

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.)
_____)

R.09-03-014
(Filed March 12, 2009)

**COMMENTS OF
CALIFORNIA WATER ASSOCIATION
ON PROPOSED DECISION**

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September 9, 2010

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**COMMENTS OF
CALIFORNIA WATER ASSOCIATION
ON PROPOSED DECISION**

Pursuant to Rule 14.3 of the Commission's Rules of Practice and Procedure, and an extension of time granted by an e-mail ruling of Administrative Law Judge ("ALJ") Weatherford, on August 11, 2010, California Water Association ("CWA") hereby submits its comments on the Proposed Decision of Commissioner Bohn ("Proposed Decision" or "PD") issued August 3, 2010, in the above-captioned rulemaking. California American Water Company, California Water Service Company, Golden State Water Company, Park Water Company, San Gabriel Valley Water Company, San Jose Water Company, Suburban Water Systems, and Valencia Water Company, all members of CWA, join in CWA's comments on the Proposed Decision.

A. Summary of Comments

The Proposed Decision would improperly impose a single template to govern regulatory accounting for funds derived from very different sources and that may be applied to very different uses. Beginning with a set of procedures the Commission developed and adopted to govern the ratemaking treatment of funds derived from state government grants for water quality improvements,¹ the Proposed Decision would apply the same procedures to all

¹ Rulemaking To Develop Rules and Procedures to Preserve Public Interest Integrity of Government Financed Funding, Including Loans and Grants, to Investor-Owned Water and Sewer Utilities, Decision ("D.") 06-03-015.

government grants for such purposes, and goes on to apply the same or very similar procedures to government loans and to any proceeds derived from court judgments or settlements resulting from contamination claims. Proceeds from loans and contamination claims should **not** be treated the same as grants.

The parties to this proceeding agreed that it made sense to extend the procedures and rules adopted in D.06-03-015 to all government grants. There was controversy over the appropriate means for recording and recovering in rates the costs associated with government loans, and the Proposed Decision's resolution of these issues overlooks serious flaws in the comparative cost analysis on which DRA and The Utility Reform Network ("TURN") relied and which the Proposed Decision, unfortunately, accepts.

In its treatment of proceeds from contamination claims, whether by way of damage awards, settlements, government orders, or insurance, the ratemaking procedures the Proposed Decision would impose are unfair and prejudicial to water utilities and inconsistent with policies adopted and applied by the Commission over the past two decades. In addition, the regulatory accounting procedures that the Proposed Decision would require for all classes of funds addressed in this proceeding are seriously flawed in ways that would deprive water utilities of a fair opportunity to earn the rates of return on their investments in utility plant that the Commission has authorized for them. In both these respects, the Proposed Decision would impose unprecedented requirements that violate the fundamental Constitutional right of utilities to a fair opportunity to earn a reasonable rate of return.

In these comments, CWA first addresses the flawed regulatory accounting procedure that the Proposed Decision would mandate for funds received as a result of contamination claims or from government grants or loans. Thereafter, CWA addresses other serious deficiencies in the Proposed Decision's analysis and ratemaking treatment of proceeds derived from contamination claims. CWA also challenges the complex and

unexamined² regulatory accounting rules for funds derived from government loan and contamination claims, as specified in Appendices B and C to the Proposed Decision, , which are beyond the scope of the proceeding and are not based on record evidence, and provides corrections to DRA's and TURN's flawed cost comparison of alternative methods for recovering the costs associated with government loans, a comparison on which the Proposed Decision unfortunately relies. Finally, CWA addresses the timing for implementing the adopted rules.

B. The Most Far-Reaching Flaw in the Proposed Decision Is Its Misguided Mandate That All Funds Within the Scope of the Rulemaking That a Utility Receives Must Be Recorded Immediately as Contributions in Aid of Construction ("CIAC").

The Proposed Decision declares that "government loans used to fund replacement plant should be treated as CIAC with corresponding ratepayer surcharges for loan repayment." PD, at 33. The Proposed Decision would provide a new sub-account 265.2 for "Government Loan Contamination Proceeds," and would require that "[w]hen government loan proceeds are initially received from the funding source, the water utility should place those funds in that dedicated 265.2 sub-account." PD, at 39.

Likewise, the Proposed Decision imposes CIAC treatment for all contamination proceeds received from third parties. PD, at 39-40. The Proposed Decision would provide additional sub-accounts 265.3 through 265.6 for booking "contamination proceeds" derived from damage awards, settlements, government-ordered private or public funding, or insurance, and would require that "[w]hen contamination proceeds are initially received from any of the foregoing funding sources, the water utility should place those funds in the appropriately numbered and named dedicated account." PD, at 42-43.

It is critically important to recognize that the Proposed Decision would impose these regulatory accounting requirements from the moment that "proceeds" of all these

² As will be explained in Section D of these comments, there is no evidentiary record whatsoever to support application of the many of the rules in Appendices B and C to the proceeds of government loans and contamination claims.

varieties “are initially received” by a water utility – regardless of whether the utility has previously made investments or expenditures to which such funds will be directed or has not yet made such investments or expenditures. Thus, for example, if a utility receives a government loan, or payment of settlement proceeds, or a court judgment, in the amount of \$1 million on July 1, 2011, and then undertakes construction of a new well or a treatment facility at a cost of \$1 million that is completed and goes into service on July 1, 2012, the Proposed Decision would require an increase in a CIAC sub-account 12 months before the investment is reflected in the Utility Plant account. The effect will be a **reduction** in the utility’s rate base during that 12-month period, with the rate base increasing incrementally only as the funds are expended on new plant and eventually reaching the original level only when the project is completed. Thus, obtaining a low-interest government loan or achieving a settlement or judgment paid by polluters will not merely provide no benefit to the utility – it will directly reduce the utility’s rate base and thus, when rates are subject to adjustment during that 12-month period, reduce the utility’s revenues.³

