulty assumptions. Furthermore, this reduction is already included in the reduction in the revenue requirement in Adjustment #1, discussed above.

The Commission should be sure, however, to take into account new positions at CalCorp. At the CalCorp level, DRA and Overland did not recommend any staffing reductions.²⁰⁸ Since Overland based its recommendation on 2010, however, it does not provide group insurance for the new CalCorp positions and new meter reader positions that Overland and DRA agreed to. Overland’s recommended group insurance adjustment provides no recovery for these positions.

Overland’s assertion that California American Water’s request is needed to “replenish” the VEBA trust is incorrect and contrary to the record. California American Water never stated that it had overdrawn the VEBA trust or that it was seeking future recovery to meet expenses incurred in past years. To the contrary, Mr. Dana stated, “a large increase is needed to bring the trust contributions up to an amount consistent with *current* health care costs.”²⁰⁹ Mr. Dana further explained that “[i]n order to bring the trust balance back down to a level consistent with the reserves required for incurred but not reported/paid claims, no increase in contributions to the trust was necessary through 2010. However, the extra reserves in the trust are projected to be depleted by year end 2010 as *current* health care costs have grown to an amount higher than what is *currently* being contributed to that trust.”²¹⁰ In April 2011, Mr. Dana reported that the VEBA trust balance had not been exhausted but that “it may have if 2011 group insurance rates

²⁰⁷ See CAW Exh. 55, Hobbs GO Rebuttal.

²⁰⁸ DRA Exh. 31C, p. 5-11.

²⁰⁹ CAW Exh. 9, Dana Direct, p. 26 (emphasis added).

²¹⁰ CAW Exh. 9, Dana Direct, p. 26 (emphasis added).

were not increased to match 2011 expected costs as was done proactively by the Company.”²¹¹

California American Water’s stated need to maintain a group insurance trust balance that is sufficient to fund current and future claims would not shift recovery for past expenditures to future years. To the contrary, while the VEBA trust balance has been sufficient in the past, the rapid rate of depletion of the excess trust balance described by Mr. Dana and the need for California American Water to increase 2011 rates by 20.3% over 2010 is overwhelming evidence that currently authorized group insurance expense is insufficient.

As discussed above, California American Water has already decreased the number of plan options available to employees; increased employee co-pays; increased the cap on annual out-of-pocket expenses per employee; and significantly increased employee payroll contributions to the VEBA trust. Mr. Stephenson testified that his own contributions toward medical coverage have risen from \$140 per month in 2010 to \$245 a month in 2011 and that co-pays have increase from \$15 per visit to 20% of the cost for each visit.²¹²

California American Water has established that it is facing actual current increases to group insurance expense costs and expects to face the medical cost trend in 2012 and 2013. Any reduction or adjustment to the updated filed request will likely harm the Company by depriving it of a reasonable rate of return, harm California American Water’s employees by burdening them with further cost increases, and harm ratepayers by driving employees to competitors with better health care and compensation packages.

In summary, California American Water’s approach to estimating group insurance in the 2012 test year, which the Commission should adopt, is to take the actual amounts, implemented on October 1, 2010, being paid by the Company on a per employee basis and escalate those amounts by 8.0% to get to the 2012 test year and then multiply the 2012 expected expense per employee by total headcount agreed upon in settlement of 291 employees. For the Service Company, California American Water used the same approach as Overland, except we

²¹¹ CAW Exh. 54, Dana GO Rebuttal, p. 17.

