

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



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Order Instituting Rulemaking on the )  
Commission's Own Motion to Develop Rules )  
and Procedures to Ensure That Investor- )  
Owned Water Utilities Will Not Recover )  
Unreasonable Return on Investments )  
Financed by Contamination Proceeds, )  
Including Damage Awards, and Public Loans )  
Received Due to Water Supply Contamination. )  
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R.09-03-014  
(Filed March 12, 2009)

**OPENING COMMENTS OF  
CALIFORNIA WATER ASSOCIATION  
ON WORKSHOP REPORT**

John K. Hawks  
Executive Director  
CALIFORNIA WATER ASSOCIATION  
601 Van Ness Avenue, Suite 2047  
Mail Code #E3-608  
San Francisco, CA 94102-3200  
Tel: (415) 561-9650  
Fax: (415) 561-9652  
E-mail: [jhawks\\_cwa@comcast.net](mailto:jhawks_cwa@comcast.net)

NOSSAMAN LLP  
Martin A. Mattes  
50 California Street, 34th Floor  
San Francisco, CA 94111  
Tel: (415) 398-3600  
Fax: (415) 398-2438  
E-mail: [mmattes@nossaman.com](mailto:mmattes@nossaman.com)  
Attorneys for CALIFORNIA  
WATER ASSOCIATION

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## SUBJECT INDEX

	Page
A. DWA RIGHTLY CONCURS IN THE WORKSHOP CONSENSUS THAT SHARING OF CONTAMINATION PROCEEDS SHOULD BE DETERMINED ON A CASE-BY-CASE BASIS, WITH ATTENTION TO UTILITY RISKS AND INCENTIVES.....	2
B. DWA UNDULY RELIES ON RATEMAKING PROCEDURES, ESPECIALLY COST OF CAPITAL REVIEWS, TO ADDRESS KEY ASPECTS OF CONTAMINATION RISKS AND RESPONSES .....	3
C. DWA’S RECOMMENDATION THAT UTILITY PLANT FUNDED BY CONTAMINATION PROCEEDS SHOULD NOT BE INCLUDED IN RATE BASE CONFLICTS WITH OTHER DWA RECOMMENDATIONS.....	6
D. IN ADDITION TO UNDERSTATING THE RISKS CONTAMINATION INCIDENTS PRESENT FOR UTILITIES, DWA ERRS IN FOCUSING SO EXCLUSIVELY ON RISK CONSIDERATIONS .....	8
E. DWA’S VIEW OF THE COMMISSION AS “AWARDING” CONTAMINATION PROCEEDS TO THE UTILITIES MISCONCEIVES THE PROCESS BY WHICH UTILITIES ACHIEVE SUCH PROCEEDS .....	9
F. DWA OVERSTATES THE BENEFIT TO RATEPAYERS OF APPLYING A SPECIAL SURCHARGE TO COVER THE COSTS OF GOVERNMENT LOANS .....	11
G. CERTAIN IMPORTANT POINTS OF TERMINOLOGY AND ACCOUNTING REFERENCED IN THE WORKSHOP REPORT SHOULD BE CLARIFIED .....	14
H. CONCLUSION .....	15

## TABLE OF AUTHORITIES

	Page
<b>CALIFORNIA PUBLIC UTILITIES COMMISSION CASES</b>	
<i>Re Quincy Water Company,</i> Decision 88973 (1978).....	11, 12, 13
<i>Re San Gabriel Valley Water Company,</i> Decision 07-04-046 (2007).....	15
Decision 08-06-024 (2008).....	15
<b>CALIFORNIA PUBLIC UTILITIES COMMISSION RULINGS</b>	
<i>Order Instituting Rulemaking on Investments Financed by</i> <i>Water Contamination Proceeds,</i> ALJ’s Ruling, November 12, 2009.....	1
Assistant Chief ALJ’s Ruling, December 23, 2009.....	1
<b>OTHER AUTHORITIES</b>	
U. S. Internal Revenue Code, Section 1033 .....	15
Uniform System of Accounts of Class A Water Utilities, effective January 1, 1955, as amended .....	15

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ON WORKSHOP REPORT**

In accordance with the Ruling of Administrative Law Judge (“ALJ”) Weatherford issued November 12, 2009, and an extension of time granted by Assistant Chief ALJ Cooke on December 23, 2009, California Water Association (“CWA”) hereby submits its opening comments on the Workshop Report (“WSR”), dated November 25, 2009, prepared by the Division of Water and Audits (“DWA”) for this rulemaking proceeding.<sup>1</sup>

CWA commends DWA staff for facilitating the several days of workshops in this proceeding, including their meticulous efforts to record the stated positions of the various active parties in the Summaries and Notes that are provided as Attachment A to the Workshop Report. The WSR itself is generally accurate in presenting the parties’ positions, except, in the case of CWA, for a few instances that will be addressed in these comments.

CWA is very concerned, however, that some of DWA’s recommendations and conclusions stated in the Workshop Report are unsubstantiated and poorly reasoned. As will be discussed in these comments, several fundamental recommendations of the Workshop Report must be rejected.

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<sup>1</sup> CWA members California Water Service Company, Golden State Water Company, San Gabriel Valley Water Company, San Jose Water Company, Suburban Water Systems, and Valencia Water Company join with CWA in submitting these reply comments.

A. DWA RIGHTLY CONCURS IN THE WORKSHOP CONSENSUS THAT SHARING OF CONTAMINATION PROCEEDS SHOULD BE DETERMINED ON A CASE-BY-CASE BASIS, WITH ATTENTION TO UTILITY RISKS AND INCENTIVES.