Similarly, if a utility receives a lump sum of \$1 million in settlement or litigation proceeds to compensate for the increased cost over the next ten years of an alternative water supply or for ten years of operation and maintenance costs for a new water treatment plant, the Proposed Decision will increase the utility’s CIAC balance by \$1 million immediately upon receipt of the funds and there will be no increase, either then or later, in the Utility Plant account.⁴ The result will be an immediate \$1 million reduction in rate base, which may at best be restored gradually over the ten years that the \$1 million is used to pay ongoing water supply or operating expenses – but the Proposed Decision makes no provision for restoring

³ Pursuant to the Rate Case Plan, Class A water utilities typically adjust rates annually, implementing either test year rates or step rate increases, in each case based on recorded rate base. Any increase in CIAC will reduce rate base, either as estimated for the test year or as applied in the calculation of step rate increases

⁴ This is not just a theoretical possibility. As the Proposed Decision recognizes, San Gabriel Valley Water Company, for example, receives reimbursements from polluters for operation and maintenance costs that are not investments in utility plant. See, PD, at 20-21, citing San Gabriel’s Opening Comments, filed June 1, 2009.

the loss of rate base. Such treatment of payments to cover operating costs as CIAC is inconsistent with basic accounting principles, which require matching CIAC to utility plant.

Either of these scenarios, imposing a reduction in rate base, would be grossly unfair to the water utility. They are just two examples of the catastrophic effects that would necessarily flow from the Proposed Decision's overly broad mandate that all funds received from various sources be recorded immediately to CIAC. Following this ill-conceived rule will necessarily diminish both earnings and rate base. This aspect of the Proposed Decision is unworkable and unlawful – effectively denying the utility a fair opportunity to earn a reasonable return on its past investments in utility plant.⁵

There is a simple and readily available alternative to the Proposed Decision's inappropriate and unlawful expansion of CIAC for regulatory accounting. That alternative is one that already is commonly applied by the Commission – the use of **memorandum accounts**. Over the years, the Commission has authorized water utilities to employ memorandum accounts in a variety of fact situations where it has been appropriate to record revenues and/or expenses as they accrue, subject to subsequent consideration of possible adjustments – either upward or downward – in the utility's rates. Since 1998, the Commission has authorized most or all of the Class A water utilities to establish Water Quality Memorandum Accounts, to record investments and expenses for remediating contamination incidents and replacing plant impaired by contamination, and Water Quality Litigation Memorandum Accounts, to record legal and other expenses incurred in pursuing contamination claims and defending against countersuits directed against them. These memorandum accounts have been and remain the appropriate places to record the receipt of government funds and the proceeds of litigation or settlements related to such contamination incidents.

⁵ See, *Bluefield Water Works & Improvement Co. v. Public Service Comm'n* (1923), 262 U.S. 679, 692-93; *Federal Power Comm'n v. Hope Natural Gas Co.* (1944), 320 U.S. 591, 603.

The memorandum account bears interest, and so will track appropriately the timing when proceeds are received and related cash expenditures are made. Once construction is complete, and the plant goes into operation, the investment amount will be credited to the Utility Plant account with a corresponding credit to CIAC reflecting the ratepayers' share of the invested proceeds. By this means, with the correct and concurrent timing of these accounting entries, the utility's rate base will be unaffected – neither increased nor diminished – by the addition of plant funded by a government loan or by the ratepayers' share of contamination proceeds. The memorandum account procedure, which has been employed for contamination cases since 1998 without any fundamental problems, should continue to be used.⁶

C. The Proposed Decision Would Adopt Misguided and Unfair Policies to Govern the Utilities' Response to Contamination Incidents and the Ratemaking Treatment of Proceeds From Contamination Claims.

The Proposed Decision observes that past decisions determining ratemaking treatment of proceeds from contamination claims have resulted in unique outcomes “based on the specific circumstances of the case.” The Proposed Decision effectively ignores these prior Commission decisions, asserting that none of them were “precedential.” PD, at 3. Indeed, the Proposed Decision reaches the extraordinary legal conclusion that past Commission decisions “may be consulted” only where they are “consistent with and complementary to this decision.” PD, at 53, 57 (Conclusion of Law 13).

CWA emphatically disagrees with this view of the Commission's jurisprudence. The fact situations the Commission has addressed in the past have differed from case to case, but they have provided an array of circumstances in which the Commission consistently has sought to reach fair results. Those cases offer guidance that should be helpful to the present rulemaking. The most direct lesson of these past decisions is that the Commission

⁶ Alternatively, depending on the facts, the utility could apply for a different ratemaking treatment of these funds.

should consider the very different facts and circumstances that produced differing results in these cases, and must not impose a set of rules and procedures so rigid as to bar achieving fair results consistent with the facts of each case.

There have, in fact, been only a handful of cases in which the Commission has reviewed and determined ratemaking treatment for the proceeds of contamination claims. The Commission's normal practice in these cases has been to examine the relative costs and risks borne by the utility and its ratepayers and to determine a fair assignment or allocation of all the proceeds in that context. The disposition of proceeds in each case has depended on its unique facts, but the Commission's evaluation of those facts consistently has aimed to encourage and recognize initiatives undertaken by the utility, while seeking to make ratepayers whole for costs that have been borne through rates due to loss of water supplies and/or the construction of replacement plant.

While continuing to encourage water utilities to pursue the polluters to recover costs of remediation and replacement plant, the Proposed Decision would deviate from the Commission's past practice in several major respects. First, the Proposed Decision strongly implies that the utilities have an obligation to litigate, without balancing the competing considerations that go into the decision to initiate litigation, such as: the time and expense of litigation, the expense of studies to identify responsible parties, the prospects for recovering damages from such parties, and the costs of remediation, treatment, and replacing plant and water supplies. These cases can be enormously difficult and expensive, and while the Commission should encourage recovery of damages from responsible parties, the decision to bring such an action must be wholly within the utility's business judgment..