²¹² CAW Exh. 56, Stephenson GO Rebuttal, p. 31.

substituted the actual increase of 20.3% implemented for 2011 and the Hewitt and Associates trend of 8.0% for 2012 to estimate group insurance expense. As a result of the above methods and additional cost cutting measures the Company implemented, California American Water is agreeable to a \$377,841 adjustment in the 2012 test year to reduce our original group insurance request, as explained in the rebuttal testimony of Mr. Dana.²¹³

4. Business Transformation

The Business Transformation project is aptly named. Its purpose is to transform, automate, update and modernize all aspects of the information technology platforms and business processes used by the Service Company and the American Water operating companies, including California American Water.²¹⁴ As described below, there is no dispute as to either the need for or the merits of the Business Transformation Project. Nonetheless, DRA and Overland recommend that customers not be required to fund investments in Business Transformation Project systems “prior to their implementation.” This is so, says Overland, “Due to a lack of demonstrated customer benefits.”²¹⁵ TURN, while recognizing the merits of the project, joins in that recommendation for the same reason.²¹⁶

California American Water strongly disagrees with DRA and Overland’s disallowance recommendation and the analysis supporting it. California American Water proposes that: 1) all of the Business Transformation Project expenditures be included in ratebase, 2) that Applicant be allowed to earn a return on and of the project costs included in the application as a result of including all such estimated costs in rate base, 3) that Applicant track the difference between the revenue requirement provided in the application and the actual revenue requirement of and on the project in a memorandum account, 4) that Applicant also

²¹³ CAW Exh. 54, Dana GO Rebuttal, pp. 17-18.

²¹⁴ E.g. CAW Exh. 27, *Direct Testimony of David P. Stephenson*, dated July 1, 2010 (“Stephenson Direct”), pp. 54, 118-120, Attachment 6; CAW Exh. 58, *Rebuttal Testimony of Andrew Twadelle on General Office Issues*, dated April 25, 2011 (“Twadelle GO Rebuttal”), pp. 2-4.

²¹⁵ DRA Exh. 31C, p. 2-27.

²¹⁶ TURN Exh. 2, *Direct Testimony of Donna Ramas On Behalf of The Utility Reform Network*, dated February 4, 2011 (“Ramas Direct”), pp. 22-26.

track in the memorandum account all cost savings that result directly from the project and 5) that all costs in the memorandum account will be subjected to future review in a tier 3 advice letter.²¹⁷ Under the Commission’s Water Industry Rules, the deferred charges and credits recorded in a Memorandum Account “may be recovered in rates only after a request by the Utility, a showing of reasonableness, and approval by the Commission.”²¹⁸ Tier 3 advice letters require approval by the Commission, not just by staff; they “generally will be disposed of by Commission resolution pursuant to General Rule 7.6.2.”²¹⁹

a. Merits of the Project

There is no dispute among the parties that the Business Transformation Project is necessary. Overland concedes it.²²⁰ DRA witness Steingass makes a general statement in her Supplemental Testimony that the “BT project is inadequately justified”²²¹ but gives the Commission absolutely no factual support, explanation or justification for that single, unsupported statement and it appears to directly contradict both the DRA/Overland testimony and the TURN testimony.²²² DRA’s seemingly offhand statement is not supported by any explanation or record evidence and, indeed, the Steingass testimony is really focused not on the merits of the Business Transformation Project but on the accounting for its costs (expense vs. capitalize).²²³ In its lengthy discussion of the Business Transformation Project²²⁴ Overland assumed that the Business Transformation Project is necessary and there is not a single word suggesting otherwise. The Overland criticisms, findings and recommendations all go to other issues primarily focused on “the absence of any quantification of customer benefits” and

²¹⁷ See, e.g. CAW Exh. 56, Stephenson GO Rebuttal, p 92.

²¹⁸ General Order 96-B, Sec. 1.8.

²¹⁹ General Order 96-B, Sec. 7.3.3.

²²⁰ “Due to a lack of demonstrated customer benefits, the DRA has recommended customer (sic) not be required to fund investments in BT systems prior to their implementation.” Emphasis added. DRA Exh. 31C, p. 2-7.

²²¹ DRA Exh. 16, *DRA Supplemental Testimony Incorporating Findings of the Overland Consulting Audit for the DRA Review of Results of Operations of California American Water Company Statewide All-District General Rate Case*, dated March 15, 2011 (“DRA Exh. 16”), p. 8.

²²² TURN Exh. 2, Ramas Direct, pp. 25-26.

²²³ DRA Exh. 16, pp. 8-10.