The WSR correctly presents the three basic principles proposed by CWA, which may be summarized as follows: (1) that any sharing of proceeds from contamination litigation or settlements should be limited to net proceeds, after allowance for the utility to recover its expenses of securing those proceeds; (2) that an important factor in determining the sharing of proceeds should be the extent to which the utility's shareholders and ratepayers have borne the associated costs and risks; and (3) that the allocation of proceeds also should provide a direct and substantial incentive for the utility to pursue cost recovery from the polluters and should reward such efforts. WSR, at 10-11, 18. The Report also notes the contradictory position of the Division of Ratepayer Advocates ("DRA") that all net proceeds should be passed through to ratepayers, but that the utilities should "earn a proportionate benefit" if they can show they have borne some portion of the risks. *Id.* at 18-19.

Of key importance is DWA's concurrence with CWA, the individual water utilities, and DRA "that the determination of whether and how water contamination proceeds are shared should be made on a case-by-case basis based on the facts of each case." *Id.* at 19. While supporting compensation or incentives for the utilities to take on water contamination cases, DWA would give priority to using net contamination proceeds to cover costs of replacement plant and remediation to ensure safe and reliable water supply, while minimizing cost impacts for affected customers. *Id.* In this context, and despite a lack of consensus as to the relevant risks, DWA supports providing the utilities "some incentive" to pursue contamination litigation that ultimately will benefit customers. DWA would have such incentives determined on a case-by-case basis. *Id.* at 20.

CWA generally supports these recommendations, subject to the caveat that it may not always be feasible or advisable to fund replacement plant and remediation projects, in whole or even in part, by use of contamination proceeds.<sup>2</sup> The Workshop Report correctly recognizes the relevance of the risks borne by the utility and ratepayers in connection with contamination incidents, their remediation, and the pursuit of the polluters to recover the associated costs, while also recognizing the need to provide the utility sufficient incentive to undertake those challenging and risky efforts. The Workshop Report recognizes – and DWA joins in – the consensus view that these risk and incentive factors must be considered on a case-by-case basis and that the allocation of net proceeds from contamination litigation and settlements should be determined on a case-by-case basis as well.

Unfortunately, beyond these important points of agreement, CWA has serious concerns about DWA's analysis, as presented in the Workshop Report.

**B. DWA UNDULY RELIES ON RATEMAKING PROCEDURES, ESPECIALLY COST OF CAPITAL REVIEWS, TO ADDRESS KEY ASPECTS OF CONTAMINATION RISKS AND RESPONSES.**

While recognizing the need for a case-by-case review of risk and incentive factors relevant to the allocation of contamination proceeds, the WSR disregards or seriously understates the magnitude of the risks to utilities presented by contamination incidents and associated litigation. The WSR also undervalues the initiatives taken by water utilities to respond to such incidents by remediating their effects and pursuing potentially responsible parties to pay the costs. DWA unjustifiably looks to “existing cost recovery and ratemaking

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<sup>2</sup> CWA is concerned by DWA's recommendation that contamination proceeds, after deducting litigation-related expenses, should be used to cover costs of replacement plant or remediation. WSR, at 19. While the need to fund such projects may be relevant to allocating proceeds between the utility and its customers, the Commission should not adopt a rigid rule requiring that particular funds be devoted to particular projects. The facts and circumstances, including especially timing considerations, may justify the utility funding plant replacement or remediation projects from sources that are more immediately available. Until now, the Commission has considered the design, construction, and funding of such replacement plant or remediation facilities in a water utility's general rate case or a special application, but always by a process that allows consideration of the factual context.

mechanisms” as means to mitigate risks that CWA and the water utilities identified in connection with contamination problems, and relies on such mechanisms to justify a proposal to deny rate base treatment for utility plant funded by contamination proceeds. WSR, at 2.

In several instances, DWA recommends that utility risks and responses be “considered” in the utilities’ cost of capital proceedings. WSR, at 6, 9 (re utilities’ efforts to pursue funds), 10 (re utility risks identified in Table 1). The WSR notes DRA’s assertion that water utilities “have raised the issue of water contamination risk” in cost of capital testimony and have requested higher return on equity (“ROE”) to compensate for such risk. WSR, at 12, 14. However, neither DRA nor the WSR points to any instance in which the Commission has actually recognized water contamination risk as a basis for granting a higher ROE to any water utility. To the contrary, DWA concedes that the Commission “has denied their request to factor water contamination and regulatory risk in their ROE request.” WSR, at 13, 14.

Despite this inauspicious history, DWA declares its belief that “cost of capital proceedings provide the proper forum to address any additional risk that the IOUs may face as a result of water contamination” and “to address any additional compensation to the IOUs’ [sic] for pursuing water contamination proceeds and their success with those cases.” WSR, at 15. Neither DRA nor DWA, however, has stated that a water utility should be granted a higher ROE upon demonstrating water contamination risks or litigation successes, and DRA has adamantly opposed any such allowances in all previous cases. In this context, CWA is very concerned that, the WSR’s recommendation that such risks be “considered” in cost of capital proceedings will merely send water utilities up a blind alley and leave them unrewarded for their achievements and uncompensated for their risks.

CWA also is concerned by DWA’s apparent expectation that generic cost of capital reviews for multiple utilities could become the forum for detailed inquiry into each utility’s management of contamination problems and its pursuit of funding from polluters or

government loans. Considering the expediting scheduling required for such proceedings and their focus on capital cost issues, DWA's expectation is unjustified. Cost of capital proceedings present neither an appropriate nor a convenient forum for addressing the allocation of contamination proceeds.