Second, the Proposed Decision would deviate from the Commission's past practice by adopting a definition of "net proceeds" that deducts remediation or replacement costs "off the top" and only considers an allocation between the utility and its ratepayers if some portion of the proceeds are left after covering all those costs. Since there typically will be no

remaining proceeds to be allocated under this definition, the new definition of “net proceeds” would create a perverse disincentive for utilities to pursue litigation to recover costs from polluters.

Third, despite the Commission’s past ability to address ratemaking disposition of contamination proceeds in the utilities’ GRCs, the Proposed Decision would shift consideration of utilities’ risks associated with contamination issues to their cost of capital proceedings – a very unpromising forum for resolving such issues. Moreover, the Proposed Decision would impose a hurdle requiring a utility to demonstrate that it has assumed “unique and exceptional risk related to contamination litigation” prior to any consideration in the cost of capital context and possibly for any utility sharing in contamination proceeds.

Finally, the Proposed Decision would require that all contamination proceeds initially be recorded as CIAC, automatically reducing the utility’s rate base, with any portion of the proceeds assigned to cover the utility’s litigation costs or allocated to the utility as a share of “net proceeds” only being removed from CIAC at a later – and perhaps much later – date, to the utility’s financial detriment. The Proposed Decision’s unprecedented and inappropriate imposition of CIAC treatment for regulatory accounting was addressed in Section B, above, as it would unfairly skew the ratemaking effects not just for contamination proceeds but for the receipt of loan funds as well. The Proposed Decision’s inadequate reasons for treating all contamination proceeds as CIAC will be addressed further in Section C.4, below.

1. The Commission should continue to encourage water utilities to pursue recovery of contamination costs from responsible parties but should not extend the obligation to serve to include an obligation to sue.

The Proposed Decision quotes and appears to agree with TURN’s assertion that “dealing with water contamination remediation and damage recovery from third parties is a regular part of operating as a regulated water utility.” PD, at 18. CWA does not disagree with the Proposed Decision’s statement that “contamination events are among the contingencies which a contemporary water utility . . . needs to be prepared to confront and manage,” but is

troubled by the Proposed Decision's juxtaposition of such statements with references to contamination litigation. PD, at 48. The choice whether to pursue contamination litigation, and if so by what means, requires management to weigh many factors and should not be micromanaged by the Commission. Especially concerning is the apparent requirement that a utility show that it is assuming "unique and exception risk related to contamination litigation" in order to be considered for any of the cost recovery mechanisms the Proposed Decision would adopt. PD, at 49.

Water utilities sometimes are faced with contamination and threats of contamination, and most respond promptly in a variety of ways. One potential response is to seek to require responsible parties to conduct remediation or to pay the utility's costs of such remediation or replacement of water supplies or plant. What form that response should take depends on the facts and circumstances, including the degree of certainty as to the identity of the responsible party or parties, the resources of such party or parties both to pay for clean up and to resist the utility's demands, and the possible involvement of other parties either as allies or adversaries, and perhaps both. Litigation is one option. Negotiation is another. Recourse to a governmental funding source is a third. A prudent utility will explore all these and other options.

Whether litigation is a prudent choice depends on the facts and law available at the time, which may be subject to change, leading to a different set of choices. Prior Commission decisions have enabled utilities to pursue litigation where warranted, with the support of memorandum accounts for accrual of litigation and remediation costs and with the prospect for retaining a fair share of litigation proceeds as an inducement to take risks offering benefits both to the utility and its customers. Seeking "damage recovery from third parties" is part of management's responsibility, but is appropriate only when consideration of all the relevant facts justifies taking such an inherently risky course of action.

2. The Proposed Decision's definition of "net proceeds" subject to allocation between the utility and its ratepayers is inconsistent with prior Commission decisions and would lead to unfair and dysfunctional results.

CWA has noted above the Proposed Decision's acknowledgement that prior decisions in proceedings considering contamination proceeds have "resulted in a unique outcome based on the specific circumstances of each case," and has criticized the PD's claim that none of those decisions were precedential. PD, at 3. The Proposed Decision ignores common features of those decisions that **should** be considered precedential.⁷ In particular, in each of the five cases to which the Proposed Decision refers, the Commission included the assignment of proceeds to cover remediation or replacement plant as an **element** of its allocation of proceeds between ratepayers and the utility rather than as a **deduction** in calculating "net proceeds" to be allocated. The Proposed Decision ignores this important fact.

For example, the Proposed Decision, at 4, notes that in a 1993 Great Oaks Water Company case, the Commission split the contamination proceeds 50/50 between CIAC and rate base, but neglects to mention that this allocation was made without any prior assignment of any replacement plant investment to CIAC. In fact, the entire \$2.5 million in settlement proceeds that Great Oaks received were invested in replacement plant, of which only a 50% "ratepayer share" was recorded as CIAC.⁸

Likewise, the Proposed Decision, at 5, describes the more recent decisions addressing San Gabriel Valley Water Company's settlement with the County of San Bernardino as having allocated "net contamination proceeds" 67% to ratepayers and 33% to

⁷ This approach is consistent with the Commission's *Southern California Water Company* decision that the Proposed Decision cites. In that case, the Commission noted that it approached contamination proceeds cases on a "case-by-case basis" but went on to rely on "principles set forth in" *Great Oaks* and other prior cases. *Re Southern California Water Co.*, D.04-07-031, at 16. Those principles make sense and the Commission should continue to apply them.

⁸ See, *Re Great Oaks Water Co.*, D.93-04-061, 1993 Cal. PUC Lexis 238, at *15-22; *id.*, D.93-09-077, 1993 Cal. PUC Lexis 674, at *1-5. The Proposed Decision also fails to note that the Commission accepted an allocation of slightly more than 50% of the total settlement proceeds to the utility's President and her family trust, so that CIAC treatment of 50% of the utility's share related to less than 25% of the total proceeds. D.93-04-061, *supra*, at *14.

shareholders, with replacement plant recorded as CIAC. Again, the Proposed Decision fails to mention that CIAC regulatory accounting for the replacement plant was treated as part of the ratepayers' share – and **not** as a deduction in calculating the “net proceeds” subject to sharing.⁹

The Commission could choose not to follow its precedents in the present rulemaking decision, but that does not render the decisions “not precedential.” For the Commission to ignore its prior decisions that addressed an issue so central to the concerns of the present rulemaking would be arbitrary. For the Commission to depart from those precedents requires a reasoned explanation that is altogether lacking in the Proposed Decision.