²²⁴ DRA Exh. 31C, Chapters 1 and 4.

accounting issues.²²⁵ In fact, Overland breathes not a single word disputing the merits of the Business Transformation Project.

b. Ratemaking Treatment

The Business Transformation Project is appropriately treated as a major capital project. Capitalizing rather than expensing these costs is the proper regulatory approach fully supported by Commission precedent. Further, including the project costs in ratebase rather than expensing them provides a major benefit to the ratepayers by spreading and leveling out the rate impact and better matches cost recovery to the customers who will benefit from the Project. DRA and Overland would eliminate the entire Business Transformation Project expenditure from the California American Water revenue requirement in this general rate case cycle notwithstanding the admitted merits and prudence of the Project. While DRA, Overland and TURN argue for various reasons addressed below that capitalizing such costs is not proper, they also see the obvious handwriting on the wall and hedge their recommendations with vaguely supported alternatives in the event that the Commission rejects the DRA and Overland zero allowance recommendation.²²⁶

The Commission should reject all such recommendations. The Company's proposal is that the entire Business Transformation Project is a major capital project and thus all of the Business Transformation Project costs captured in the proposed memorandum account should be treated as construction work in progress beginning in 2012 for ratemaking purposes, until each phase of the three-year project become used and useful. Once used and useful, the proportionate share of costs for such phases (offset by any calculable pecuniary benefits) would, following authorization pursuant to a Tier 3 advise letter filing, then become plant-in-service and depreciated as appropriate.²²⁷

²²⁵ *E.g.*, DRA Exh. 31C, pp. 4-2 – 4-3.

²²⁶ DRA Exh. 16, p. 10, mid-page; compare DRA Exh. 31C, pp. 4-3 and 4-4 [“should the Commission approve rate recovery of forecasted BT expenditure (i.e., choose not to adopt DRA’s recommendation), we recommend [various adjustments]...”].

²²⁷ CAW Exh. 56, Stephenson GO Rebuttal, p. 77.

It is important to note that, as Mr. Twadelle testified,²²⁸ substantial costs for the early stages of the Business Transformation Project have already been and are continuing to be incurred. A return on those costs incurred prior to authorization of the requested memorandum account will never be recovered by California American Water. Accordingly, even under California American Water's proposal there will be a substantial under-recovery of the actual Project costs. Additionally, the Project costs captured in the proposed memorandum account will be offset by any realized savings. In sum, these facts assure there will be no over-recovery of the authorized revenue requirement.

Capitalizing each component of these Business Transformation Project expenses is the correct treatment for both accounting and sound regulatory reasons:

1. Sound regulatory policy compels California American Water's proposed treatment of these costs. These are very significant costs. "Given the sheer magnitude of the costs it would be problematic to expense them" as it would require a much larger revenue requirement over a relatively short period. "By using the rate base treatment we propose, those costs can be spread over the useful life of the project and be recovered on a levelized basis to avoid rate shock."²²⁹ Overland's own Table 4-2 at page 4-5 in its Exhibit 31C vividly demonstrates Mr. Stephenson's point that the ratepayer impact will be spread out by capitalizing these expenses.²³⁰

2. DRA's reliance in AICPA Statement of Position 98-1²³¹ is misplaced. As Mr. Stephenson demonstrates, even SOP 98-1 specifically allows capitalization of many of these Business Transformation Project costs, including: a. "External direct costs of materials and services consumed in developing or obtaining internal-use computer software;" b. Payroll and related costs incurred for employees "directly associated with ... the internal-use software

²²⁸ CAW Exh. 58, Twadelle GO Rebuttal, pp. 9-10, 11-12. *See also* CAW Exh. 56, Stephenson GO Rebuttal, p. 80, Attachments 4 and 5, spreadsheets showing Business Transformation Project costs from 2009 forward.

²²⁹ CAW Exh. 56, Stephenson GO Rebuttal, pp. 82-83.

²³⁰ Compare Table 4-2 in DRA Exh. 31C the "BT Plant Additions" line with the California American Water Requested (last) line. *See also* CAW Exh. 56, Stephenson GO Rebuttal, p. 86 and Attachment 7.

