STATE OF CALIFORNIA ARNOLD SCHWARZENEGGER, *Governor*

PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298

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October 6, 2006

Agenda ID #6077
Ratesetting

TO PARTIES OF RECORD IN A.05-02-012, A.05-02-013

This is the proposed decision of Administrative Law Judge (ALJ) Walwyn. It will not appear on the Commission's agenda for at least 30 days after the date it is mailed. The Commission may act then, or it may postpone action until later.

When the Commission acts on the proposed decision, it may adopt all or part of it as written, amend or modify it, or set it aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties to the proceeding may file comments on the proposed decision as provided in Article 14 of the Commission's **Rules of Practice and Procedure** (Rules) accessible on the Commission's website at www.cpuc.ca.gov. Pursuant to Rule 14.3 opening comments shall not exceed 15 pages.

Comments must be filed either electronically pursuant to Resolution ALJ-188 or with the Commission's Docket Office. Comments should be served on parties to this proceeding in accordance with Rules 1.9 and 1.10. Electronic copies of comments should be sent to ALJ Walwyn at cmw@cpuc.ca.gov. All parties must serve hard copies on the ALJ and the Assigned Commissioner, and for that purpose I suggest hand delivery, overnight mail or other expeditious method of service. The current service list for this proceeding is available on the Commission's website, www.cpuc.ca.gov.

/s/ ANGELA K. MINKIN
Angela K. Minkin, Chief
Administrative Law Judge

ANG:jt2

Attachment

Decision _____

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of California-American Water Company (U 210 W) for an order authorizing it to increase its rates for water service in its Monterey District to increase revenues by $9,456,100 or 32.88% in the year 2006; $1,894,100 or 4.95% in the year 2007; and $1,574,600 or 3.92% in the year 2008; and for an order authorizing sixteen Special Requests with revenue requirements of $3,815,900 in the year 2006, $5,622,300 in the year 2007, and $8,720,500 in the year 2008; the total increase in rates for water service combined with the sixteen Special Requests could increase revenues by $13,272,000 or 46.16% in the year 2006; $7,516,400 or 17.86% in the year 2007; and $10,295,100 or 20.73% in the year 2008.	Application 05-02-012 (Filed February 16, 2005)
In the Matter of the Application of California-American Water Company (U 210 W) for Authorization to Increase its Rates for Water Service in its Felton District to increase revenues by $796,400 or 105.2% in the year 2006; $53,600 or 3.44% in the year 2007; and $16,600 or 1.03% in the year 2008; and for an order authorizing two Special Requests.	Application 05-02-013 (Filed February 16, 2005)

OPINION RESOLVING GENERAL RATE CASES

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OPINION RESOLVING GENERAL RATE CASE

I. Summary

This decision resolves the general rate case (GRC) applications of California-American Water Company (Cal-Am) for the Monterey and Felton districts and adopts rates for test years 2006 and 2007 and attrition year 2008. Pursuant to Decision (D.) 05-12-024, the two districts have been on interim rates since January 1, 2006. With our adoption of final rates today, these interim rates will be trued-up and a surcharge amount established to collect the balance over the coming 12 months.

Partial settlements for the Monterey and Felton districts and corporate General Office (GO) rate case were filed by Cal-Am and the Division of Ratepayer Advocates (DRA). The settlements were contested by the Monterey Peninsula Water Management District (MPWMD) and the Felton Friends of Locally Owned Water (Felton FLOW). We approve both the Monterey and GO settlements but not the Felton settlement. We also find for both Monterey and Felton that there are several areas, particularly regarding tracking and monitoring customer service and justification for expense items, where further information must be collected and analyzed prior to the next GRC.

For the Felton proposed settlement, we do not find reasonable the amount proposed for the Highway 9 project and general and administrative expenses; we also adopt an adjustment for lobbying activities by employees.

For Monterey district issues outside the proposed settlement, we allow recovery of Carmel River Dam expenses over a four-year period. We move all San Clemente Dam retrofit costs to a memorandum account and provide for carrying costs that reflect Cal-Am's long-term debt and equity costs for this account. We adopt memorandum accounts for compliance costs but not for fines, and we retain the existing rate design structure.

For Felton district issues outside the proposed settlement, we retain the existing rate design, adopt DRA's proposal for a low-income program, and adopt a rate increase cap of 50% for the next 12 months.[1] We recognize that a formal process for public acquisition of the district has started with the passage in July 2006 of Measure W. We commit to vigilantly overseeing future plant investment in the Felton district as the acquisition goes forward and we encourage Cal-Am and Santa Cruz County to use our alternative dispute resolution program, either as a substitute for or in tandem with court litigation.

II. Background

The Commission regulates water service provided by Cal-Am in its nine California districts pursuant to Article XII of the California constitution and the Public Utilities Code.[2] The Monterey and Felton districts are approximately 50 miles apart; Monterey is located on the coast south of Santa Cruz and Felton is located in the mountains east of Santa Cruz.

There are approximately 39,000 connections in the Monterey district, and of these about 37,600 are "main system" customers who rely on the Carmel River system and Seaside Basin as their primary water sources. The district and the entire Monterey peninsula have long-term water supply problems, which became immediate and pressing when the State Water Resources Control Board (SWRCB) issued Order No. WR 95-10 (Order 95-10) on July 6, 1995. In this order, the SWRCB (1) determined that Cal-Am did not have legal right to about 10,730

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[1] The cap will be calculated to include the rate increase and balancing account amortization authorized in D.05-09-044.

[2] The Commission regulates all prices and terms of service of all investor-owned water utilities operating in California.

acre-feet annually of the water it was diverting from the Carmel River aquifer (about 69% of the water Cal-Am then supplied to its customers), (2) set a production limit for water that could be pumped, (3) required Cal-Am to implement environmental mitigation measures, and (4) required Cal-Am to actively pursue a replacement source of water.[3] All but two of the 16 special requests in Cal-Am's Monterey application relate to its water supply issues.

Felton is a small, self-sufficient water district of approximately 1,300 customers located in a redwood rainforest. All water for the district is surface water taken from three springs. Water quality is high and the system has one relatively new treatment plant, brought online in 1997 to meet the requirements of the Surface Water Treatment Rule.[4] The Felton district was acquired by Cal-Am in 2001 as part of its purchase of the water utility assets of Citizens Utilities Company of California (Citizens).

On July 26, 2005, a special election was held in Felton on Measure W, an $11 million bond proposal to acquire the water system from Cal-Am through Community Facilities District No. 1. With 64% of the registered voters casting ballots, Measure W passed 74.8% to 25.2%, and Santa Cruz County has begun negotiations with Cal-Am.[5]

Cal-Am's GRC applications for the Monterey and Felton districts were made pursuant to the rate case requirements for Class A water utilities in Pub. Util. Code § 455.2 (§ 455.2) and the implementing rate case plan (RCP) we

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[3] Order 95-10 is Exhibit 72.

[4] This plant was funded with California Safe Drinking Water Bond Act loans and is being repaid through a special surcharge.

[5] Santa Cruz County Clerk's election statement is at Exhibit 24.

adopted in D.04-06-018.[6] Each Class A water utility must file a GRC application every three years. The application must have specified documentation and supporting material. For the 2005 transitional first year filings under the RCP, we adopted an expedited schedule, allowing a February 1 rather than January 1 filing date while retaining a projected completion date by the end of the calendar year; Cal-Am's Monterey and Felton applications are part of the February 2005 expedited filing schedule.

On February 16, 2005, Cal-Am filed these applications but did not serve the parties on its service list. On February 28, 2005, Cal-Am filed amended applications and served all parties. Notices of the amended applications appeared in the Commission's Daily Calendar on March 3, 2005, with protests due by April 4, 2005.[7]

Protests to Cal-Am's Monterey application were filed by the Independent Reclaimed Water Users Group (IRWUG), Monterey Commercial Property Owners Association (MCPOA), Monterey County Water Resources Agency (MCWRA), MPWMD, the Commission's DRA, Pajaro/Sunny Mesa Community Services District (PSMCSD), Public Citizen, and the United States Department of Defense and other affected Federal Executive Agencies (DOD).[8] Protests to

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[6] Class A utilities are investor owned water utilities with greater than 10,000 service connections. All Section (§) references are to the Public Utilities Code.

[7] On March 21, 2005, an administrative law judge (ALJ) ruling memorialized the filing delays, confirmed the protest date, directed Cal-Am to file a revised procedural schedule by March 25, 2005, set a pre-hearing conference (PHC) for April 5, 2005, and gave interested parties until March 30 to file PHC statements addressing the revised procedural schedule and the scope of issues in the applications.

[8] In 1978, the legislature created the MPWMD to provide a regional approach to managing and augmenting ground and surface water resources.

Cal-Am's Felton application were timely filed by Felton FLOW and DRA.[9] PHC statements were filed by Cal-Am, the County of Monterey and MCWRA, DOD, and DRA.[10]

At the April 5 PHC, the scope of issues was discussed, a preliminary expedited procedural schedule was set and public participation hearings (PPHs) were scheduled for both Monterey and Felton. Due to problems with the accuracy of numbers in Cal-Am's applications and public notices, the ALJ directed Cal-Am to quickly perform an independent verification of both applications. On April 29, Cal-Am filed its verification, with corrected pages. Cal-Am's cover letter characterizes the corrections as being of a minor dollar amount and an attached 11-page matrix details the corrections.

PPHs were held at 2 p.m. and 7 p.m. on May 12, 2005 in Monterey and on May 13, 2005 in Felton. All sessions were well attended and transcribed, and many of the questions raised were to be responded to by Cal-Am in writing, with copies to the Commission and the service list.