Examining the Proposed Decision’s “net proceeds” rule in practical terms demonstrates that implementing the “net proceeds” rule can be expected to produce unfair and dysfunctional results. A simplified version of the Proposed Decision’s definition of “net proceeds” is gross proceeds received minus (1) reasonable legal expenses, (2) remediation costs, and (3) all other reasonable costs that directly result from the contamination. Only after all such costs have been determined and deducted, would there be any allowance for sharing the net proceeds between the utility and its ratepayers. PD, at 43. The Proposed Decision’s admission that “it is possible that no net proceeds will be left” to allocate (PD, at 44) greatly understates the likelihood of this result.

⁹ The recent *San Gabriel Valley Water Company* decisions disposed of revenue from several different sources, of which the relevant item was \$8,559,863 in proceeds from settling a contamination claim against the County of San Bernardino, to which an additional \$26,114 of proceeds were added and from which \$208,554 in previously unreimbursed legal costs were deducted, leaving \$8,337,423 of “net proceeds,” which the Commission chose to allocate between shareholders and ratepayers by a 33/67 split. *Re San Gabriel Valley Water Co. (Fontana Water Co. Division)*, D.07-04-046, at 93-99, 124-25 (Findings of Fact 75-79), corrected by D.08-04-005, at 5. The utility’s previous \$2,618,291 investment of some of the proceeds in replacement plant, which was treated as CIAC, was included in the ratepayers’ share. This confirms that the Commission’s analysis determined the amount of “net proceeds” **before** assigning any of those proceeds to cover remediation or replacement costs. See, D.07-04-046, at 93, 99-100.

In practical terms, “nothing left to allocate” is the most likely result. When a water utility pursues a polluter, and the utility goes to court, the heart of the legal action is a claim for damages. When the case is done, if the utility is successful, it wins an award of damages to the utility’s property. But damages are just another word for costs, and costs incurred and to be incurred are the most likely measure of damages. So, if all legal expenses, all remediation costs, and all other reasonable costs must be deducted from a damages award, there very likely will be no “net proceeds” to allocate.¹⁰

The effect of the Proposed Decision’s “net proceeds” rule will certainly be to create a set of perverse incentives for utility management. When facing, for example, a contamination incident presenting a cost of \$2.0 million for remediation and other direct costs, the utility will be financially indifferent to proceeds (after recovery of its legal expenses) ranging from zero to \$2.0 million and will only have a financial inducement to litigate to the extent it can secure proceeds (after recovering its legal expenses) exceeding \$2.0 million – the amount of its damages. Thus, the utility’s financial incentives will be either to spend no more than a nominal amount to pursue the polluter (and thereby limit its risk of not recovering legal expenses) or to pursue a highly aggressive strategy seeking an award of damages in excess of its actual costs but with a meager chance of success. The Proposed Decision would leave no incentive for a utility to pursue the preferable result – a hard-negotiated settlement with the polluter that returns a high proportion of the utility’s costs without running up enormous legal bills.

In short, the Commission needs to provide an affirmative incentive to the utility for effective pursuit of contamination claims. Prior Commission decisions in the Great Oaks,

¹⁰ The Proposed Decision notes that a plaintiff’s expense of outside counsel fees in contamination law suits “commonly is contingent upon there being a successful outcome in the litigation.” PD, at 48 n. 94. In such cases taken to trial, contingency counsel’s fee commonly is 40% of the damages award, which simply confirms the likelihood that litigation proceeds will leave no “net proceeds,” by the PD’s definition, for sharing between the utility and its ratepayers.

Bakman,¹¹ Southern California Water, and San Gabriel cases, for example, have provided the necessary incentives, by their consideration of the fair allocation of proceeds prior to assigning the bulk (or all) of the proceeds to cover remediation costs. Adoption of clearer rules and procedures in the present rulemaking will eliminate some of the uncertainties attendant on past cases. But recognizing the fact-specific review necessary in all contamination proceeds cases and applying a fairness evaluation to allocate a larger pool of “net proceeds” will provide utilities proper incentives to pursue polluters aggressively while settling successful cases prudently and well – to the benefit of the utility and ratepayers alike.

3. The Proposed Decision offers no more than an illusory opportunity for utilities to be compensated for pursuing risky contamination claims.

Another respect in which the Proposed Decision departs from the Commission’s past practice is in offering the water utilities’ cost of capital proceedings as a forum to consider a showing of “unique and exceptional risk related to contamination litigation” as possible justification for higher rates of return.¹² The Proposed Decision would impose the “burden of a strong showing that the risk is unique and exceptional,” and observes that such burden was not met in the 2008 cost of capital proceedings for the multi-district companies, where the Commission stated that the “risks of water quality litigation are not unique” to the applicants in those proceedings.¹³

¹¹ See generally, *Re Bakman Water Co.*, D.03-10-002.

¹² See, PD, at 49. The Proposed Decision first presents this “unique and exceptional risk” standard as applicable “in connection with the cost recovery mechanisms discussed below.” *Id.* The “cost recovery mechanisms” thereafter discussed include not only cost of capital proceedings but also GRCs and memorandum accounts. The “unique and exceptional risk” standard sets a troublingly high hurdle for consideration of company-specific risk factors in a cost of capital proceeding. Extending that standard to issues of cost recovery in a GRC or for permission to amortize a memorandum account is totally inappropriate. The wording of the Proposed Decision’s relevant finding of fact and conclusion of law suggests that the intention is to impose this unprecedented “unique risk” standard only for purposes of cost of capital reviews. If the Commission insists on retaining this inappropriately difficult standard, it should at least modify the text at the top of page 49 to limit its application to cost of capital reviews. Compare, PD, at 49, with PD, at 54-55 (Finding of Fact 4 and Conclusion of Law 7).