More fundamentally, it makes no practical sense to have the primary analysis of contamination risks, responsibilities, and rewards in cost of capital proceedings rather than in the "case by case" reviews of the facts of each water contamination case that should determine "whether and how water contamination proceeds are shared." See, WSR, at 19. If the Commission wishes to have water utilities continue to vigorously protect and defend their water supplies against risks of contamination and to undertake costly and risky litigation to pursue those responsible for contamination to ensure adequate remediation and compensation, then the water utilities must have greater assurance than is provided by a suggestion that they ask for an extra allowance in their rate of return. A reasonable certainty of retaining a major share of contamination settlement or litigation proceeds has provided, and should continue to provide, a real and more substantial incentive.

The Workshop Report also relies excessively on the potential availability of memorandum accounts to protect the utilities from having to bear costs associated with contamination incidents, their remediation, and the associated litigation and settlement processes. Whether the Commission will allow timely creation of memorandum accounts, under its ever more rigidly applied four- or five- prong test, is very uncertain. Even in the event that a memorandum account is allowed, the utility must bear the costs and risks of litigation, often on a long-term basis, because permission to recover the recorded costs in rates may be denied or, at best, delayed for years on end. For example, the WSR recognizes that San Gabriel Valley Water Company has accrued litigation costs in a memorandum account since 1998, but still has not been allowed to recover those costs in rates. WSR, at 14.

The WSR incorrectly attributes to CWA an “understanding” that any water contamination related expenses not projected in a general rate case “can be subject to memorandum account treatment” and “are dealt with” through that mechanism. WSR, at 15. This passage and the further discussion of memorandum accounts in the WSR may leave a false impression that memorandum account treatment is assured for previously unforeseen expenses related to water contamination. In fact, while some utilities have accounts in place to record the company’s actual expenditure of such costs, the chances of recovering such costs in rates are always uncertain, as is the timing of that recovery.

C. DWA’S RECOMMENDATION THAT UTILITY PLANT FUNDED BY CONTAMINATION PROCEEDS SHOULD NOT BE INCLUDED IN RATE BASE CONFLICTS WITH OTHER DWA RECOMMENDATIONS.

DWA recommends that utility plant funded by water contamination proceeds should not be allowed in rate base, but then, in the same paragraph, recommends that utility plant funded by “contamination proceeds awarded to the IOUs by the Commission” should be included in rate base. WSR, at 2. The recommendation of a blanket disallowance not only directly contradicts the more nuanced recommendation that follows, but also is completely inconsistent with the case-by-case approach for allocating contamination proceeds that was supported by a consensus of workshop participants, including DWA. Moreover, as will be discussed in more detail below, the Commission does not “award” contamination proceeds to IOUs; that is done by the courts.<sup>3</sup>

The slightly more detailed treatment of this subject later in the WSR indicates that DWA’s recommendation of a blanket disallowance results from its evaluation of utility risks as not justifying the inclusion in rate base of utility plant funded by contamination proceeds. See, WSR, at 17, 20. The reasons DWA gives for discounting utility risks are weak and

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<sup>3</sup> As DWA well knows, the Commission has not been a party to contamination litigation proceedings, and it has no role in determining whether the outcome of such litigation will be favorable to the utility.

should not be persuasive to the Commission, especially considering the two points noted above. *Id.* at 13, 16-17.

After listing numerous “examples of risks” in Table 1 of the Workshop Report, DWA dismisses many of the risks identified by CWA and the utilities because they are just “part of the IOUs [*sic*] responsibilities as a regulated water utility.” *Id.* at 12-13. This claim ignores the unusual and unpredictable character and effects of serious contamination incidents.<sup>4</sup> These factors prevent adequate recognition of the indicated risks and associated costs in routine ratemaking processes. This is why contamination incidents pose exceptional risks to the utilities, which is an important reason for allocating a substantial share of any net proceeds derived from such incidents to the utilities.

A further basis on which DWA relies to discount the utility risks listed in Table 1 is that no utility is prohibited from filing an application to address “new or unusual problems.” The prospect of filing and pursuing an exceptional application seeking an off-schedule Commission review and authorization of a request for extraordinary rate relief or other extraordinary authorizations offers no realistic prospect for ameliorating the worst effects of a contamination incident, and certainly does not relieve the utilities of risk. In fact, the undertaking of such an extraordinary application presents new and additional risks for the utility, including at best regulatory lag and at worst the fruitless expenditure of regulatory expense.

DWA’s discussion of utility risks indicates an even more basic problem – a serious disconnect between DWA’s view of allocating contamination proceeds between ratepayers and utilities and its view of whether to include in rate base plant constructed with such proceeds. Thus, for example, DWA states that the risk of diversion of management

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<sup>4</sup> Given that neither DWA nor the Commission participates in such litigation, neither is well positioned to make value judgments on the risks involved.

resources should be considered in the Commission's determination of how to allocate contamination proceeds but "does not justify rate basing the utility plant." *Id.* at 16-17.

This dichotomy in DWA's recommendations is of great concern to CWA. It appears that DWA fails to recognize that the choice between treating new plant, funded by contamination proceeds, as CIAC or as an addition to rate base is the same thing, both functionally and from a policy perspective, as the choice between allocating contamination proceeds to ratepayers or to the utility. DWA's failure to recognize this linkage results in DWA's blanket recommendation to disallow rate basing of plant funded by contamination proceeds, despite its inconsistency with DWA's support for a case-by-case determination of how to allocate net contamination proceeds.