On May 31, 2005, the Assigned Commissioner and ALJ issued a scoping memo that consolidated the two applications for the purpose of evidentiary hearings, removed Special Requests 2 and 3 of Application (A.) 05-02-012 from consideration in this proceeding, addressed Cal-Am's assertion that the lobbying

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[9] On April 14, 2005, Cal-Am filed a reply to the protests.

[10] After the close of the record, the Office of Ratepayer Advocates changed its title to Division of Ratepayer Advocates (DRA). We use DRA throughout this decision.

expense documents it provided DRA were confidential, and set a procedural schedule for evidentiary hearings.[11]

DRA, Felton FLOW, and MPWMD served testimony on June 29 and June 30, 2005, and Cal-Am served rebuttal testimony on July 14 and 15, 2005. The parties held a noticed settlement conference on July 18, 2005 and settlement discussions continued through July and early August.

Evidentiary hearings were held at the end of July and through August 10, then continued to August 17 to consider a partial settlement agreement anticipated to be filed on August 15 by Cal-Am and DRA. On September 16, an additional day of hearing was held based on a motion by Felton FLOW to reopen the record for the receipt of additional evidence. Cal-Am later also requested, and was granted, an opportunity to reopen the record to receive additional evidence; it withdrew its request by motion filed on September 20.

Pursuant to Rule 51.4 of the Commission's Rules of Practice and Procedure (Rule 51.4), comments on the proposed settlement were filed on September 20 by Felton FLOW and MPWMD and reply comments were filed by Cal-Am on October 5. Opening briefs were filed on October 11 by Cal-Am, DOD, DRA, Felton FLOW, and MPWMD.[12] On October 18, reply briefs were filed by Cal-Am, DRA, Felton FLOW, IRWUG, and MPWMD. On October 21, Cal-Am and

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[11] In addition, the scoping memo set dates for Cal-Am to request interim rates and parties to request final oral argument. Special requests 2 and 3 seek cost recovery for the Coastal Water Project and are being addressed in a separate proceeding.

[12] Cal-Am filed a motion for acceptance of late-filed brief on October 12, 2005, and we grant the motion here.

DRA filed final settlement documents.[13] The hearing record was submitted on October 21, 2005. No party requests final oral argument before the Commission.[14]

Cal-Am timely requested and was granted interim rate relief in D.05-12-024.

III. Issues Included in the Settlement Agreements Between Cal-Am and DRA

In addressing the issues before us, we examine partial settlement agreements for the Monterey and Felton districts and GO expenses for all nine of Cal-Am's California districts.

We review these settlements, all of which are contested, pursuant to Rule 12.1(d), which provides that, prior to approval, the Commission must find a settlement "reasonable in light of the whole record, consistent with the law, and in the public interest."[15] Cal-Am and DRA state each settlement is an integrated agreement, so that if the Commission rejects any portion of the settlement, each party has the right to withdraw. Further, they state that approval of the agreements should not be construed as a precedent or statement of policy of any kind for or against any party in any current or future proceeding.

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[13] Pursuant to a request by the assigned ALJ at the August 17 hearings, Cal-Am and DRA submitted their earlier August 15, 2005 settlement agreement as three separate and severable agreements. These agreements show the final construction costs for Felton's Highway 9 project and the impact of D.05-09-004 on the rate impacts shown in the Felton settlement.

[14] As a procedural matter, we note that the transcript does not show Exhibits 107 through 115 as entered into evidence. This is an administrative oversight, and we receive these exhibits into evidence here.

[15] The Commission's revised Rules of Practice and Procedure became effective on September 15, 2006. The requirements of Rule 51.1(e) are now contained in Rule 12.1(d).

We will first review the Monterey district application, beginning with the partial settlement, then the issues not included in the proposed settlement. We will then proceed to the Felton district application, reviewing first the settlement and then the issues not included in the settlement. Lastly, we separately review the GO settlement.

IV. Monterey District Application

A. Contested Settlement Issues

1. Cost of Capital

The Commission normally uses a consolidated capital structure, which includes a consolidated cost of debt and equity, for multi-district Class A water utilities. In its application, Cal-Am presents a consolidated capital structure for Monterey and Felton, followed by separate imputed capital structures and costs of debt and equity for Monterey and Felton.[16] DRA in its report uses the consolidated capital structure, but in the settlement agrees to use separate capital structures and separate costs of debt and equity.[17] We first examine the proposed settlement's imputed capital structure for Monterey, then the separate cost of debt and equity.

The capital structure proposed by Cal-Am and DRA for Monterey is 56.6% debt and 43.4% equity. This represents a decrease in leverage from the consolidated capital structure of 59.37-60.14% debt for the upcoming three years that is shown in Cal-Am's application and DRA's cost of capital report. This is also a less leveraged capital structure than the 63% debt/37% equity capital

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[16] See Exhibit 58, Chapter 2, pages 9-11. The consolidated debt/equity for fiscal year 2005 is 60.14%/39.86% for 2005 and is projected for 2006-2008 in the range of 59.4%/40.6% each year.

[17] Exhibit 94, page 1-2.

structure that Cal-Am and DRA propose for the Felton district. Because Cal-Am's cost of debt is lower than its cost of equity, imputing a less leveraged capital structure for the Monterey district results in Monterey customers being charged a higher cost of capital, and correspondingly higher rates.

Cal-Am first proposed imputing separate capital structures in the last Monterey GRC.[18] In Chapter 3 of its application in that proceeding, Cal-Am states that separate capital structures need to be imputed for a "reasonable" period of time after its 2002 acquisition of Citizens Utilities' water properties in order to prove to the Commission and the customers of the former Citizens' districts the value of the merger.[19] In the earlier decision approving the acquisition, D.01-09-057, the Commission approved Cal-Am amortizing the acquisition premium it paid to all its California districts, original and former Citizens, provided it proved its claimed synergy savings in its 2002 GRC filings and again in its 2004 GRC filings. Thereafter, the synergy savings would be carried forward using agreed-upon escalation methods and factors. The Commission also ordered in D.01-09-057 that Cal-Am carry the burden of proving that any new or increased GRC expenses (excluding those due to inflation and customer growth) in future years were not erosions of earlier-

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[18] While Cal-Am first proposed the separate capital structures for the purpose of showing synergy savings, it states in its Monterey report that "the proof of the value of this acquisition will be shown in the former Citizens' properties rate case filing, occurring later this year." (Id. at page 3-1.) In this proceeding, Cal-Am has not provided the underlying documents in support of the synergy calculation for either Monterey or Felton districts, as will be discussed under the GO settlement section.

[19] See Cal-Am's Report on the Rate of Return for the Monterey District, Chapter 3, page 3-1, prepared April 15, 2002 and submitted in A.02-04-022. This report is also included in Exhibit 33, Volume 1, Appendix 1 of A.06-01-005.

estimated synergies.[20] We designed our review of synergy savings to focus on overall increases in GRC expenses after the initial GRC cycles because we recognized that as each year passes, the modeling assumptions relied on to demonstrate synergy savings are less and less reliable.[21]

In the settlement, Cal-Am and DRA state that they agree to the use of separate capital structures in order to appropriately calculate the synergy and acquisition premium.[22] There are two other capital structures in the record that we can consider for the Monterey district.

First, we can impute the same capital structure proposed by Cal-Am and DRA in the Felton settlement, 63% debt/37% equity. Parties in this proceeding have testified to the extraordinary capital expenditures Monterey district customers have already paid and those they face in this GRC period and beyond. By imputing the same capital structure as Felton for the Monterey district, customers are given the benefit of the less expensive capital structure.[23] While

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[20] See D.01-09-057, mimeo. at pages 67-8 and Ordering Paragraph 3, mimeo. at page 73.

[21] The issue is similar to the tracking of cost savings we ordered in D.02-12-068 following the RWE merger. In Special Request 14 of this application, Cal-Am requests the Commission end the separate tracking of RWE merger savings earlier than the four years ordered in D.02-12-068. Cal-Am states that as each year passes, the tracking of past savings becomes embedded in the normal operations, and accurate comparison to what might have occurred becomes even more difficult.

[22] We separately consider in this decision Cal-Am's showing for amortization of the acquisition premium in Section VI.D.

[23] As we will discuss in later sections, customers in the Monterey district have paid in the past for capital projects that were not used and useful, and customers are being asked in this proceeding to pay for the abandoned Carmel River Dam project and the uncertain San Clemente Dam retrofit project. In addition, in separate proceedings, Cal-Am is asking for approval to begin recovery for the Coastal Water Project, which has estimated project costs of over $160 million in 2004 dollars. (See Exhibit 57, Chapter 13, page 2 of 12.)

we do not have a record to assess the impact this change may have on other districts, our record does contain reference to the proposed sale by RWE of Cal-Am and its parent, American Water Works (AWW), through an initial public offering (IPO). The proposed IPO allows an opportunity for Cal-Am to change its consolidated capital structure in the 2006-2008 period of this GRC, which could mitigate or eliminate any impact on other districts of our imputing the proposed Felton capital structure for Monterey. The specific details of the proposed IPO were not available at the time of hearing.

The other capital structure we can consider is a return to a consolidated capital structure. There is stronger support in the record for this option, with Cal-Am and DRA in agreement that this would be 59.41% debt in 2006, 59.36% debt in 2007, and 59.37% debt in 2008.