¹³ PD, at 49, quoting, *Re California Water Service Co., et al.*, D.09-05-019, at 28-29.

Nor does the prospect for recognition of a risk premium for water quality litigation risk exposure appear any more promising in the current 2009 cost of capital proceeding for another five, generally smaller, Class A water companies. The recently circulated proposed decision in that proceeding (“Cost of Capital PD”) would disallow all proposals for company-specific risk premiums, including San Gabriel Valley Water Company’s request for a risk premium that would recognize the contamination risks presented to all of San Gabriel’s sources of water supply as well as the litigation risks presented by San Gabriel’s pursuit of polluters and related litigation.¹⁴ The Cost of Capital PD would dismiss San Gabriel’s evidence of risk related to water contamination incidents and litigation as “unsupported rhetoric.”¹⁵ Given this inappropriate and completely dismissive approach, the Cost of Capital proceeding is a virtual non-starter for consideration of “unique and exceptional” risk.

Despite the Commission’s past success in addressing ratemaking disposition of contamination proceeds in the utilities’ GRCs, the Proposed Decision would shift consideration of utilities’ risks associated with contamination issues to their cost of capital proceedings – a very unpromising forum for such issues. As noted above, given the past and current decisions in the Commission’s recent cost of capital proceedings, as well as the decidedly unsupportive commentary in the present Proposed Decision, the deck appears stacked against any utility being able to meet the “unique and extraordinary risk” standard the Proposed Decision would set for gaining any benefit in the cost of capital proceeding.

Not only is the cost of capital proceeding an unpromising forum for a utility to seek recognition of contamination litigation risks, it is also an inappropriate forum to the extent that

¹⁴ *Re San Jose Water Co., et al.*, A.09-05-001, *et al.*, Proposed Decision, issued August 3, 2010, at 57-58.

¹⁵ *Id.* at 58. While the Cost of Capital PD considers San Gabriel’s evidence relating to a company-specific risk to be “unsupported rhetoric,” that evidence includes 40 pages of detailed testimony by San Gabriel’s CEO, Michael Whitehead, to which neither DRA nor any other adverse party offered either rebuttal or cross-examination. One regulatory aspect of that risk is indicated by the fact that San Gabriel still awaits reimbursement of contamination litigation costs that have been lodged in a memorandum account since 1998. See, Resolution W-4904, issued March 26, 1994 (authorizing San Gabriel and other water utilities to establish water contamination litigation memorandum accounts).

cost of capital is determined on a company-wide basis while contamination costs and proceeds may be specific to a single service district. If rates are being set on a district-specific basis, and contamination affects a single district, then ratemaking accounting for contamination proceeds should be done on a district-specific basis as well – not in a company-wide cost of capital proceeding.

4. The Proposed Decision’s Imposition of CIAC Treatment for All Proceeds of Contamination Claims Is Unjustified, Inconsistent With Proper Regulatory Accounting Rules, and Grossly Prejudicial and Unfair to Water Utilities.

The Proposed Decision concludes that CIAC treatment is appropriate for damage awards and settlement or insurance proceeds used to fund replacement plant.¹⁶ This conclusion is based on a single consideration – that CIAC treatment “results in less cost to the ratepayer.” PD, at 40. The Proposed Decision goes on to assert that “[t]reating capital infusion from sources other than investors as CIAC is standard practice under the Uniform System of Accounts [USOA],” and that there is no persuasive basis for “departing from CIAC treatment” in connection with damage proceeds. *Id.* The first of these assertions is insufficient, by its failure to consider the utility’s right to a fair opportunity to earn a reasonable rate of return; the second is false; and the third is, therefore, based on a false premise.

The fact that CIAC treatment is not costly to ratepayers is obvious – CIAC treatment denies inclusion in rate base of utility plant, thereby giving customers the benefits of that plant’s use without having to pay for it. But to use this fact as the basis for concluding that CIAC treatment is appropriate completely preempts – and avoids – the fairness evaluation that the Commission historically has applied on a case-by-case basis, in virtually all prior cases addressing damage proceeds, to determine what allocation of damage proceeds is fair to **both** the utility and its ratepayers.

¹⁶ PD, at 40. The PD refers to funding from all these sources as “damage awards” (*id.* at 39 n. 86), and CWA will do the same in these comments except where specific reference to the sources of such awards is appropriate.

The Proposed Decision's second point – that treating “capital infusion from sources other than investors as CIAC” is “standard practice under the Uniform System of Accounts” is simply false. If it were true, the Commission, the water utilities, and consumer representatives would not have spent the past 18 months puzzling their way through the complex factual, legal, and equitable considerations relevant to deciding how damage proceeds should be allocated. The Proposed Decision quotes the relevant provision of the USOA – which refers to “donations or contributions in cash, services, or property . . . for construction purposes.” PD, at 40 n. 88. If the Proposed Decision limited its “CIAC mandate” to contributions made “for construction purposes,” its contention would be arguable. But the broad assertion that it is “standard” regulatory accounting practice to treat “capital infusion from sources other than investors as CIAC” is unsupported. Therefore, it is plainly unreasonable for the Proposed Decision to characterize the central issue presented in this proceeding as whether there is a “persuasive basis” for “departing from CIAC treatment in connection with proceeds from damage awards.” PD, at 40.