²³¹ DRA Exh. 16, pp. 8-10.

project”; and, c. associated interest costs.²³²

3. Under the Commission’s Uniform System of Accounts, California American Water should record these costs in Account 101.²³³

4. In any event, SFAS-71 overrides SOP 98-1 and allows the regulated utility to follow the orders of its regulator.²³⁴

5. Finally, as discussed in the next section, Commission precedent directly supports capitalizing applications software development and conversion costs, training costs and hardware maintenance costs.

c. Commission Precedent

The Company’s proposed treatment of the entire cost of Business Transformation Project as a capital project is consistent with sound public policy expressed in controlling Commission precedent. For example, in a Southern California Edison Company case, D.04-07-022, the Commission expressly approved Edison’s policy of capitalizing application software development costs in excess of \$1 million (reduced to a threshold of \$100,000 by settlement).²³⁵ In a Southern California Gas Company case, D.97-07-054, the Commission adopted an agreement to capitalize software conversation costs and rejected the Company’s request to expense computer training and hardware maintenance costs.²³⁶

In a Golden State Water Company (“Golden State”) case, D.07-10-034, Golden State requested \$9.1 million projected costs for a new computer system for its general office to handle customer service issues. Golden State proposed that the investment be treated as a capital project. DRA (and the Commission) had no objection to the need for and merits of the project or to the rate base treatment of the investment. There were issues as to the reasonableness of

²³² CAW Exh. 56, Stephenson GO Rebuttal, pp. 84-86.

²³³ CAW Exh. 56, Stephenson GO Rebuttal, p. 85.

²³⁴ CAW Exh. 56, Stephenson GO Rebuttal, p. 85.

²³⁵ D.04-07-022, *Application of Southern California Edison Company (U 338-E) For Authority to, Among Other Things, Increase Its Authorized Revenues For Electric Service in 2003, And to Reflect That Increase in Rates; Investigation on the Commission's Own Motion into the Rates, Operations, Practices, Service and Facilities of Southern California Edison Company*, 2004 Cal. PUC LEXIS 325, *285.

²³⁶ D.97-07-054, 1997 Cal. PUC LEXIS 751, **142-143.

Golden State's cost estimates and questions as to its use by nonregulated Golden State affiliates. The Commission agreed that the cost estimates were vague and that their recovery should, therefore, be done by Tier 3 advice letter filing with more detailed cost information.²³⁷

d. Quantifiable Business Transformation Benefits

All appear to agree that the Business Transformation Project will provide the substantial benefits as discussed in detail by both Mr. Stephenson²³⁸ and Mr. Twadelle.²³⁹ Neither DRA/Overland nor TURN, nor any other party has challenged the need to upgrade and modernize these systems. However, Overland complains, "CalAm has not quantified any BT benefits for California, only costs, and it hedges concerning the proposition that there will be any savings."²⁴⁰

California American Water agrees that there will likely be future productivity savings, primarily in reduced personnel costs over time, once the Business Transformation Project is fully implemented in 2013.²⁴¹ However, as Mr. Twadelle states, the ability to measure those savings today is "a matter of timing." "To the extent that one were to attempt to estimate savings before system implementation [in 2013], any estimates would be very preliminary and of limited predictive value."²⁴²

Initially, it is vital to understand that the Business Transformation Project is driven by critical business necessity (as all concede). It is not driven by potential savings. Savings may occur down the road in personnel and reduced maintenance costs, but that is pure speculation and it is secondary to the purpose of the Project. If savings become quantifiable the will be captured in the proposed memorandum account and in future rate cases.

²³⁷ D.07-10-034, *In the Matter of the Application of Golden State Water Company (U133W) for an order authorizing it to increase rates for water service by \$ 14,926,200 or 15.77% in 2007; by \$ 4,746,000 or 4.31% in 2008; and by \$ 6,909,300 or 6.02% in 2009 in its Region II Service Area*, 2007 Cal. PUC LEXIS 505, **69-87.