We find the time is ripe to consider returning to the use of a consolidated capital structure. It has been almost five years since the acquisition of the Citizens' properties, and pursuant to the requirements of D.01-09-057, we have had the comprehensive initial showing of synergy savings in each district in the 2002 and 2004 GRC filings. In this proceeding, Cal-Am and DRA testify that they agreed in the Sacramento/Larkfield GRC proceeding, A.04-04-040/A.04-04-041, to a permanent acquisition premium allocation; Cal-Am relies on that proceeding for its claim of synergy savings here rather than submitting supporting documentation. Finally, Cal-Am has recently filed an application for another change in corporate ownership, A.06-05-025, and we have approved Cal-Am's request to refinance its capital structure in D.06-07-035.

While there is good cause to return to the use of a consolidated capital structure, we find it best in this proceeding to adopt Cal-Am's and DRA's proposal. First, Cal-Am and DRA have settled on an imputed separate capital

structure and no party is contesting the settlement on this issue. The settlement is a product of negotiation and is presented as an integrated agreement. Second, we are now at a point where all the other districts, following the last Monterey GRC, have adopted separate capital structures. We could lead again in Monterey in adopting a change, but prefer to give Cal-Am and parties notice and an opportunity to provide a more comprehensive record.

Therefore, we find that adopting the separate capital structure proposed in the settlement is reasonable, and consistent with the record. We will adopt an imputed capital structure of 56.6% debt and 43.4% equity for the Monterey district for 2006, 2007, and 2008.

Based on our discussion above, we direct Cal-Am to present a comprehensive showing in support of a consolidated capital structure in its scheduled January 2007 GRC filings for the Sacramento, Larkfield, Coronado, and Village districts.[24]

We turn now to the cost of debt. The settlement proposes 6.98% for Monterey for all three years. This is higher than the consolidated cost of debt shown in Cal-Am's application and originally proposed by DRA, but almost the same as the separate cost of debt originally proposed by Cal-Am.[25] The proposed 6.98% is also 61 basis points higher than the 6.37% proposed by Cal-Am and DRA in the Felton settlement.

As we found in our discussion of capital structure, there are strong reasons to consider returning to a consolidated cost of debt. However, for the same

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[24] We also have a record discussing this issue in the pending Los Angeles district GRC.

[25] In Exhibit 58, Chapter 2, page 10, Cal-Am proposes for the original Cal-Am districts a cost of debt of 6.92% for 2006, 7.03% for 2007, and 7.00% for 2008.

reasons stated earlier, we will adopt Cal-Am and DRA's proposal and direct Cal-Am to present a comprehensive showing in support of a consolidated cost of debt in its next GRC filing. In this proceeding, we find the proposed separate cost of debt of 6.98% for the three years of this GRC period reasonable and consistent with the record.

We next address the cost of equity in the capital structure. The settlement proposes a return on equity (ROE) for Monterey of 10.10%. Cal-Am and DRA state that the ROE is reasonable because it falls between the original positions of their served testimony and is the same amount authorized by the Commission in Cal-Am's most recent GRC decision, D.04-12-055 (Coronado & Village Districts) and in the Commission's two most recent decisions for Class A water utilities (D.05-07-044 for San Gabriel Valley Water Company and D.05-07-022 for California Water Service Company).

This portion of the settlement is contested by Felton FLOW, which recommends an ROE of 8.79%. Felton FLOW requests that the Commission look at the June 24, 2005 short and long term bond and stock index yields and year-to-date graphs reported in the Wall Street Journal (WSJ), together with three WSJ articles discussing investors' lowered expectations. Felton Flow concludes that the return on equity required by investors in the upcoming GRC period will be lower than Cal-Am's present authorized ROE of 9.79% by at least 100 basis points.

Our legal standards for selecting a fair and reasonable return on equity have been set in three U.S. Supreme Court cases: *Bluefield*, *Hope,* and *Duquesne.*[26]

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[26] Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia (*Bluefield)* 262 U.S. 679, 692-93 (1923), The Federal Power

(*Footnote continued on next page.*)

Together, these cases provide that a public utility is entitled to a reasonable opportunity to earn a return on the value of its property employed in serving the public. This return should be commensurate with returns on investments in comparable companies, and should be sufficient to (1) assure confidence in the financial integrity of the company, (2) maintain its credit, and (3) attract necessary capital.

Determining a fair and reasonable ROE that meets our legal standards is a matter of informed judgment. We do not rely solely on the analytical modeling results of any one party or a specific model application but do consider the range of results that two of these models, the Discounted Cash Flow (DCF) and the Risk Premium (RP) provide. We also look to interest rate trends and interest forecasts, but temper our reliance on the predictive value of this evidence as the current market has shown anomalous behavior. In addition, we look at Cal-Am's earning history, the performance of comparable companies, credit rating agencies' creditworthiness ranking of Cal-Am's parent, RWE, and the commitment of RWE to pass through all cost of capital savings to ratepayers.

We turn first to the financial models. The DCF model calculates an investor's expected ROE by looking at the current market price of a share of common stock and the present value of all future dividends that shareholders expect to receive. Cal-Am's and DRA's analysis is done using six comparable water utilities to compensate for any biases introduced by a single company's performance. Cal-Am calculates future dividend yield and then adds this to its

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Commission v. Hope Natural Gas Company (*Hope)* 320 U.S. 591, 603 (1944), and Duquesne Light Co. v. Barasch (*Duquesne)* 488 U.S. 299, 310 (1989).

calculated dividend growth rate, which results in an ROE of 10.3–10.4%.[27] DRA uses a blend of historical and forecasted growth rates to arrive at an average growth rate of 5.16% and adds to that an average current dividend yield of 3.29% to arrive at an ROE of 8.45%.

For the RP model, both Cal-Am and DRA use forecasts of interest rates for the upcoming GRC period, taken from reports published by Data Resources Inc. (DRI). DRI reports are commonly relied on by the Commission in cost of capital proceedings, but in using these forecasts, our consistent practice has been to moderate changes in ROE relative to changes in interest rates in order to increase the stability of ROE over time.[28] In its RP model, Cal-Am uses DRI's forecasted interest rates for 2006-2008 of 6.08% for 30-year Treasury and 5.50% for 10-year Treasury, and then adds the 10-year historical risk premium differential for the six comparable companies, using their authorized rather than earned ROE. Cal-Am's model estimates ROE of 10.6–10.8%, for an overall ROE of 10.50, before the addition of a 50-point leverage adjustment. In its RP model, DRA uses DRI's forecasted interest rates for 2005-2008 of 5.69% for 30-year Treasury and 5.25% for 10-year Treasury and adds the 5- and 10-year historical risk premium differential for the six comparable water utilities using the historical differential between earned ROE rather than Cal-Am's authorized ROE. DRA's RP model yields a 10.41–10.59% range, for an RP recommended ROE of 10.53%, and an overall ROE, averaging DCF and RP, of 9.49%.

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[27] Cal-Am adds a 50 basis point leverage adjustment to this ROE. We separately address the leverage adjustment below.

[28] See D.05-12-043, mimeo. at 24.

While we use the DCF and RP models in reaching our decision on ROE, we do not rely on Cal-Am's capital asset pricing model (CAPM). In this model, Cal-Am includes natural gas distribution utilities, an inclusion we find to be inappropriate as the risk characteristics of the two industries differ; in the last GRC decision we stated that we have "consistently and unequivocally rejected this in the past."[29]

Felton FLOW's testimony shows that there were some anomalies in market conditions at the time of hearing, particularly in the narrow spread between short- and long-interest yields. In addition, it introduces a July 21, 2005 WSJ article that recommends 13 stocks to investors, including RWE, citing RWE's attractive dividend yield and low payout ratio.[30] We find this evidence is insufficient to support a finding that an ROE of no more than 8.79% is warranted.[31]

On the other hand, we also reject Cal-Am's request to add to its ROE a 50-basis point "leverage adjustment" to compensate the utility for its above-average debt ratio. Cal-Am is not a company with more risk than comparable water companies. It has a history of strong earnings. In addition, its shareholders are already rewarded for a lower equity ratio through the amortization of the Citizens acquisition premium and our reliance on projected

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[29] D.03-02-030 mimeo. at 66.

[30] See Exhibit 38, "Investors Hunt for Better Returns."

[31] On October 25, 2005, Felton FLOW filed a Motion to Strike a sentence on page 22 of Cal-Am's Reply Brief as it referenced interest rates since the time of evidentiary hearings. We deny Felton FLOW's Motion to Strike, and its request to reopen the record to allow Felton FLOW to submit new evidence. Cal-Am's statement is general and we will provide it the appropriate weight. The Commission in the past has taken official notice of changes that occur in the financial markets up to the time of the submittal date. See D.05-12-043, mimeo. at 25.

cost of capital savings in approving the RWE merger. In D.04-05-023, we discussed Cal-Am's long history of overearning its authorized ROE in California.[32] Furthermore, as Felton FLOW points out, Cal-Am claimed in the RWE merger proceeding that Commission approval of the merger would provide significant benefits to ratepayers from savings on cost of capital, specifically from increased leverage, and that these benefits would be passed through 100% to ratepayers. Felton FLOW states that the capital structure of 63% debt and 37% equity proposed by Cal-Am in the Felton settlement is within the range RWE then represented would produce net benefits for ratepayers, and is actually slightly less leveraged than the capital structure RWE represented would be used at the time of its acquisition of AWW.[33] We also give weight to the fact that Cal-Am's application here shows there have been no net capital cost savings for the Monterey district from Cal-Am's debt cost reduction initiative through 2004, and none are projected for the period 2005-2008.[34]

Based on the discussion above, we find Cal-Am should receive no additional compensation in its authorized ROE for a "leverage adjustment." The Monterey settlement's proposed ROE is higher than the ROE proposed in the Felton settlement, 10.10% versus 9.95%. The basis of the .15% difference appears to be a downward adjustment to the Felton ROE to give recognition to the

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[32] D.04-05-023, mimeo. at 54.