What this crucial paragraph at the top of page 40 of the Proposed Decision apparently seeks to accomplish is a prejudicial imposition of a burden of proof on the water utilities to justify a “departure” from a regulatory accounting practice that is neither “standard” nor consistent with past Commission decisions. The next paragraph on page 40 is not much better. It begins by recognizing CWA's contention that damage proceeds become the utility's property upon receipt, but then attributes to CWA an assertion that such proceeds “lose any character of being third-party contributions before investments thereafter are made in new plant (to replace contaminated plant), or expenditures are made in remediation.” *Id.* at 40. CWA made no assertion that damage proceeds lose “any character of being third-party contributions” when they become utility property. CWA simply made the points that “funds invested in . . . utility plant are the utility's funds, regardless of the source from which they were derived” and that, “if rate base treatment is going to be denied, the burden should rest on

DRA or the Commission itself to justify a denial of normal rate treatment, which, in essence, would constitute a taking.”¹⁷

The Proposed Decision summarily rejects “any suggestion that the denial of ratebasing treatment for damage proceeds” would constitute a taking, asserting that the status of damage awards as utility property “in no way removes those proceeds from the ambit of reasonable and prudent Commission regulation.” PD, at 40-41. This misses the point of CWA’s argument. Of course damage awards are within “the ambit of reasonable and prudent Commission regulation.” CWA would never deny that. But surely the Commission will agree that denying rate base treatment to an investment of utility property in utility plant (which is thereby dedicated to public utility service) constitutes a taking.

Such a taking would be justified if, for example, the utility property had been contributed by a land developer. It might also be justified if the utility property were derived from damage proceeds specifically intended to pay for replacement plant. All that CWA contended in the comments referenced by the Proposed Decision was that there should be a burden of proof to justify denying rate base treatment of such investments in utility plant. As CWA stated,

If the reason for denying rate base treatment is that the funds invested were “contamination proceeds,” then the challenge should address the particular facts and circumstances, including the utility’s initiative to pursue recovery of the proceeds and the relevant costs and risks borne by the utility and its ratepayers in connection with the contamination incident, its remediation, and the associated litigation or settlement efforts. There certainly should *not* be a presumption, as DRA would have it, that a plant investment made with contamination proceeds should not be rate-based.¹⁸

CWA stands by that assertion, which is the basic premise for CWA’s position that the Commission should and must engage in a case-by-case analysis to determine the fair and appropriate allocation of proceeds from contamination claims between a utility and its

¹⁷ CWA Reply Comments on Workshop Report, filed February 2, 2010, at 2-3.

¹⁸ CWA Reply Comments, *supra*, at 3 (emphasis in original).

ratepayers – and should not impose a misguided requirement that all such proceeds must be recorded as CIAC.

D. There Is No Basis in the Evidentiary Record for the Proposed Decision's Adopting Many of the Complex and Unexamined Regulatory Accounting Rules for Funds Derived From Government Loans and Contamination Claims Set Forth in Appendices B and C to the Proposed Decision.

Attached to the Proposed Decision is a series of three appendices described as “Rules for the Accounting” of government contamination grant funds, government contamination loan funds, and “contamination proceeds” from damage awards, settlements, government orders or insurance. Each of these three sets of accounting rules is modeled very closely on the “Rules for the Accounting of State Grant Funds” that were adopted by and attached as an appendix to D.06-03-015, which set rules to govern the receipt and use of state grant funds received by water utilities.

As noted in Section A, above, and in the Proposed Decision, the parties to this rulemaking proceeding agreed that it was appropriate to extend the procedures and rules adopted in D.06-03-015 to all government grants. PD, at 10. Appendix A to the Proposed Decision accomplishes this purpose and CWA has no objection to the Proposed Decision’s adoption of the rules in Appendix A.

Appendices B and C would adopt rules very similar to those specified in Appendix A, but applicable to funds derived from government loans and contamination claims, respectively. There is no basis in the evidentiary record for adopting many of the rules set forth in Appendices B and C.

For example, Rule 4 of Appendix B provides that “[n]o gain shall be recovered by utilities on the disposition of government loan-funded plant repaid through ratepayer surcharges.” Rule 5 requires that “[c]apital charges for this loan shall be offset by a quantity surcharge which last as long as the loan,” subject to “special accounting requirements and a refund condition” that are “necessary to ensure that there are no unintended windfalls to

private utility owners.” Rule 10 would prohibit utilities, their affiliates, or their shareholders from engineering or installing facilities for government loan-funded projects, Rules 11 and 12 would mandate competitive bidding on projects in which loan proceeds are invested, and Rules 16, 17, 18, and 21 would impose very complex and restrictive procedures and accounting requirements for sales of assets funded by government loans or of utility systems including such assets.

Similar rules are included in Appendix C, governing proceeds from contamination claims. Rule 2 of Appendix C provides that “[n]o gain shall be recovered by utilities on the disposition of plant funded by Water Contamination proceeds.” Rule 7 requires deduction of depreciation expenses for income tax purposes and flow-through to customers of any benefits derived from the tax deduction “in the most direct fashion possible.”¹⁹ Rules 10, 11, 12, and 15 of Appendix C, governing sales of assets funded by contamination proceeds or of utility systems including such assets, exactly track the corresponding rules in Appendix B, noted above.

Some or all of the rules referenced above may be appropriate. CWA cannot say at this time. More importantly, neither can the Commission. That is because:

- None of these rules were proposed in the Order Instituting Rulemaking that launched this proceeding.
- None of these rules were proposed in the Assigned Commissioner’s Ruling and Scoping Memo issued August 21, 2009
- None of these rules were proposed during the pendency of the workshop process in which many parties diligently participated.

¹⁹ This requirement is problematic, considering that depreciation is not allowed for tax purposes with respect to plant accounted for as CIAC or as to which the utility has elected to defer the taxable gain pursuant to Internal Revenue Code §1033 (a)(2), in which case the tax basis of the new utility plant becomes the tax basis of the plant destroyed by contamination. Under any circumstances, accelerated tax depreciation must be normalized and would increase deferred taxes, but this tax benefit cannot be flowed through to ratepayers. See, Internal Revenue Code §168(f)(2).

- None of these rules were proposed in the workshop report, on which many parties diligently commented.