D. IN ADDITION TO UNDERSTATING THE RISKS CONTAMINATION INCIDENTS PRESENT FOR UTILITIES, DWA ERRS IN FOCUSING SO EXCLUSIVELY ON RISK CONSIDERATIONS.

The Workshop Report states that risk is "the ***main issue*** underlying the IOUs' and DRA's respective position on how water contamination proceeds should be allocated" [emphasis added]. DWA then presents a weak argument, addressed above, for discounting the risks identified by CWA and the utilities. WSR, at 12. Beyond DWA's failure to give proper weight to the risks facing utilities and their shareholders, the basic premise for DWA's discussion of risks is faulty.

As the WSR recognizes, CWA enunciated three principles to guide the allocation of contamination proceeds. The first of these principles concerns the definition of net proceeds; the second calls for consideration of "costs and risks" borne by shareholders and ratepayers, respectively; and the third refers to the utility's decisions to pursue the polluters and the success those efforts have achieved – suggesting that the allocation of proceeds should provide an incentive for the utility to pursue cost recovery from the polluters and should reward success in that process. WSR, at 10-11, 18. Thus, from the utilities' perspective, risk is just one among several considerations that should guide the allocation of

contamination proceeds. The WSR's suggestion that risk is "the main issue" is an overstatement that will lead to unintended and unsatisfactory results.

E. DWA'S VIEW OF THE COMMISSION AS "AWARDING" CONTAMINATION PROCEEDS TO THE UTILITIES MISCONCEIVES THE PROCESS BY WHICH UTILITIES ACHIEVE SUCH PROCEEDS.

A further misconception in DWA's analysis, noted earlier, is evident in DWA's repeated references to water contamination proceeds being "awarded" to the utilities by the Commission. See, WSR, at 2, 17, 20. This construct is factually inaccurate and appears to have contributed to DWA's inconsistent discounting of the utilities' rights to such proceeds.

A utility acquires contamination proceeds as a result of pursuing and managing litigation or settlement efforts that it undertakes as part its response either to a threat or to an actual incident of contamination adversely affecting its water supplies. Such proceeds are paid to the utility by parties responsible for the contamination or are awarded to the utility by a court of law. They are not awarded by the Commission.

The Commission becomes involved, as in the present rulemaking, when it comes time to determine the rate impact or benefits, if any, of the utility's receipt of contamination proceeds. The Commission may permit the utility to retain the proceeds it has obtained and may require the utility to reinvest in utility plant some or all of what remains after litigation costs. Such plant, constructed or acquired with funds belonging to the utility, will be included in rate base. Alternatively, the Commission may determine that some portion of the funds invested in plant should be treated as Contributions in Aid of Construction ("CIAC"), and therefore excluded from rate base,<sup>5</sup> or that some amount of the net proceeds should be flowed through directly to ratepayers. Thus, the Commission may deprive the utility of some portion of the benefits of contamination proceeds it has received or it may allow the utility to

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<sup>5</sup> For example, a settlement might specifically earmark funds to pay for a replacement or treatment facility.

retain the benefits of the contamination proceeds, but in no instance does the Commission “award” such proceeds to the utility.

This discussion of DWA’s references to Commission “awards” is not just a quibble about a choice of words, but has much more serious implications. It is important to recognize that it is the utility that must take the initiative to respond to a contamination threat or event. It is the utility that must protect its plant and water resources, remediate the effects of contamination, construct replacement or treatment plant, and spend the considerable money and devote the enormous amounts of time and attention required to pursue the polluters and manage the litigation, in an effort to recover the costs of remediation and required plant investment, while simultaneously defending itself from plaintiff lawsuits and counter claims.

All these efforts are responsibilities of the utility, pursued on its own initiative, at its own expense, and at considerable financial risk. If the utility’s efforts eventually garner proceeds in excess of its litigation costs and the related income tax liabilities incurred, those proceeds may be used to fund replacement plant or other, unrelated, utility plant, or may be devoted to other utility purposes. Such proceeds are the property of the utility. The burden should rest with parties such as DRA – and the Commission – to justify converting any portion of those proceeds to the benefit of ratepayers in a way that deprives the utility of its ownership rights – especially since neither the Commission nor DRA has been a party to the litigation.

The WSR notes the position of California Water Service Company that the utility bears all the risks of pursuing litigation against polluters, which they have no legal obligation to undertake. WSR, at 18. Neither the Commission nor ratepayers have initiated such legal actions and so they have neither direct rights nor obligations with respect to them. The utilities have taken such initiatives at the Commission’s express urging and direction and to protect company’s and the customers’ interests, but whatever gain they achieve is property

of the utility. Any Commission policy that aims to allocate the net proceeds from such initiatives should start from that premise.

F. DWA OVERSTATES THE BENEFIT TO RATEPAYERS OF APPLYING A SPECIAL SURCHARGE TO COVER THE COSTS OF GOVERNMENT LOANS.

DWA recommends that utility plant investments funded by government loans should be accounted for separately from the rest of the utility's revenue requirement, with the costs recovered by a special surcharge. DWA bases this recommendation on policy objectives on which the Commission relied in providing a similar cost recovery method for Safe Drinking Water Bond Act ("SDWBA") loans in a 1978 decision for Quincy Water Company (a Class D water company that was non-creditworthy and so unable to obtain conventional financing). See, WSR, at 5. For the sake of consistency, we refer to this method using DWA's moniker, the "CIAC" approach, but there is, in fact, nothing CIAC-like about this approach. On the contrary, plant purchased with the proceeds of government loans is in no way contributed, but is, in fact, funded with long-term debt that happens to come from a different source than the utility's standard debt issuance portfolio.