[33] September 21, 2005 Comments of Felton FLOW on the Settlement Agreement, page 8.

[34] See Exhibit 59, Chapter 9, page 7 of 7.

methodology used in determining the acquisition premium rather than an upward adjustment for the Monterey district to reflect a leverage adjustment.[35]

Because Felton's 9.95% ROE reflects considerations beyond Cal-Am's cost of equity for the coming GRC period, we will not apply it to Monterey. However, recognizing that Monterey customers should be given all cost of capital benefits possible due to the extraordinary investment projects they face, we direct Cal-Am in its next GRC filing to address why the Felton district, or any other district, should be authorized a lower ROE and the measures Cal-Am has taken to ensure Monterey customers receive the benefit of the least expensive capital carrying costs.

Finally, we find that adopting the 10.10% ROE proposed in the settlement for Cal-Am is reasonable because it falls in the lower range of the financial analytical models, is consistent with recently authorized ROEs for comparable water utilities, reflects Cal-Am's strong performance history and creditworthiness, and does not include a leverage adjustment. Further, we find that an ROE of 10.10% is fair because this return is commensurate with returns on investments in comparable companies, and this return is sufficient to (1) assure confidence in the financial integrity of the company, (2) maintain its credit, and (3) attract necessary capital. Therefore, we adopt a 10.10% ROE for the Monterey district for the three upcoming GRC years.

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[35] We rely for this finding on the language of the settlement, Section 3.5 of Exhibit 2, and Cal-Am's assertion that the Monterey district ROE settlement does not contain a leverage adjustment.

We adopt the following cost of capital for the Monterey district for 2006, 2007 and 2008:

	Ratio	Cost	Weighted Avg. Cost
Debt	56.6%	6.98%	3.95%
Equity	43.4%	10.10%	4.38%
Total	100.0%		8.33%

2. Unaccounted-for Water Percentages

Cal-Am and DRA agree, for ratemaking purposes only, to set unaccounted-for water at 8.5% for the main system, 9.0% for the Ambler/Bishop subsystems, and 10.0% for the Hidden Hills/Ryan subsystems.

MPWMD does not object to this portion of the settlement if it is clear that it is for ratemaking purposes only and the Commission recognizes that MPWMD's Expanded Water Conservation and Standby Rationing Plan effective March 1, 1999 (Ordinance 92) sets a standard of no more than 7% unaccounted-for water. In its response, Cal-Am affirms that the settlement percentages are for ratemaking purposes only and then proceeds to caution against using the percentage of unaccounted-for water as an indicator of the efficiency or condition of a water system, citing to industry publications and the testimony of a MPWMD witness for corroboration.[36]

The settlement figures are clearly stated to be for ratemaking purposes only. We find that the levels set by the proposed settlement are reasonable for

[36] Based on Cal-Am's comments, we recommend that the utility and MPWMD confer on whether a different measurement should be used to meet the objectives of Ordinance 92.

ratemaking purposes because the percentages for each system fall between Cal-Am's and DRA's positions and are represented as providing levels that should create some incentive to lower the current five-year averages. Therefore, we adopt the proposed figures for ratemaking purposes.

3. Meter Replacements

In the settlement, Cal-Am agrees to lower its three-year expenditures for meter replacements from $185,500 to DRA's proposed $37,200. This change reflects Cal-Am's past five-year history of average annual meter expense of $13,000.

MPWMD objects to this portion of the settlement, stating more rapid replacement of existing meters would assist Cal-Am in meeting its SWRCB production limits. Therefore, it recommends that meter expense be set at $40,000 year, as projected by Cal-Am in its Urban Water Management Plan.[37] In its response, Cal-Am states that the Commission should not assume that a more aggressive meter replacement plan will necessarily reduce unaccounted for water as inaccurate meter readings may be a function of the size of the meter, i.e., larger meters supporting residential fire suppression sprinklers, rather than the age of the meter.

MPWMD's recommendation is consistent with Cal-Am's original testimony and also with Cal-Am's Urban Water plan. As a matter of policy, we find MPWMD's position is a reasonable amount in relation to the overall expenditures we are authorizing for compliance with Order 95-10. On rebuttal, Cal-Am questions whether a more aggressive meter replacement plan will

[37] See Exhibit 60 at page 33.

directly translate to lower unaccounted-for water; its position, however, is not consistent with its Urban Water Plan.

While we have a policy preference for MPWMD's recommendation, we find the settlement amount is also supported by the record. With a difference between the two proposals of less than $100,000 per year, we do not find this issue sufficient to cause us to reject the settlement as a whole. Therefore, we adopt the settlement's position of $37,200.

We encourage Cal-Am and DRA to give further consideration to MPWMD's recommendation. Cal-Am and DRA have an opportunity to state their agreement to the Commission modifying the proposed settlement in opening comments on the proposed decision. If both parties to the settlement state their agreement, we will adopt a modified settlement approving $120,000 for the three-year GRC cycle in the final decision.

4. Carmel Valley Main Segments 4, 5, 6, and 10

Cal-Am agrees to DRA's slightly lower figure of $4.2 million a year based on an updated cost review. Cal-Am identifies 9 of 23 miles of Carmel Valley Main segments that need repair: 3 miles have been completed and 3.13 miles are proposed for this GRC cycle.

MPWMD recommends that Cal-Am's replacement program be analyzed by an independent expert hired by DRA to review whether the rate of replacement should be accelerated. MPWMD also expresses concern that the Carmel Valley main dates from the 1930s and many portions suffer from extensive deterioration and produce excessive leakage. In its response, Cal-Am states MPWMD provides no evidence to support its assertion of excessive leakage.

We find the record here supports the settlement's proposed expenditures for Carmel Valley main repairs. However, we agree with MPWMD that Cal-Am customers may be unnecessarily exposed to SWRCB imposed fines if Cal-Am is not replacing sufficient portions of the main. Therefore, we direct Cal-Am, as part of its next GRC filing, to provide a specific analysis of leakage in the Carmel Valley main system.

5. Bishop Treatment Plant

Cal-Am and DRA agree that improvements to the Bishop subsystem treatment plant built in 2000 are necessary and recommend the costs of the project be recovered through an advice letter filing, capped at $750,000; the advice letter process is used due to the uncertain timing of the project. Cal-Am's filing shows that capital projects for the Bishop subsystem from the last case and this proceeding total $2,240,925.[38]

MPWMD objects to customers of the Monterey main system being required to pay for capital improvements to the subsystems of Bishop, Ambler, Ryan Ranch and Hidden Hills prior to the Commission analyzing the economic subsidies these customers may be receiving from main system customers and the environmental and financial risks that rapid expansion of the subsystems may be causing by exacerbating the overdraft in the Seaside basin. The main system is not interconnected to these subsystems, and the subsystem customers are not subject to SWRCB fines or to proposed surcharges for the Coastal Water Project. MPWMD points out that subsystem customers pay only 4% of Cal-Am's revenue

[38] Exhibit 1, Schneider testimony at Tab G, page 27.

requirement, yet in this GRC, proposed project expenditures for the four subsystems total $2,150,000.[39]

In its response, Cal-Am states that the Bishop subsystem repair is necessary to maintain water quality. Further, many of Cal-Am's districts are composed of subsystems that are not interconnected, yet the costs of all system improvements are allocated to all customers in the district as a whole.

We disagree with Cal-Am that the Monterey subsystems should be viewed as similar to other Cal-Am districts. The Monterey district main system customers are facing extraordinary water issues, both in the need to conserve and in the need to develop new water sources. The record shows the Bishop subsystem is a small but rapidly expanding system, with new demand driven by new homes in the Pasadena subdivision that sell for over $2 million on average.[40] With main system customers facing proposed surcharges for the Coastal Water Project, it may be appropriate to consider a capital improvement surcharge for the subsystem customers. We direct that Cal-Am provide, in its next GRC filing, a full breakout of all capital improvement projects undertaken in each of the four subsystems since SWRCB Order 95-10, and a breakout of estimated costs for additional capital projects planned over the coming ten years.

While we find a comprehensive analysis should be done on this issue, the record does not support delaying plant investment in this GRC period that Cal-Am represents is necessary to comply with water quality regulations.

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[39] Exhibit 76, page 12 cites to Cal-Am's request for $400,000 for treatment plant improvements in Ryan Ranch, $1 million for Ambler Park water tanks, and $750,000 for Bishop iron/manganese removal facilities.

[40] 7 RT at 876.

Therefore, we approve the ratemaking treatment proposed in the settlement for the Bishop treatment plant.[41]

6. Special Request 4 – Establishment of a Water Revenue Adjustment Mechanism (WRAM) Account to Track Emergency Rate Overcollections

Cal-Am and DRA agree to establish this balancing account to return any overcollected monies to customers consistent with the process adopted in D.05-03-012. MPWMD has two concerns with the use of the funds collected.