The only proposal for extending the application of the D.06-03-015 rules for state government grant-funded plant, on which the Appendix B and Appendix C rules were modeled, was the proposal to extend those rules to plant funded by local and federal government grants. That is what the Rules in Appendix A would do. Similar, highly complex and limiting rules should not be applied to plant funded by government loans or contamination proceeds without the benefit of focused consideration of specific, proposed rules by all interested parties on the record. In the meantime, without such a full record, the rules specified in Appendices B and C to the Proposed Decision should not be adopted.

E. The Proposed Decision Errs in Relying on TURN's Flawed Cost Comparison of Alternative Methods for Recovering Costs of Government Loans, Which Obscures the Fact That Surcharging Is Not A "Better Deal" For Ratepayers.

This section of CWA's comments addresses the May 28, 2010 Reply Comments of the Utility Reform Network to the Administrative Law Judge's Ruling Inviting Comments and Rescheduling Proposed Decision ("TURN's Reply Comments"). The reason for CWA's focus on TURN's Reply Comments is that the Proposed Decision specifically refers to "DRA's and TURN's comparative analysis," concluding that such analysis demonstrates "that CIAC treatment results in less cost to ratepayers than does ratebasing." PD, at 41. This is the first opportunity CWA has had to address TURN's Reply Comments, and it is critical to do so here.

The conclusions in TURN's Reply Comments are based on a financial analysis by TURN's consultant, JBS Energy. TURN attempts to buttress earlier conclusions of DRA,²⁰ in TURN's words, that "surcharging rather than adding to rate base is a better deal for ratepayers." TURN Reply Comments, at 5. TURN attempts to unring the bell, correcting errors that CWA had pointed out in DRA's July 1, 2009 Reply Comments. TURN concurs,

²⁰ Response of DRA, July 1, 2009.

albeit reluctantly, with CWA's assessment that DRA had used the wrong depreciation rate in its calculations, and had also failed to consider deferred income taxes. TURN asserts that "the purported errors in DRA's approach would seem easy to fix.," and so tries to fix them. TURN Reply Comments, at 2. But TURN's fixes are inaccurate as well.

On August 24, 2010, in response to a data request, CWA obtained the financial model used by TURN to support its conclusions. In reviewing that financial model, CWA found that while TURN corrected DRA's earlier errors, TURN's model had other errors at least as grievous as DRA's.

In disaggregating cash flow differences between rate basing and surcharging, TURN begins with a welcome dismissal. TURN acknowledges that "It is not clear whether property taxes will be charged or not on plant when the costs are recovered through a surcharge." TURN Reply Comments, at 4. CWA agrees that this is an issue for another day and in these comments CWA also puts the property tax issue aside.²¹

TURN goes on, however, to conclude that "[b]eyond the property tax question, there is another \$26,110 in extra costs . . . from rate basing over the life of the project" (in its analysis TURN had assumed a \$1 million interest-free governmental loan-financed project). TURN makes serious errors in coming to that conclusion.

- TURN rationalizes the alleged \$26,110 benefit of surcharging by concluding that "[t]hese costs are largely caused by the fact that the plant is depreciated over 35 years but its low-cost financing runs out after 20 years. The surcharge on the other hand, ties the life of the financing to the amortization of the asset, so there isn't a tail of return to be paid for another 15 years. . . . Essentially by putting the plant in rate base, the utility can make the project cheaper on a present value

²¹ Like CWA and TURN, the Proposed Decision should also should refrain from reaching conclusions about whether CIAC-funded property is subject to property tax. The Proposed Decision's contrary statement should be deleted: "Although costs may differ from one proceed type to another in the individual instance, the analysis is applicable as well to damage award funding of replacement plant because of the common property tax savings associated with CIAC." PD, at 41.

basis over the first 20 years but at the expense of a very large payment in the last 15 years.” *Id. at 4, 5.* The “tail of return to be paid over another 15 years” that TURN refers to is fully accounted for by lower returns in earlier years. There is no “\$26,110 benefit.” Customers do not get a “better deal” or a “worse deal.” The ratemaking process ensures that customers pay only the utility’s return on the capital it has invested, no more, no less. More to the point, this “tail of return” is a fact of life for all utilities, regardless of funding source, whenever the term of a loan is shorter than the life of the related plant, which is the situation for most utilities. It does not cause a “better deal” or a “worse deal” for customers.

- TURN uses the wrong discount rate to calculate the NPV of rate basing cash flows. TURN erroneously uses the utility’s “return” of 8.28% for all years without considering the impact of the assumed \$1 million interest-free loan. TURN’s financial model shows, as one would expect, returns differing in each of the 20 years of the government loan. TURN should have used those varying returns in calculating net present value.
- In evaluating rate basing versus surcharging protocols, TURN erroneously concludes that “rate base treatment of the government loan-funded \$1 million has a present value of cost of \$585,000 at an 8.28% discount rate (a relatively low figure because we are assuming a zero interest loan).” The proper discount rate for a zero interest loan is zero; *i.e.*, the present value of a zero interest \$1 million loan is \$1 million.

The complexity of the DRA and TURN financial models on which the Proposed Decision relies obfuscates rather than reveals what is at the heart of the governmental loan rate basing versus surcharging alternative. That is, setting aside the unsettled issue of property taxes, there is ***no difference*** between the net present value (“NPV”) of cash flows resulting from rate basing versus surcharging. Over the life of a construction project, the

sum of the NPV of cash flows with rate basing is identical to that with surcharging. This is an inherent aspect of cost of service rate setting. Therefore, the Proposed Decision is mistaken in saying, in the context of government loan accounting, that “. . . CIAC treatment is appropriate for this class of proceeds because it results in less cost to the ratepayer.” PD, at 40. So long as NPV is calculated using authorized returns that properly consider the cost of government loans, then the respective NPVs of rate basing versus surcharging should be identical. For ratepayers, over the life of governmental loan-financed property, it is a case of “no harm, no foul.”