DWA prefers this plan over the "conventional cost of capital approach" proposed by CWA. CWA's "conventional" approach would recognize the lower cost of the government loan in calculating the utility's weighted cost of debt and its overall rate of return, but then would allow the plant funded by that loan to be included in a rate base that earns a somewhat lower rate of return reflecting the favorable cost and terms of the loan. While noting the utilities' concern that government loans are a liability like, and in some respects more onerous than, other debt, DWA presumes without justification that the costs to ratepayers of the conventional cost of capital approach would be greater than the costs associated with a CIAC/surcharge arrangement. WSR, at 7-8.

DWA ignores the demonstration, in CWA's Opening Comments in response to the OIR, that the cost to ratepayers of either ratemaking approach would be approximately the

same, and that neither approach would create a “windfall” for the utility. See, CWA Opening Comments in Response to OIR, June 1, 2009, at 6-8. Instead, DWA relies on a table in the 30-year-old *Quincy* decision, which indicated that the conventional cost of capital approach (which the *Quincy* decision called the “rate base method”), was more costly to ratepayers than the “CIAC” approach. WSR, at 8-9, Table 2, citing *Quincy Water Company* (1978), D.88973.

The *Quincy* decision used an example of a surcharge loan to show that over the life of the loan, the present value of revenue requirement under the rate base method was \$187,891 greater than under the “CIAC” approach. In other words, the rate base method was \$187,891 more costly to ratepayers in current dollars. This \$187,891 difference was entirely due to differences in timing of recovery of plant investment funded by the loan.

Under the rate base method, plant investment is recovered by depreciation on a conventional straight line basis over the life of the related plant, regardless of the terms of the loan. This is the conventional way utility plant investment is recovered and is a method the investment community understands and universally accepts. In contrast, under the “CIAC” approach, investment is recovered not on a straight line basis, but rather like an annuity, and not over the life of the related plant, but over the life of the loan. The annuity method defers recovery of plant costs toward the end of the loan term, just as payment of principal is deferred in payments on a home loan. This is a highly unconventional method of cost recovery for utilities.<sup>6</sup> If a government loan were for a significant amount, investors likely would react negatively to use of the “CIAC” approach, demanding additional return to

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<sup>6</sup> Moreover, the survival characteristics of utility plant almost never follow the trend-line of an annuity, with decline in service value occurring mostly at the end of a plant’s service life.

account for the added risk of deferring capital recovery to later years in place of conventional straight line recovery.<sup>7</sup>

In addition, there appear to be two significant errors in the *Quincy* decision table. First, for discounting purposes, the table appears to assume that the life of the loan (“CIAC” approach) is equal to the life of the plant (rate base method). This is almost never true. Life of the plant is almost always longer. Second, overall rate of return, when interest on the government loan is included, is no lower under the “CIAC” approach than under the rate base method, and may be higher to account for investors’ perceptions of added risk.

Finally, it should be noted that the *Quincy* decision acknowledged that the “CIAC” approach was not developed with conventional large water utilities in mind.

If we were dealing with the capital formation problems of conventional credit-worthy utilities, this phenomenon would be of little importance. Since such utilities normally seek new capital on a recurring basis and have regular programs of continued plant additions, the excess revenue requirements from newer projects are largely offset by the cash-flow deficiencies of older projects.

*Quincy*, D.88973, at 13. Because Quincy was not credit-worthy, had no long-term debt, and had no reliable means of repaying a conventional loan, the Commission required a special billing surcharge with the proceeds to be deposited in a trust account set up with an independent bank and not controlled by the utility, so as to ensure payments against the loan. None of these factors apply to the financings of a Class A water company.

Considering the errors in the *Quincy* analysis, noted above, it is likely that including the cost of a government loan in the utility’s weighted average cost of debt and including the plant funded by that loan in rate base would produce a revenue requirement approximately equal to the cost of the CIAC approach preferred by DWA. The Commission,

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<sup>7</sup> The repayment term for government loans, such as SDWBA loans, is commonly 20 years. While this provides a somewhat shorter cost recovery period under the “CIAC” approach as compared to the rate base method, nevertheless cost recovery under the “CIAC” approach remains skewed toward the end of the 20-year term. Again, investors would likely see this unconventional timing of cost recovery from customers as indicating additional overall risk.

therefore, should adopt CWA's proposal, which offers a simpler ratemaking procedure that is less likely to be confusing to customers or investors.<sup>8</sup>

Whichever cost recovery method the Commission prefers for government loans, the Commission needs to recognize that utility plant funded by a government loan is just as much the property of the utility as any other utility plant. Whether accounted for using the "CIAC" approach or the rate base method, such plant must be operated and maintained as utility property and must eventually be replaced. The Commission should not adopt any general rule limiting utilities' rights with respect to their ownership of such property.