First, MPWMD requests the Commission clarify that no SWRCB fines will be paid from this WRAM account. In its application, Cal-Am proposed to use this account to first pay "any fines that are imposed by the SWRCB." DRA also objects to this use of WRAM and language permitting this use is not included in the proposed settlement. Therefore, we clarify, as requested by MPWMD, that funds from this account cannot be used to pay SWRCB fines.[42]

Second, MPWMD requests that any overcollections from WRAM balancing accounts, be they from this new emergency rate overcollections WRAM or the existing WRAM for the inverted rate design structure, should be applied toward conservation projects rather than being refunded directly to customers. It requests the Commission implement this ratemaking treatment in this GRC, or, in the alternative, establish a policy for the next GRC.

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[41] MPWMD's concerns regarding overdrafting the Seaside basin are being addressed through the complaint Cal-Am filed in Monterey County Superior Court, discussed in Exhibit 76 at pages 14-19; Cal-Am is not requesting authority to recover its litigation costs here.

[42] Later, under Special Request 8, we further address treatment of SWRCB fines.

Cal-Am objects to MPWMD's proposal to change the WRAM refund mechanism. Cal-Am urges that the refund method set forth in D.05-03-012 for overcollections from the 2004 emergency rate structure be returned.[43] Also, Cal-Am says MPWMD's proposal would unnecessarily complicate the funding of conservation programs by making these programs dependent on a fluctuating balancing account.

We find that using the refund mechanism adopted in D.05-03-012 for this request is reasonable because it allows any overcollection to be quickly returned to customers, rather than waiting for the next GRC. In addition, funding levels for conservation programs should be set based on the district's needs and not fluctuate due to the WRAM balances. We are authorizing over $1 million in conservation funding in this proceeding and these programs should have a stable base. Finally, we find the present refund mechanism directly rewards customers who avoided the high use emergency rates through prudent water usage.[44]

Therefore, we adopt the proposed settlement's language on Special Request 4, with the clarification that funds from this account cannot be used to pay SWRCB fines.

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[43] The emergency rates would be implemented if Cal-Am is in danger of exceeding the water production limit imposed by SWRCB Order 95-10 and would target high-use customers.

[44] The mechanism refunds half of the overcollection directly to the high use customer who paid the emergency rates and distributes the rest of the overcollection among all ratepayers.

7. Special Request 5 – Endangered Species Act (ESA) Memorandum Account

Cal-Am and DRA agree on a memorandum account to track compliance with ESA requirements other than ESA compliance associated with the San Clemente Dam retrofit. They do not agree on inclusion of San Clemente Dam compliance costs or whether any fines levied on Cal-Am for ESA violations should also be tracked in this account.

Together with DRA, MPWMD requests we exclude from this memorandum account ESA fines and ESA compliance costs associated with the San Clemente Dam. We will address these two issues in a later section on contested issues. Therefore, we adopt here a memorandum account for ESA compliance costs unrelated to the San Clemente Dam.

8. Special Request 7 – MPWMD Special Conservation Surcharge

Cal-Am and DRA agree to a conservation surcharge not to exceed $300,000 annually from Cal-Am to MPWMD and to special reporting requirements that break out (1) conservation activities Cal-Am undertakes on its own, (2) conservation activities MPWMD undertakes from its own budget, (3) programs MPWMD undertakes under Cal-Am's emergency conservation surcharge (Special Request 6, discussed later), and (4) conservation programs MPWMD undertakes under the surcharge proposed here.

MPWMD requests we add a requirement that Cal-Am enter a formal agreement with MPWMD. That agreement would include a description of reimbursable activities, the rates at which services are reimbursed, the invoicing format, the categorization of services to reflect Commission authorization, the reporting format, the ownership of work product, and the term of the agreement.

Cal-Am states this proposal would unnecessarily complicate matters. DRA, in its reply brief, supports MPWMD.

We find conservation activity is critical for the Monterey district and the funds being provided by customers, over $1 million a year, are substantial. Therefore, it is reasonable and in the public interest to have Cal-Am and MPWMD enter a formal agreement for the conservation funds that Cal-Am provides to MPWMD, in addition to the reporting requirements it develops with DRA. Therefore, we adopt Special Request 7 and also require Cal-Am to enter into a formal agreement with MPWMD.

9. Special Request 16 – Balancing Accounts

Cal-Am and DRA propose that all current balancing accounts be refunded in accordance with standard Commission policies. MPWMD recommends that the WRAM account for rate design instead be made part of the final revenue requirement in this and future GRCs and used to fund conservation programs. As we discuss earlier under Special Request 4, we do not adopt MPWMD's recommendation as the existing methodology allows for the balancing accounts to be cleared in a more timely manner and for conservation programs to be funded based on actual needs.

B. Uncontested Settlement Issues

The following issues are uncontested. The settlement provides cites to the underlying testimony of Cal-Am and DRA in support of the resolution of each issue. We address these issues by category, in the order presented in the settlement.

1. Customer Sales and Revenues

Cal-Am and DRA agree on customer counts and the average water use per customer, including an allowance for unaccounted water. MPWMD's concerns

regarding unaccounted for water percentages are addressed in the previous section.

2. Operations and Maintenance (O&M) Expenses

For purchased power expense, Cal-Am and DRA agree that the benchmark of kilowatt hours (kwh) per hundred cubic feet will be based on Cal-Am's recorded 2003 and 2004 kwh usage. They also agree to use the latest rates from Pacific Gas and Electric Company (PG&E), and the numbers are subject to update prior to the start of the test period. Finally, Cal-Am and DRA agree that changes in the cost per unit of electricity purchased are to be tracked in the purchased power balancing account.

Based on discussions and explanations by Cal-Am of previously provided information, the parties agree to use the current chemical costs and current usage as the base in estimating chemical costs for the GRC period. For the remaining O&M expenses, Cal-Am and DRA agree to split the minor differences.

The total O&M expense proposed for 2006 is $5,244,200. This figure is less than the 2000-2005 historical figures used by Cal-Am (also shown at Table 1 of DRA's Exhibit 108), but it is significantly higher than the $4,501,000 we adopted for 2003 in D.03-02-030. DRA testifies that it did a "top down" approach whereby it escalated the total O&M cost adopted in D.03-02-030 and separately estimated purchased power based on the forecasted change in PG&E rates. The settlement states the major differences are in purchased power and chemicals, which are explained. Therefore, we find the settlement reasonable on this issue.

3. Administrative and General (A&G) Expenses

The proposed settlement represents a compromise between Cal-Am and DRA that is substantial. For payroll expense, the settlement proposes $4,443,700, a middle ground between Cal-Am's original $4,749,700 and DRA's $3,955,200, and reflects (1) DRA's agreement to use Cal-Am's methodology and (2) Cal-Am's agreement to remove three additional employees from its request, to reduce estimated overtime expenditures, and to remove its request for employee incentive compensation. The settlement amount is significantly higher than the $3,750,000 we adopted for test year 2003 in D.03-02-030. The record is weak on explaining the increases. Cal-Am represents that overtime expenditures are higher due to the need to immediately make repairs to avoid water loss from leaks, and that payroll expense is higher due to offsetting reductions in O&M expense for temporary labor used historically in lieu of full-time employees. We find the settlement compromise acceptable but in the next GRC, we direct Cal-Am to provide in its testimony supporting its application a more comprehensive showing of any changes in payroll expenses that are greater than the rate of inflation.

For A&G items other than payroll, there were also substantial differences. For pension payments, the parties agreed to a separate balancing account, discussed below. In addition, under the proposed settlement, Cal-Am agreed to a substantially lower regulatory expense, and other miscellaneous amounts are not charged to ratepayers. A final difference of approximately $200,000 was split between the parties. The adjusted settlement figure for A&G other than payroll and pension expense is $3,718,000.

We do not have a clear record to evaluate the reasonableness of the proposed settlement on this issue. Cal-Am has reclassified several expense items between A&G and GO. DRA's five-year comparison between total O&M, A&G, and GO in Table 1 of Exhibit 108 shows expenses have increased at a rate greater than inflation, but this table does not separate pension expenses from benefits expenses, and DRA does not provide further analysis. DRA's original position escalated Cal-Am's expenses from those adopted in the last GRC, but this is hard to rely on when Cal-Am has reclassified items. The settlement provides a table of A&G expense categories but the large difference in miscellaneous expense is not explained.

While we find the record is weak on this issue, DRA has performed a full review before reaching settlement, and no party contests this issue. Therefore, we find the settlement is reasonable, with the requirement that in the next GRC filing Cal-Am must present in its direct showing a comprehensive analysis of changes since 2000 in total O&M, A&G, and GO expenses, with pension expenses removed.

Cal-Am's minimum pension payment of $1,052,100 is given separate treatment. Cal-Am and DRA recognize that this expense is based on minimum Employee Retirement Income Security Act (ERISA) funding requirements and can have wide fluctuations. They agree to collect pension expenses via a balancing account funded by a 3% monthly surcharge on customers' bills. We find a separate surcharge treatment of pension costs to be reasonable. We adopt this portion of the settlement and will review the 3% level in the next GRC.

4. Taxes and Net-to-Gross Multiplier

All differences in taxes other than income tax were the result of differences in projected payroll expense and capital investment. The remaining difference is

due to the contested issue of the ratemaking treatment for the San Clemente Dam and will be resolved as part of that issue.

For income taxes, the parties agree that interest for tax deduction purposes should be calculated based on total rate base times the projected annual weighted cost of debt. Cal-Am agrees with DRA that differences in revenue requirement because of tax law changes should be tracked in a memorandum account for later determination of distribution. We find these methodologies reasonable.

There are no issues for net-to-gross multiplier.

5. Utility Plant in Service

We discussed and resolved earlier MPWMD's opposition to the settlement on meters, Carmel Valley Main Segment 4, 5, 6, and 10, and the Bishop Treatment Plant.