²³⁸ CAW Exh. 27, Stephenson Direct, pp. 54, 118-120, Attachment 6; CAW Exh. 56, Stephenson GO Rebuttal, pp. 71-72.

²³⁹ CAW Exh. 58, Twadelle GO Rebuttal, pp. 4-7.

²⁴⁰ DRA Exh. 31C, p. 4-9.

²⁴¹ *E.g.*, CAW Exh. 56, Stephenson GO Rebuttal, pp. 76-77; CAW Exh. 58, Twadelle GO Rebuttal, p. 1

²⁴² CAW Exh. 58, Twadelle GO Rebuttal, p. 9.

Many, perhaps most, capital expenditures do not result in quantifiable savings that offset the project costs. Examples abound: utility offices and their contents (desks, computers, etc.), dams, rolling stock, water tanks, wells and their equipment, etc., ad nauseum. Mr. Welchlin of Overland agrees.²⁴³ All such investments are clearly essential and beneficial, as is the Business Transformation Project, but it is simply not possible (nor required) to calculate up front a quantifiable benefit to offset the costs of such capital investments.

More fundamentally, there is, as Mr. Stephenson correctly points out,²⁴⁴ “no requirement that even if quantifiable benefits exceed the costs of an expenditure they must be proven and captured in the revenue requirement before the revenue requirement of the expenditure may be collected from customers by a regulated utility.” The applicable standard is whether “the Company’s decision [was] reasonable and prudent, and will the assets be used and useful.”²⁴⁵ Mr. Stephenson goes on to demonstrate the accounting and Commission standards governing the issue of “probable future economic benefits.”²⁴⁶ There is no need to speculate on possible quantifiable cost savings at this early stage.

Tangible, quantifiable cost savings in reduced labor or maintenance costs may or may not occur down the road once the Business Transformation Project is fully implemented in 2013. During the period of this rate case cycle, however, they likely will not occur and to attempt to estimate them now would be gross speculation. Clearly, calculable cost savings will not occur in the 2012 test year in this case and there is, aside from the memorandum account, no way under the Rate Case Plan to capture such possible changes (other than inflation) in the attrition years. In the case of the Business Transformation Project, such changes will be captured in the memorandum account and in future general rate cases.

²⁴³ RT 954:7-25 (Welchlin/DRA).

²⁴⁴ CAW Exh. 56, Stephenson GO Rebuttal, pp. 74-77.

²⁴⁵ CAW Exh. 56, Stephenson GO Rebuttal, p. 75.

²⁴⁶ CAW Exh. 56, Stephenson GO Rebuttal, p. 75.

e. Memorandum Account and Advice Letter

As Mr. Stephenson explains,²⁴⁷ California American Water originally proposed a balancing account in this case to capture actual expenses and any quantifiable cost benefits of the Business Transformation Project. DRA and intervenors raised concerns that they should have an opportunity to review these costs and possible costs benefits. As a result, California American Water now proposes, instead, a memorandum account that will capture the expenses of the Business Transformation Project for later review by DRA and the Commission pursuant to a Tier 3 advice letter process.²⁴⁸ Overland's Mr. Welchlin plainly does not understand or appreciate that with a memorandum account and Tier 3 advice letter process in place California American Water will be required to demonstrate and prove to the satisfaction of the Commission (and not just the Commission staff) that the expenses sought, net of quantifiable benefits, are reasonable and prudent before California American Water can be authorized to recover such costs.²⁴⁹

Any quantifiable cost savings, primarily reduced employment costs, may be captured in the proposed memorandum account and will in any event be captured in future general rate case proceedings. Mr. Stephenson states:

Although it might be difficult to discern whether the Business Transformation initiative produces a cost savings directly, to the extent that Business Transformation produces more efficiencies over time that will, all things equal, result in a lower labor cost. There is no doubt that the savings produced will inure to the ratepayers over time as they will be recognized and considered as part of future forecasts.²⁵⁰

f. Other DRA Concerns

Overland incorrectly claims that the Business Transformation Project is nine to ten months behind schedule.²⁵¹ It is true that it took longer than anticipated to negotiate key vendor contracts for the Business Transformation Project. However, as Mr. Twadelle explained,

²⁴⁷ CAW Exh. 56, Stephenson GO Rebuttal, pp. 86-89.