G. CERTAIN IMPORTANT POINTS OF TERMINOLOGY AND ACCOUNTING REFERENCED IN THE WORKSHOP REPORT SHOULD BE CLARIFIED.

The Workshop Report correctly notes CWA's definition of "net proceeds" as consisting of the amount received from polluters after allowance for expenses incurred in securing the proceeds and any income taxes or other taxes and fees that the utility will have to pay with respect to such proceeds. WSR, at 10. However, subsequent references to net proceeds reference only the deduction of "litigation expenses." See, *e.g., id.* at 19. It is important that the Commission recognize the need to define "net proceeds" as net of all related taxes and fees – whether paid currently or deferred – so long as the tax obligation is

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<sup>8</sup> DWA also notes in its discussion of this issue and includes in Attachment A to the WSR a highly misleading "comparative example" that DRA provided to illustrate the impact on revenue requirement and customer bills associated with rate-basing versus CIAC treatment of replacement plant. WSR, at 8 and Att. A, at 5. After the final workshop session, San Gabriel provided DWA and the parties an alternative set of tables with comparative examples of the revenue requirement and bill impacts of premature plant retirements and different allocations of net contamination proceeds. See, electronic message from D. Dell'Osa to M. Chavez et al., November 4, 2009, and attached Excel spreadsheets. While primarily addressing the risks, costs, and benefits associated with pursuing the polluters to recover contamination-related costs, San Gabriel's submission also is more realistic than the DRA example in setting the costs and proceeds of a contamination incident in the context of a utility's overall revenue requirement, and thereby providing a more realistic estimate of customer bill impacts.

clearly known or foreseeable at the time ratemaking disposition of the net proceeds is addressed.<sup>9</sup>

The WSR also notes the parties' agreement that the Uniform System of Accounts ("USOA") adequately addresses the accounting for new and retired plant and that the utilities should continue to follow the USOA in accounting for plant funded by government loans or proceeds from contamination claims. WSR, at 17. As the WSR appears to recognize in that context (*id.*), any investment in utility plant – regardless of source – must be recorded in the utility's plant account at cost. Then, if some portion of that investment is to be excluded from rate base, a matching dollar amount must be recorded in CIAC, which is deducted from the total plant account in the calculation of rate base.

#### H. CONCLUSION

For the reasons stated above, as well as in its previously filed comments and as reported in the Workshop Report, CWA respectfully urges the Commission to apply the three principles proposed by CWA for ratemaking disposition of the proceeds from contamination settlements or litigation and that were the major themes of CWA's participation in the workshop process. Those basic principles may be summarized as follows:

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<sup>9</sup> In a pair of recent decisions addressing ratemaking treatment of the proceeds from San Gabriel Valley Water Company's settlement of a dispute with the County of San Bernardino over contamination from a landfill, San Gabriel challenged DRA's failure to deduct deferred income taxes in calculating net proceeds subject to allocation, but the Commission nonetheless concluded that Internal Revenue Code §1033, governing reinvestment of proceeds from involuntary conversions, relieved San Gabriel of current tax liability and so found there was no current tax liability on the gains San Gabriel had achieved. *Re San Gabriel Valley Water Co.*, D.07-04-046, at 95-97, and D.08-06-024, at 13-16, 37 (Ordering Paragraph 3.b). This conclusion did not, however, obviate the fact that §1033 merely defers, rather than eliminates, tax liability, because it leaves the taxpayer with little or no tax basis in property acquired with settlement proceeds. This is effectively cash-basis accounting and totally ignores the matching principle of accounting. It also creates a serious issue of intergenerational equity among ratepayers. If today's ratepayers are given a generous share of net proceeds from which no tax liability has been deducted, then future ratepayers will face rates reflecting a higher income tax expense when the utility sells or disposes of the replacement property. A fairer approach, adhering to principles of accrual accounting would be, as CWA proposes, to account for any known taxes, whether current or deferred, in calculating net proceeds.

1. that any sharing of proceeds from contamination litigation or settlements should be limited to net proceeds, after allowance for the utility to recover its expenses of securing those proceeds, including all foreseeable taxes;
2. that an important factor in determining the sharing of proceeds should be the extent to which the utility's shareholders and ratepayers have borne the associated costs and risks; and
3. that the allocation of proceeds also should provide a direct and substantial incentive for the utility to pursue cost recovery from the polluters and should reward such efforts.

DWA's recommendations presented in the WSR, should be critically evaluated in light of these principles. The Commission also should give substantial weight to the consensus recommendation that allocation of contamination proceeds "should be made on a case-by-case basis based on the facts of each case."

Respectfully submitted,

NOSSAMAN LLP

John K. Hawks  
Executive Director  
CALIFORNIA WATER ASSOCIATION  
601 Van Ness Avenue, Suite 2047  
Mail Code #E3-608  
San Francisco, CA 94102-3200  
Tel: (415) 561-9650  
Fax: (415) 561-9652  
email: [jhawks\\_cwa@comcast.net](mailto:jhawks_cwa@comcast.net)

By /S/ MARTIN A. MATTES.  
Martin A. Mattes  
50 California Street, 34th Floor  
San Francisco, CA 94111  
Tel: (415) 398-3600  
Fax: (415) 398-2438  
e-mail: [mmattes@nossaman.com](mailto:mmattes@nossaman.com)  
Attorneys for CALIFORNIA WATER  
ASSOCIATION

January 12, 2010

## CERTIFICATE OF SERVICE

I, Jeannie Wong, hereby certify that on this date I will serve by electronic mail and by hand delivery, the foregoing **OPENING COMMENTS OF CALIFORNIA WATER ASSOCIATION ON WORKSHOP REPORT** on the parties in Rulemaking 09-03-014, below:

### By electronic mail:

doug@parkwater.com; tjryan@sgvwater.com; jadarneylane@gswater.com;  
jhawks\_cwa@comcast.net; sha@cpuc.ca.gov; bfinkelstein@turn.org;  
ldolqueist@manatt.com; mmattes@nossaman.com; bcook@fruitridgevista.com;  
leigh@parkwater.com; ed.jackson@parkwater.com; lmcghee@calwater.com;  
larry@epwater.com; bjohnson@valencia.com; rdiprimio@valencia.com;  
bkelly@swwc.com; mlwhitehead@sgvwater.com; rkmoore@gswater.com;  
jgaron@gswater.com; kswitzer@gswater.com; tom@alcowater.com;  
stephen.morrison@amwater.com; mlane@nossaman.com; sleeper@manatt.com;  
tritchie@manatt.com; jguzman@nossaman.com; tsmegal@calwater.com;  
sferraro@calwater.com; bloehr@greatoakswater.com; tguster@greatoakswater.com;  
broeder@greatoakswater.com; palle\_jensen@sjwater.com; dstephen@amwater.com;  
rsf@corporatecenter.us; gw2@cpuc.ca.gov; sek@cpuc.ca.gov; mcv@cpuc.ca.gov;  
smw@cpuc.ca.gov; tpy@cpuc.ca.gov; Alex.Barrios@asm.ca.gov;  
jerri.swoyer@cdph.ca.gov;

### By hand delivery:

Hon. Gary Weatherford  
Administrative Law Judge  
California Public Utilities  
Commission  
505 Van Ness Avenue  
San Francisco, CA 94102

Hon. John Bohn  
Assigned Commissioner  
California Public Utilities Commission  
505 Van Ness Avenue  
San Francisco, CA 94102

Executed this 12th day of January, 2010 in San Francisco, California.

/S/ JEANNIE WONG  
Jeannie Wong

# CALIFORNIA PUBLIC UTILITIES COMMISSION

## Service Lists

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**PROCEEDING: R0903014 - CPUC - OIR TO DEVELO**  
**LAST CHANGED: DECEMBER 24, 2009**

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### Parties

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DOUGLAS K. MARTINET  
SENIOR VICE PRESIDENT/CFO  
PARK WATER COMPANY  
9750 WASHBURN ROAD  
DOWNEY, CA 90241  
FOR: PARK WATER COMPANY  
COMPANY

TIMOTHY J. RYAN  
GENERAL COUNSEL  
SAN GABRIEL VALLEY WATER COMPANY  
11142 GARVEY AVENUE, PO BOX 6010  
EL MONTE, CA 91734  
FOR: SAN GRABRIEL VALLEY WATER

JENNY DARNEY-LANE  
REGULATORY AFFAIRS MANAGER  
GOLDEN STATE WATER COMPANY  
630 E. FOOTHILL BLVD.  
SAN DIMAS, CA 91773-9016  
FOR: GOLDEN STATE WATER COMPANY

JOHN K. HAWKS  
CALIFORNIA WATER ASSOCIATION  
MAIL CODE E3-608  
601 VAN NESS AVENUE, SUITE 2047  
SAN FRANCISCO, CA 94102-3200  
FOR: CALIFORNIA WATER ASSOCIATION

MITCHELL SHAPSON  
CALIF PUBLIC UTILITIES COMMISSION  
LEGAL DIVISION  
ROOM 4107  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214  
FOR: DRA

ROBERT FINKLESTEIN  
LEGAL DIRECTOR  
THE UTILITY REFORM NETWORK  
115 SANSOME STREET, SUITE 900  
SAN FRANCISCO, CA 94104  
FOR: THE UTILITY REFORM NETWORK

LORI ANNE DOLQUEIST  
ATTORNEY AT LAW  
MANATT PHELPS & PHILLIPS LLP  
ONE EMBARCADERO CENTER, 30TH FLOOR  
SAN FRANCISCO, CA 94111-3719  
FOR: CALIFORNIA-AMERICAN WATER COMPANY

MARTIN A. MATTES  
ATTORNEY AT LAW  
NOSSAMAN LLP  
50 CALIFORNIA STREET, 34TH FLOOR  
SAN FRANCISCO, CA 94111-4799  
FOR: CALIFORNIA WATER ASSOCIATION

ROBERT C. COOK JR.  
FRUITRIDGE VISTA WATER COMPANY  
1108 SECOND STREET, STE. 204  
SACRAMENTO, CA 95814  
FOR: FRUITRIDGE VISTA WATER COMPANY

### Information Only

---

LEIGH K. JORDAN  
EXECUTIVE VICE PRESIDENT  
APPLE VALLEY RANCHOS WATER COMPANY  
9750 WASHBURN RD.  
DOWNEY, CA 90241  
FOR: APPLE VALLEY RANCHOS WATER COMPANY  
C/O PARK WATER COMPANY

EDWARD N. JACKSON  
DIRECTOR OF REVENUE REQUIREMENTS  
PARK WATER COMPANY  
9750 WASHBURN ROAD  
DOWNEY, CA 90241-7002  
FOR: PARK WATER COMPANY

LYNNE P. MCGHEE  
CALIFORNIA WATER SERVICE COMPANY  
1720 NORTH FIRST STREET  
SAN JOSE, CA 90505-5272

LAWRENCE MORALES  
EAST PASADENA WATER COMPANY  
3725 EAST MOUNTAIN VIEW AVENUE  
PASADENA, CA 91107  
FOR: EAST PASADENA WATER COMPANY

BEVERLY JOHNSON  
CONTROLLER  
VALENCIA WATER COMPANY  
24631 AVENUE ROCKEFELLER  
VALENCIA, CA 91355

ROBERT J. DIPRIMIO  
VALENCIA WATER COMPANY  
24631 AVENUE ROCKEFELLER  
VALENCIA, CA 91355  
FOR: VALENCIA WATER COMPANY