Cal-Am and DRA also reached agreement on network replacements, network extensions, tools and equipment, process plant, planning study, structural improvements to Forest Lake Tank #2, Forest Lake Tank #3, Segunda Tank, 13th Avenue Main, Segunda Tank #1, distribution improvements in Seaside, Carmel Valley reconfiguration, Carmel Valley system improvements, arsenic treatment, Carmel Valley Main Phase 1, distribution monitoring, and retirements. The rationale for the compromises reached is explained for each plant category, and we find the resolutions reasonable. The agreed amounts are:

Amount Requested			
Utility Plant Item	**Cal-Am (000s)**	**DRA Position**	**Settlement(000s)**
Network Replacements - 2004-2007	$654.1	$382.0	$654.1
Network Extensions - 2005-2007	277.8	99.0	225.0
Tools and Equipment 2004 change	230.9	30.2	30.2
Process Plant - 2005-2007	1208.6	953.6	1208.6
Planning Study - 2004 Construction Work in Progress	459.4	339.0	339.0
Structural Improvements to Forest Lake Tank #2 - 2005	625.0	427.0	487.0
Forest Lake Tank #3 - 2007	5000.0	4500.0 AL[45]	4575.0 AL
Segunda Tank - 2006	2150.0	2150.0 AL	2150.0 AL
13th Avenue Main - 2006-2007	350.0	306.0	320.0
Segunda Tank #1 - 2007	425.0	425.0 AL	425.0
Distribution Improvements in Seaside - 2006-2007	750.0	00.0	00.0
Carmel Valley Reconfiguration – 2007	654.0	00.0	00.0
Carmel Valley System Improvements - 2006	797.0	624.0	775.0
Arsenic Treatment 2006	3530.0	3530.0 AL	3530.0 AL
Carmel Valley Main Phase 1 – 2005	1860.0	1860.0 AL	1860.0
Distribution Monitoring - 2005	1025.0	1025.0 AL	1025.0
Retirements -			
2006	774.2	774.2	659.3
2007	493.8	493.8	233.2

[45] Cal-Am would be required to file an Advice Letter (AL) at project completion before this plant could be placed in rate base.

6. Depreciation Expense and Reserves

Cal-Am and DRA agree that depreciation expense should be based on the authorized level of plant in service. The remaining difference is related exclusively to the San Clemente Dam retrofit. The parties agree that net salvage estimates should be based on the authorized level of retirements.

7. Ratebase Including GO Allocation

Cal-Am accepts DRA's estimate of cash working capital, and the parties agree on deferred taxes exclusive of the unsettled issue of San Clemente Dam retrofit.

The rationale for GO allocation is set forth in the separate GO settlement. We will discuss our concerns and resolution of this issue in our later section on the GO settlement. We note here that Cal-Am and DRA include in this section an explanation of the GO rate base allocation of $1,305,300 for 2006 and $1,219,200 for 2007, but they do not discuss anywhere why the attached rate tables show $3,354,600 each year in GO prorated expenses, which includes $968,590 per year amortization of the Citizens' acquisition premium and a credit of $370,400 in net RWE savings for 2006.

8. Customer Service and Conservation

The proposed settlement states there are no issues. Cal-Am's showing on customer service is found in Exhibit 57 at Chapter 12, Section 1. DRA's report, Chapter 11 of Exhibit 88, finds nothing out of the ordinary in data compiled by the Commission's Consumer Affairs Branch (CAB) other than a number of billing related complaints. However, DRA does express concern over the level of customer dissatisfaction with Cal-Am's service expressed by customers at the Monterey and Felton PPHs and Cal-Am's lack of follow-up after the PPHs. DRA testifies:

> DRA is aware of a great deal of customer dissatisfaction with Cal-Am's service as evidenced by speakers at the PPHs in Felton and Monterey on May 12 and May 13. A number of complaints were raised in those hearings, on topics ranging from no water service, low water pressure, improper notification of boil orders, billing disputes, meter reading issues, hazardous construction practices, noise, a chemical accident, the inability to get prompt or courteous service from the call center in Illinois, the failure of the call center to resolve emergency issues and the failure of the call center to register complaint calls.
>
> ALJ Walwyn asked Cal-Am to respond to each customer personally in writing, and to serve a copy of each response to the entire service list. As of this writing DRA has not received a single response from Cal-Am to any of these complaints. DRA takes the testimony given by ratepayers at these hearings seriously, and is unable to reach any conclusions on the quality of Cal-Am's customer service lacking Cal-Am's response to the complaints and allegations raised. (Exhibit 89, Chapter 11, pages 2-3.)

Based on the comments received from customers at the Monterey and Felton PPHs and the discussion of service problems in the last GRC, the ALJ asked Cal-Am for further testimony and documentation on its national call centers.[46] In the evidentiary hearings, Felton FLOW also sponsored testimony from nine customers on service problems.

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[46] In the last Monterey GRC, DRA and MPWMD testified that service had deteriorated to an unacceptable level. Cal-Am presented rebuttal testimony attributing many of the customer complaints to start-up problems with its national call center, opened by AWW in mid-January 2002, and testified that complaints would return to more normal levels as startup problems are worked out. In D.03-02-030, we concluded that "while there are indications in the record that all may not be well in Cal-Am's Monterey Division, no party has made a competent showing of what the underlying problems might be, or how they should be corrected."

We also examined in hearings the quarterly performance reports on the national call center. As part of the RWE merger proceeding, D.02-12-068 established a quarterly reporting requirement to monitor the performance of AWW's national call center in responding to California customers of Cal-Am. The report measures the percentage of calls answered within 30 seconds, the percentage of calls abandoned after thirty seconds, and the "first call effectiveness."[47]

In examining the current reporting on the national call center, we discovered concerns. First, the quarterly reports are not California-specific, rather they measure all AWW subsidiaries. Cal-Am's witness stated the reports could be made California specific by mid-2006. Second, questions regarding the call effectiveness measurement elicited the information that AWW records success when the operator refers a customer complaint for a work order, not when the complaint is actually resolved. Lastly, Cal-Am provided a list of complaints kept at the regional office, Exhibit 104, but this list is considerably shorter than the list kept by CAB.

Based on DRA's CAB complaint analysis, we find the level of customer service problems is lower than the last GRC, but still remains a concern for both the Monterey and Felton districts. We have not received Cal-Am's written responses to customers testifying at the PPHs, and we direct that Cal-Am provide this as a compliance filing within 10 days. We request Consumer Service and Information Division (CSID) and Water Division review this material and, if appropriate, request further information from Cal-Am.

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[47] Id., Ordering Paragraph 4.

Based on our concerns with existing reporting, we direct Cal-Am to develop (1) a new quarterly report that provides California specific statistics, by district, from the national call center and that breaks out type of calls and final disposition of all complaints, and (2) a new quarterly report on all complaints received at district and regional levels and their final disposition. These reports should be developed within 60 days, routinely filed on a quarterly basis with CSID and Water Division, and served on all parties to this proceeding.

In the next GRC, Cal-Am must make a more comprehensive showing on its service quality for the Monterey and Felton districts. This showing must include additional data collected through better monitoring and reporting.

9. Uncontested Special Requests

Special Requests 6, 9, 11, 12, 14, and 15 are included in the settlement and are uncontested by MPWMD.[48] We briefly review each here.

Special Request 6 provides for establishment of a memorandum account for emergency conservation and rationing costs billed by MPWMD. This memorandum account was authorized in the last GRC, and we continue our authorization under the same terms. (See D.03-02-030, OP 6.)

Special Request 9 is a memorandum account for MPWMD emergency rationing costs. Cal-Am would record here costs incurred under MPWMD's Ordinance 92 in the event that rationing is implemented. This account is a

[48] Cal-Am's application contains 16 special requests. Special Requests 2 and 3 were removed from consideration by the scoping memo. Special Request 10 is moot based on D.05-09-004. Special Requests 4, 5, 7, and 16 are discussed earlier as contested settlement issues. Special Requests 1, a portion of 5, 8, and 13 are discussed under issues not included in the settlement.

companion to Special Request 6 and we continue our authorization under the same conditions we adopted in last GRC. (See D.03-02-020, OP 5.)

Special Request 11 requests authorization for an emergency rate tariff procedure. Cal-Am's emergency tariff is presented in Exhibit G and would be triggered under the same criteria the Commission adopted in D.05-03-012 at page 6 and implemented under the guidelines outlined in MPWMD Ordinance 119. Cal-Am asks to place this tariff into effect on five days notice pursuant to an advice letter filing. We find this request reasonable and adopt it.

Special Request 12 would increase the after-hours reconnection fee from $15.00 to $50.00. Customers can avoid this charge by agreeing to have the reconnection made when they are not present. Cal-Am agrees not to charge any reconnection fee to low-income customers enrolled in its Program for Alternative Rates (PAR) and to advise all customers who face reconnection because of non-payment about the PAR program at the time the request for reconnection is made. This change should be reflected in Cal-Am's Tariff Rule 11.C.1. We find this request reasonable and adopt it.

In Special Request 14, Cal-Am proposes, as required by Ordering Paragraph 12 of D.02-12-068, to return to ratepayers, with interest, all net savings produced by cost savings measures enacted by its parent, AWW, as a result of a change in control to RWE/Thames. Exhibit 59, Chapter 9, page 7 of 7 shows that through 2004 Cal-Am has returned net RWE savings of $32,000 to Monterey customers and projects to return $69,193 in 2005 and $370,400 in 2006.[49]

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[49] For 2006, $568,602 will already be accounted for in rates and $370,400 will be net additional savings.