²⁴⁸ Because significant Business Transformation Project expenses have already been and are being incurred now and cannot be recaptured, California American Water has requested that the Memorandum Account be made effective upon entry of the final decision in this proceeding.

²⁴⁹ General Order 96-B, Secs. 1.8 and 7.3.3; *see* RT 962:13-20, 964:20-23 (Welchlin/DRA).

²⁵⁰ CAW Exh. 56, Stephenson GO Rebuttal, p. 88.

²⁵¹ DRA Exh. 31C, pp. 4-2, 4-4, 4-7.

that time has been more than made up by accelerating the timeline and compressing the two major phases of the Business Transformation Project into a much tighter time frame that now essentially coincides with this rate case period. The Business Transformation Project is now planned to be completed in 2013, six months ahead of the original schedule. Further, “As of March 2011, Business Transformation spending has been \$48.5 million on a system-wide basis.”²⁵²

Overland, citing an Accenture marketing brochure, asserts that cost overruns are inevitable in the Business Transformation Project. Not so. The Service Company contracted with Accenture to, among other things, be sure that such delays would not occur. Second, Overland ignores the acceleration and compression that Mr. Twadelle testified to and ignores the built in protections of California American Water’s proposed memorandum account and Tier 3 advice letter process.²⁵³ Hiring Accenture on a fixed fee basis, an accomplished fact as of the day Mr. Twadelle testified, both avoids delay and helps accelerate the revised timeline, and will also control costs.²⁵⁴ Moreover, as discussed above, Overland plainly fails to understand this Commission’s procedures, including the memorandum account mechanism/Tier 3 advice letter process, which will give DRA and this Commission ultimate oversight as to the reasonableness of these expenses.²⁵⁵

Additionally, Overland asks the Commission to impute between five and ten percent of California American Water’s approved Business Transformation Project expenditures to nonregulated sister entities.²⁵⁶ Such imputation is completely inappropriate. Mr. Stephenson testified that the Business Transformation Project was designed for American Water’s regulated entities and, even if some portions of the Project in fact used by nonregulated American Water entities, those sister entities will reimburse the Service Company for the *fully loaded* costs of

²⁵² CAW Exh. 58, Twadelle GO Rebuttal, pp. 10-12.

²⁵³ CAW Exh. 58, Twadelle GO Rebuttal, p. 12.

²⁵⁴ CAW Exh. 58, Twadelle GO Rebuttal, p. 12; RT 947:17-948:7 (Twadelle/CAW).

²⁵⁵ See RT 962:13-20, 964:20-23 (Welchlin/DRA).

²⁵⁶ DRA Exh. 31C, pp. 4-4, 4-7.

such use, including maintenance, and such reimbursed costs will be allocated back to California American Water to reduce the revenue requirement.²⁵⁷

All agree to the merits and necessity of the Business Transformation Project. No one disputes it has the classic indicia of a capital project: very large expenditures over multiple years with an extended life, and that depreciating the costs over the life of the project components will have a much lower annual impact on ratepayers and will correlate that cost to those customers benefiting from it. With the new California American Water recommendation of a memorandum account and a Tier 3 advice letter process, all parties are fully protected. The Commission should, therefore, reject Overland's Adjustment #15 and adopt California American Water's recommendations on this issue.

III. CONCLUSION

The record in this proceeding overwhelmingly supports California American Water's plant additions for the Monterey County District, the estimated taxes, including the inability to take certain tax benefits due to its net operating loss position, the special requests addressed in this Opening Brief, and the costs related to Service Company services and the Business Transformation project. Respectfully, the Commission should reject DRA and TURN's recommendations and adopt California American Water's proposals.

²⁵⁷ CAW Exh. 56, Stephenson GO Rebuttal, p. 82.

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Respectfully submitted,

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