The surcharging approach has been commonly used for the smaller Class C and D utilities for over 30 years, since the *Quincy* decision, D.88973, was issued in 1978. However, a perverse aspect of the surcharging approach is that it does not provide for the level recovery of capital costs over the life of capital projects, commonly known as straight line depreciation, which is used by almost all utilities. Rather, surcharging causes capital recovery to be skewed toward the end of the life of plant, much like payment of principal on a home mortgage. For large government loan-funded projects this could bring about serious concerns by investors who see government debt like any other debt, as nothing more than additional financial leverage, except with surcharging there would be little cash flow generated in early years.

In short, the DRA and TURN financial models on which the Proposed Decision relies to opt for the surcharging method to account for proceeds of government loans are flawed and replete with errors. While the Proposed Decision may find other justifications for the surcharging approach, the complexity of accounting separately for plant constructed with funding from such loans, especially by the rules set forth in Appendix B to the Proposed Decision, suggests that any marginal value of the surcharging approach is simply not worth the administrative complexity and expense.

F. If the Commission Adopts Rules Unprecedented in Their Departure From Historical Practice, Those Rules Should Only Be Applied Prospectively

Contamination problems and efforts to address, remediate, and settle legal responsibility for them tend to be of very long duration. In some cases, water utilities have been pursuing contamination claims for many years and have not yet brought them to resolution. Their efforts have been premised on their legal rights and obligations and also on the Commission's encouragement of such efforts through the allowance of memorandum accounts and the fair allocation of settlement proceeds.

If the Commission were to adopt an unprecedented set of rules, departing from the Commission's historical practice and inconsistent with the Commission's past decisions, which is an apt description of the rules presented by the Proposed Decision, then it would be wholly inappropriate to impose those harsh new rules on the proceeds derived from long-pending utility initiatives and claims. Instead, such unprecedented new rules should apply only prospectively, to the proceeds that may be derived from utility initiatives and claims undertaken after the effective date of the Commission's decision in this matter.

G. Conclusion

CWA respectfully urges the Commission to revise the Proposed Decision to provide rules and procedures to account for water utilities' receipt of proceeds from contamination claims, as well as from government loans, that do not destroy the incentive of utilities' owners and managers to apply their best managerial judgment to seek and obtain such funds for the benefit of their companies and their ratepayers. A reasonable balance in

the assignment and allocation of such funds, determined on the basis of a close examination of the facts of each case, is essential for the achievement of that goal now and in the future.

Respectfully submitted,

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September 9, 2010

APPENDIX

PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW

FINDINGS OF FACT

...

4. If a utility can show that it ~~is assuming a unique and exceptional~~faces greater than normal risk related to contamination of its water supplies and/or related litigation, the Commission may take ~~that those~~ circumstances into account in the water utilities' cost of capital proceeding for ~~e~~Class A water utilities and in the GRCs for ~~the~~ Class B, C and D water utilities.

...

8. Memorandum accounts authorized by the Commission provide appropriate means for water utilities to track costs for remediating contamination of their water supplies an, constructing new and replacement plant in response to contamination, their for pursuing contamination claims by litigation and settlement efforts, and their receipt of proceeds from such contamination claims, subject to the accrual of interest, until the Commission determines the appropriate assignment or allocation of such costs and proceeds for ratemaking purposes.

9. The Commission has encouraged water utilities to pursue contamination claims against potentially responsible parties by authorizing the use of memorandum accounts to record relevant costs for eventual recovery either in rates or from the proceeds from contamination claims and by allocating fair portions of the proceeds from such claims to the utilities.

CONCLUSIONS OF LAW

...

4. The extent to which ~~N~~new plant (replacing contaminated plant) funded by contamination proceeds should be given CIAC accounting treatment should be determined based on a case-specific evaluation of the factors to inform the allocation of net proceeds set forth in Appendix D to this decision~~because it results in less cost to the ratepayer than does ratebasing.~~

5. New plant funded by government loans should be ~~treated as CIAC rather than being~~ included in rate base and earning at the utility's rate of return should be calculated based on a cost of debt that includes an appropriate weighting of the cost of such government loans.

6. The extent to which ~~N~~new plant funded by proceeds from damage awards, settlements, government order or insurance should be treated as CIAC rather than being included in rate base and earning a rate of return should be determined based on a case-specific evaluation of the factors to inform the allocation of net proceeds set forth in Appendix D to this decision.

7. Where a utility can show that ~~it is assuming a unique and exceptional~~faces greater than normal risk related to contamination of its water supplies and/or related litigation, the Commission may take those circumstances into account in setting the company's rate of return in the cost of capital proceedings for ~~class~~Class A water utilities and in the GRCs for ~~the~~Class B, C and D water utilities.

8. . . . When contamination proceeds are initially received from the funding source, the water utility should place those funds in the appropriate ~~dedicated 265-sub~~memorandum account.

9. The following definition of "net proceeds" should be adopted:

Gross proceeds received minus all ~~(1)~~(1) reasonable legal expenses related to pursuit of contamination claims by litigation or settlement efforts, ~~(2)~~(2) costs of remedying plants, facilities, and resources to bring the water supply to a safe and reliable condition in accordance with General Order 103-A standards, and ~~(3)~~(3) all other reasonable cost and expenses that are the direct result and would not have had to be incurred in the absence of such contamination,

~~including all relevant costs already recovered from ratepayers (for which they have been, or will be, repaid or credited).~~

...

13. Past decisions of the Commission need not have controlling effect but ~~where consistent with and complementary to this decision~~ may be consulted for guidance.

14. The rules described in the foregoing Opinion and set forth in Appendixes ~~A, B and C~~ should be adopted.

...

16. If the Commission adopts rules unprecedented in their departure from historical practice, those rules should only be applied prospectively.

CERTIFICATE OF SERVICE

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

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Executed this 10th day of September, 2010 in San Francisco, California.

/S/ JEANNIE WONG

Jeannie Wong

CALIFORNIA PUBLIC UTILITIES COMMISSION

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