Cal-Am states that D.02-12-068 requires that the memorandum accounts be effective for four years following the close of the RWE transaction. The transaction closed on January 10, 2003, making the last effective date January 10, 2007.[50] In this application, Cal-Am states that as each year passes, the tracking of past savings becomes embedded in the normal operations, and accurate comparison to what might have occurred becomes even more difficult. Therefore, it requests authority to discontinue this memorandum account tracking as of the date of this decision.

We expect to issue the final decision in this proceeding in the last quarter of 2006. With only a few months difference to the time specified in D.02-12-068, we find the settlement's proposed granting of Cal-Am's request to be reasonable.

In Special Request 15, Cal-Am requests revision to its Rule 14.1 to comply with proposed changes by MPWMD to Ordinance 92. The revision would be made by advice letter and would cross-reference all changes to Ordinance 92 and the underlying staff report and decision. We find this request reasonable and grant the request.

10. Step Rate Increases

This section of the settlement addresses the mechanism and authority for Cal-Am to file, by advice letter with supporting workpapers, the escalation year rate increase for 2007 and 2008 authorized in this decision.

The parties agree that the step and attrition increases for Monterey should be based on weather-adjusted recorded earnings for the latest 12 months ending September 30 each year, and that the language and separate capital structures

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[50] See Exhibit 1, Stephenson direct at page 48. Exhibit 57, Chapter 13, page 11 of 12 mistakenly uses January 2006, as does DRA in its report.

previously adopted for historical Cal-Am properties and former Citizens properties should be used.

In accordance with the Commission's policy for approving step and attrition increases, should Cal-Am's earnings, based on the recorded test above, exceed its authorized return, the requested step or attrition increase should be reduced to offset the earnings in excess of its authorized return in this proceeding.[51]

C. Action on Proposed Monterey Settlement

Based on our review of the proposed settlement, we find the issues agreed to between Cal-Am and DRA to be reasonable in light of the whole record, consistent with the law, and in the public interest. Therefore, we adopt the Monterey settlement.

In our review, we have also found several areas, particularly regarding tracking and monitoring customer service, justification of expense items, and capital improvements for the four subsystems, where further information must be collected and analyzed prior to the next GRC. We find these tracking and monitoring requirements do not conflict with any provision of the settlement. Therefore, we adopt these requirements in addition to the settlement provisions.

D. Monterey Issues Not Addressed in the Settlement

1. Recovery of Costs Associated With San Clemente Dam

Cal-Am requests it be allowed to continue to have retrofit costs for the San Clemente Dam given ratebase treatment as construction work in progress

[51] See D.05-07-022, Appendix L, page 44.

(CWIP), and to have interim ratemaking treatment adopted in the last GRC raised from $7,073,000 to $27,854,525 to reflect work it expects to undertake in the upcoming period.[52] These costs will be incurred for adding a new layer of concrete to the front of the existing dam to meet seismic safety concerns. The funds will first be spent for planning and environmental studies and later for construction. The estimated total cost of the project, expected to be completed in December 2009, is $47 million.

Cal-Am testifies that the San Clemente Dam is a concrete arch dam constructed in 1921 and operated by Cal-Am since the 1960s. The reservoir has not been dredged and thus excessive amounts of sediment have accumulated, removing over 90% of the storage capacity.[53] However, Cal-Am asserts that the dam is used and useful because it provides a point of diversion in the winter months that produces energy savings to customers to the extent that the diverted water replaces well water that must be pumped uphill to serve customers at higher elevations; in addition, water could be diverted in emergency circumstances. Further, Cal-Am in its rebuttal to MPWMD's testimony asserts that it is not illegally diverting the water at the dam because it operates in compliance with the overall requirements of SWRCB Order 95-10, and it does have pending water rights applications. While the dam's usefulness is limited, Cal-Am testifies it is required by regulatory agencies to address seismic safety

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[52] D.03-02-030 gave CWIP treatment to $4,406,700 of costs incurred before January 1, 2002 and $2,666,300 in costs estimated to be incurred in the coming GRC period.

[53] See Exhibit 1 and 7 RT 888. The original design storage capacity of the reservoir was 1,425 acre-feet. This has been reduced to about 137 acre-feet today.

issues, and therefore its shareholders should be allowed to continue to earn a full rate of return on all costs expended, as authorized in the last GRC.

Cal-Am acknowledges it is actively pursuing other options for the dam. The National Oceanic and Atmospheric Administration (NOAA) Fisheries is one of several environmental agencies recommending the dam be removed. Because Cal-Am needs NOAA Fisheries' approval for the retrofit project, Cal-Am recognizes that the agency could require the dam's removal. Cal-Am testifies it is currently participating in negotiations with governmental agencies and organizations to share in the cost of dam removal; Cal-Am estimates the cost of dam removal to be more than its retrofit estimates.

In addition, Cal-Am recently began considering a new option for the dam, called the River Bypass Option. As part of their environmental impact report (EIR) for the retrofit project, the two EIR lead agencies, the California Division of Safety of Dams (DSOD) and the U.S. Army Corps of Engineers, are requiring Cal-Am to develop a bypass alternative. Cal-Am estimates this alternative would cost somewhere between the cost to retrofit and the cost for dam removal. Cal-Am first presented this alternative in its rebuttal testimony. The cost estimates were not reviewed by DRA.

MPWMD opposes Cal-Am's request to continue to receive ratebase treatment for the project costs. It states that San Clemente Dam retrofit costs are the largest single item in this GRC, Cal-Am has failed to exercise reasonable managerial skill and care in maintaining the dam, and Cal-Am has not met its burden of proof to have costs included in rates. MPWMD testifies that Cal-Am was advised in a 1981 DSOD report to conduct a seismic stability analysis but that it waited until the early 1990s to retain a consultant to perform the study. Further, Cal-Am ignored the reservoir sedimentation problem to the point that

the dam is no longer used and useful, and will not be after the retrofit. The reservoir feature of the dam has not been used for 10-15 years and the spillway gates have not been used since 1966.[54]

In addition, MPWMD testifies that due to a conservation agreement Cal-Am entered with NOAA Fisheries in 2001, it can only use the dam as a diversion point when the river flow is above 21 cubic feet per second, which effectively limits the use to the winter months, when Cal-Am has sufficient water other than in emergency conditions.[55] Lastly, MPWMD asserts that for the Commission to continue to allow ratebase treatment for the project violates Section 727.5(e)[56] because the retrofit project is not a used and useful investment, it will not maintain the reliability of water service, nor minimize the long-term costs to ratepayers, nor provide equity between present and future ratepayers. MPWMD urges the Commission to thoroughly review the project in a separate proceeding, or in the alternative, adopt DRA's recommendation to place the costs in a memorandum account for later review.

DRA opposes Cal-Am's request because the solution to the San Clemente Dam safety issue is still uncertain and the dam's future usefulness is unclear. DRA finds the project is similar to the Coastal Water Project in that the scope is

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[54] Exhibit 1, Feizollahi and testimony in transcript, 7 RT 888.

[55] Exhibit 1 and 7 RT at 890-95.

[56] Section 727.5(e): In establishing rates for recovery of the costs of used and useful water plant, the commission may utilize a capital structure and payback methodology that shall maintain the reliability of water service, shall minimize the long-term cost to ratepayers, shall provide equity between present and future ratepayers, and shall afford the utility an opportunity to earn a reasonable return on its used and useful investment, to attract capital for investment on reasonable terms and to ensure the financial integrity of the utility.

still uncertain, and the project is years away from completion. The case law on granting CWIP ratebase treatment to water utilities is for short-term projects, as discussed in D.03-09-002. Consistent with the Commission's ratemaking treatment of the Coastal Water Project in that case, the San Clemente Dam retrofit costs should be placed in a memorandum account and accrue interest at the 90-day commercial paper rate. Further, after reviewing the cost estimates, DRA recommends that the costs be capped for this GRC period at $23,997,940, primarily due to excessive management and contingency fee estimates. When Cal-Am completes its environmental review and chooses a final project, it can file a separate application.

Discussion

We agree with MPWMD and DRA that the San Clemente Dam retrofit project is uncertain, and ratepayers should not be required to fund estimated project costs until the Commission has fully reviewed a final project proposal, either in the next GRC or by separate application if Cal-Am is ready to proceed before its next GRC. The funds Cal-Am has and will expend that are associated with this project should be placed in a memorandum account until this review is complete, subject to the cap recommended by DRA.

Our position is consistent with the treatment we authorized Cal-Am's Coastal Water Project in D.03-09-002. In that decision, we found CWIP treatment should only be used for water utilities' construction projects that are of short-term duration, and we directed the costs of a longer term project, especially one with uncertainties as to whether ratepayers would realize benefits, should be booked into a memorandum account.[57]

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[57] D.03-09-002, mimeo. at 21 and 22.

The Commission articulated its policy in D.03-09-002 after it had issued D.03-02-030 in Cal-Am's last GRC. We find that D.03-09-002 should guide us here. In D.03-02-030, we proposed an interim ratemaking treatment with the expectation that a final project would be before us in this GRC and, in doing so, we did not find it necessary to fully consider the history and purpose of CWIP treatment for water utilities. The policy articulated in D.03-09-002 is consistent with our policies for energy utilities. Further, removing the project from ratebase when the dam's usefulness is unclear and placing the balance in a memo account with an allowance for funds used during construction (AFUDC) is consistent with the treatment prescribed in Section 455.5.