ROBERT L. KELLY  
VICE PRESIDENT-REGULATORY AFFAIRS  
SUBURBAN WATER SYSTEMS  
1211 E. CENTER COURT DRIVE  
COVINA, CA 91724-3603  
FOR: SUBURBAN WATER SYSTEMS

MICHAEL L. WHITEHEAD  
SAN GABRIEL VALLEY WATER CO.  
PO BOX 6010  
EL MONTE, CA 91734  
FOR: SAN GABRIEL VALLEY WATER COMPANY

RONALD MOORE  
SR. REGULATORY ANALYST  
GOLDEN STATE WATER CO/BEAR VALLEY  
630 EAST FOOTHILL BLVD.  
SAN DIMAS, CA 91773

JOHN GARON  
REGULATORY AFFAIRS MANAGER  
GOLDEN STATE WATER COMPANY  
630 E. FOOTHILL BLVD.  
SAN DIMAS, CA 91773-9016

KEITH SWITZER  
VICE PRESIDENT, REGULATORY AFFAIRS  
GOLDEN STATE WATER COMPANY  
630 EAST FOOTHILL BOULEVARD  
SAN DIMAS, CA 91773-9016

THOMAS R. ADCOCK  
VICE PRESIDENT  
ALCO WATER SERVICE, INC.  
249 WILLIAMS ROAD  
SALINAS, CA 93905  
FOR: ALCO WATER SERVICE, INC.

STEPHEN A. S. MORRISON  
CALIFORNIA AMERICAN WATER  
333 HAYES ST., SUITE 202  
SAN FRANCISCO, CA 94102

MARI LANE  
NOSSAMAN LLP  
50 CALIFORNIA STREET, SUITE 3400  
SAN FRANCISCO, CA 94111

SARAH E. LEEPER  
ATTORNEY AT LAW  
MANATT, PHELPS & PHILLIPS, LLP  
ONE EMBARCADERO CENTER, 30TH FLOOR  
SAN FRANCISCO, CA 94111  
FOR: CALIFORNIA AMERICAN WATER COMPANY

TRAVIS RITCHIE  
MANATT, PHELPS & PHILLIPS, LLC  
1 EMBARCADERO CENTER, 30TH FLOOR  
SAN FRANCISCO, CA 94111

JOSE E. GUZMAN, JR.  
ATTORNEY AT LAW  
NOSSAMAN LLP  
50 CALIFORNIA STREET, 34 TH FLOOR  
SAN FRANCISCO, CA 94111-4799

THOMAS F. SMEGAL  
VP - REGULATORY MATTERS  
CALIFORNIA WATER SERVICE COMPANY  
1720 NORTH FIRST STREET  
SAN JOSE, CA 95112

FRANCIS S. FERRARO  
VICE PRESIDENT  
CALIFORNIA WATER SERVICE COMPANY  
1720 NORTH FIRST STREET  
SAN JOSE, CA 95112-4598  
FOR: CALIFORNIA WATER SERVICE COMPANY

ROBERT A. LOEHR  
ATTORNEY AT LAW  
GREAT OAKS WATER COMPANY  
15 GREAT OAKS BLVD., SUITE 100  
SAN JOSE, CA 95119  
FOR: GREAT OAKS WATER COMPANY

TIMOTHY S. GUSTER  
GENERAL COUNSEL  
GREAT OAKS WATER COMPANY  
20 GREAT OAKS BOULEVARD, SUITE 120  
SAN JOSE, CA 95119

JOHN ROEDER  
GREAT OAKS WATER COMPANY  
PO BOX 23490  
20 GREAT OAKS BLVD., STE. 120  
SAN JOSE, CA 95153-3490

PALLE JENSEN  
DIRECTOR OF REGULATORY AFFAIRS  
SAN JOSE WATER COMPANY  
374 WEST SANTA CLARA STREET  
SAN JOSE, CA 95196  
FOR: SAN JOSE WATER COMPANY

DAVID P. STEPHENSON  
DIRECTOR - RATE REGULATION  
CALIFORNIA-AMERICAN WATER COMPANY  
4701 BELOIT DRIVE  
SACRAMENTO, CA 95838

ROBERT S. FORTINO  
PRESIDENT  
DEL ORO WATER COMPANY, INC.  
DRAWER 5172  
CHICO, CA 95927  
FOR: DEL ORO WATER COMPANY, INC.

## State Service

---

GARY WEATHERFORD  
CALIF PUBLIC UTILITIES COMMISSION  
DIVISION OF ADMINISTRATIVE LAW JUDGES  
ROOM 5020  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

JASJIT S. SEKHON  
CALIF PUBLIC UTILITIES COMMISSION  
WATER BRANCH  
ROOM 4203  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

MOISES CHAVEZ  
CALIF PUBLIC UTILITIES COMMISSION  
WATER AND SEWER ADVISORY BRANCH  
AREA 3-C  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

SEAN WILSON  
CALIF PUBLIC UTILITIES COMMISSION  
DIVISION OF ADMINISTRATIVE LAW JUDGES  
ROOM 5103  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

TING-PONG YUEN  
CALIF PUBLIC UTILITIES COMMISSION  
WATER BRANCH  
AREA 3-D  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

ALEX BARRIOS  
SENIOR FIELD REPRESENTATIVE  
OFFICE OF ASSEMBLY MEMBER DAVE JONES  
915 L STREET, STE 110  
SACRAMENTO, CA 95814

JERRY SWOYER  
CA DEPARTMENT OF PUBLIC HEALTH  
PO BOX 997377  
1501 CAPITOL AVE., STE. 71.5001/MS0506  
SACRAMENTO, CA 95899-7377