We next turn to the issue of an appropriate interest rate for the memo account. When the San Clemente Dam project was authorized AFUDC in D.00-03-053, the order adopted an uncontested settlement that provided for the San Clemente Dam and Carmel River Dam projects to accrue AFUDC at the rate for 90-day commercial paper. DRA proposes we use the same interest rate again and this rate is consistent with the carrying costs authorized for the CWP in D.03-09-022.

However, for energy projects, the Commission generally uses an AFUDC interest rate that also reflects long-term debt and equity. We find this calculation is more appropriate here as Cal-Am will need to obtain financing over several years for the project. Therefore, we authorize AFUDC to be calculated in the manner prescribed in our Uniform System of Accounts (USOA) for energy utilities, as follows:

(a) The formula and elements for the computation of the allowance for funds used during construction shall be:

$$Ai = s(S/W)+d(D/D+P+C)(1¥S/W)$$

Ae = [1¥S/W][p(P/D+P+C)+c(C/D+P+C)]

Ai = Gross allowance for borrowed funds used during construction rate.

Ae = Allowance for other funds used during construction rate.

S = Average short-term debt.

s = Short-term debt interest rate.

D = Long-term debt.

d = Long-term debt interest rate.

P = Preferred stock.

p = Preferred stock cost rate.

C = Common equity.

c = Common equity cost rate.

W = Average balance in construction work in progress plus nuclear fuel in process of refinement, conversion, enrichment and fabrication, less asset retirement costs (See General Instruction 25) related to plant under construction.

(b) The rates shall be determined annually. The balances for long-term debt, preferred stock and common equity shall be the actual book balances as of the end of the prior year. The cost rates for long-term debt and preferred stock shall be the weighted average cost determined in the manner indicated in § 35.13 of the Commission's Regulations under the Federal Power Act. The cost rate for common equity shall be the rate granted common equity in the last rate proceeding before the ratemaking body having primary rate jurisdictions. If such cost rate is not available, the average rate actually earned during the preceding three years shall be used. The short-term debt balances and related cost and the average balance for construction work in progress plus nuclear fuel in process of refinement, conversion, enrichment, and fabrication shall be estimated for the current year with appropriate adjustments as actual data becomes available. (USOA, page 335.)

We find the cost cap recommended by DRA for the memorandum account is reasonable. We are allowing Cal-Am carrying charges on this account, and therefore we should remove cost estimates that are excessive. DRA does not adjust for 2004 costs that Cal-Am has already incurred. For 2005 and 2006, DRA lowers to 5% Cal-Am's use of a 10% factor for company administration of consultants. DRA bases its recommendation on R.S. Means 2005 Edition of Construction Cost Estimates for the Western Region (R.S. Means). On the same basis, DRA lowers Cal-Am's 30% factor for project contingencies to 10%. In addition, DRA notes the only key activity will be studies, not construction. For 2007, DRA uses similar R.S. Means estimates to adjust for estimated design fee, administrative costs, construction contingencies, and inspection costs.

In establishing a cap on this account, we are not finding the costs reasonable. All costs booked into a memorandum account are subject to a reasonableness review before being included in ratebase; Cal-Am can make this showing either in a separate application or in a future GRC filing. The cost cap we adopt is $9,379,525 for 2004, $1,321,590 for 2005, $1,863,825 for 2006, and $11,433,000 for 2007; the total cap is $23,997.940.

2. Special Request 1: Carmel River Dam

In Special Request 1, Cal-Am seeks authorization from the Commission to recover all its historic and now stranded costs related to the Carmel River Dam and Reservoir Project (Carmel River Dam). It seeks to recover $3,646,452 through a six-year monthly meter surcharge. Generally, utility shareholders must bear the full costs of abandoned projects.[58] The Commission has recognized a limited exception to this principle when it has found that ratepayers may be responsible

[58] See *Re Pacific Power and Light Company,* (1984), 15 CPUC 2d, 118, 119 (D.84-05-097).

for some of the costs of an abandoned project during times of dramatic and unanticipated change where the utility can demonstrate that it exercised reasonable managerial skill.[59]

In the last GRC, pending the Carmel River Dam project either being put into service or abandoned, the Commission allowed Cal-Am to place into rate base as CWIP $2,852,900 in pre-1/1/02 expenditures and $750,000 per year for each of 2003, 2004, and 2005 and earn a rate of return of 8.56% on $5,102,900. In that decision, D.03-02-030, at page 44, we state that this ratemaking treatment was temporary and that when Cal-Am filed its next GRC it should remove from CWIP any amounts that were not spent on the Carmel River Dam and propose a final ratemaking treatment.

In its direct testimony, Cal-Am supports its request.

> Prior to selecting the Coastal Water Project as the long-term water supply solution for customers of the Monterey District, Cal-Am focused on securing the permits and rights for the Carmel River Dam project. Environmental studies, however, revealed the Carmel River Dam would have potentially unacceptable impacts, including impacts on endangered species. Political opposition in the local communities added to the likelihood the Carmel River Dam could not proceed. Cal-Am still believes that the Carmel River Dam is the most cost-effective alternative, but also recognizes that obtaining the permits to build it would be impossible. Additionally, unlike the Carmel River Dam, the Coastal Water Project is not prone to water supply limitations in an extended drought.

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[59] See *Re Pacific Gas and Electric Company,* (1984) 15 CPUC 2d 123 (D.84-05-100) and D.89-12-057, *Re Pacific Gas and Electric* Company (1989) 34 CPUC 2d 199, 269 (D.89-12-057) and *Re Southern California Edison Company* (1996) 68 CPUC 2d 25, 31 (D.96-09-039, affirmed in D.97-01-047).

> For projects such as the Carmel River Dam, the Commission requires Cal-Am to investigate and compare the cost of alternatives and to evaluate those alternatives prior to completing significant capital investment projects. In fact the Carmel River Dam will be used as one of the alternatives to the Coastal Water Project in the Coastal Water Project environmental analysis. These Carmel River Dam costs should be recovered from the customers that benefit from the investigation. (Exhibit 1, Stephenson, pages 31 and 32.)

In its report, DRA provides a comprehensive analysis of the six-year Carmel River Dam project and recommends that the Commission disallow the entire $3,636,452 because Cal-Am fails to show that an exception to our used and useful standard should be granted under the criteria we established in D.84-05-100 and later cases. DRA testifies Cal-Am did not undertake this project in a time of extraordinary change or great uncertainty and did not act reasonably in (1) selecting this project rather than pursing other alternatives, (2) properly assessing and regularly reevaluating the risks of community opposition and environmental uncertainties, and (3) continuing to actively pursue the project and incur costs for six years when the legal, regulatory, and political risks that led to abandonment were well known for some time prior to this. According to DRA, Cal-Am fails to document how the risks and uncertainties of the Carmel River Dam project were identified and analyzed, what weight they were given, and why they were dismissed from consideration. DRA testifies no further ratepayer recovery is warranted, especially in light of the fact that, without the Commission finding Cal-Am acted in a reasonable manner, customers have already paid Cal-Am $933,000 on this project.[60]

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[60] This has occurred because the CWIP treatment allowed Carmel River Dam costs in the last GRC.

DRA also places the Carmel River Dam project in the context of the long history of water supply problems on the Monterey peninsula and the large amount of money that customers have already paid for this and other projects that never materialized. In the early nineties, ratepayers paid $1.5 million plus interest in preliminary costs for Cal-Am's proposed Canada de la Segunda reservoir that was never built. Ratepayers are still paying the $1.25 million plus interest for the Plan B water supply contingency plan required by Assembly Bill 1182 in 1998 and, in a separate proceeding, Cal-Am is requesting ratepayers start paying preconstruction costs on the Coastal Water Project. Potential future costs include the San Clemente Dam retrofit, estimated to be $47 million, and discussed in the previous section. Finally, DRA points out that Cal-Am's Carmel River Dam figures do not include the costs paid by Monterey residents to MPWMD for preliminary work on its proposed New Los Padres Dam. The Carmel River Dam is physically identical to the New Los Padres Dam project sponsored by MPWMD that was earlier defeated by voters; DRA asserts that ratepayers are being asked to cover the costs of a project that they have already paid for once.[61]

In its rebuttal, Cal-Am asserts it acted reasonably to pursue a project that was already well along in the regulatory review process and could, therefore, be implemented much faster than any other water supply project. Key regulatory agencies such as SWRCB had already extensively reviewed and approved the

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[61] DRA testifies the survey Cal-Am conducted of voters in November 1995 on their views of the Los Padres Dam project does not support Cal-Am's conclusion that voters would support the same project if the water proposed for new growth was reallocated to fire protection and increased river flow and the project was funded and managed by a private water utility instead of MPWMD.

Los Padres Dam project and were supportive of Cal-Am pursuing the project. In addition, Cal-Am interprets responses to a 1995 voter survey it commissioned after the Los Padres Dam project was defeated to show some public support for Cal-Am, rather than MPWMD, to proceed with a dam project provided it did not have a growth component. On the issue of why it continued to pursue the Carmel River Dam until August 2003, even after MPWMD requested it withdraw the project in January 2002 and Cal-Am itself in February 2003 had applied to the Commission to replace the Carmel River Dam with the Coastal Water Project, Cal-Am testifies that it needed to always have an active project before the SWRCB or it would face substantial fines. Further, it states that DRA should have no objections to Cal-Am recovering costs incurred in the later years because they largely related to Plan B.[62]

In its brief, Cal-Am asserts it has prudently managed its efforts to identify and implement a long-term replacement water supply, and its efforts meet the standards set by the Commission for recovery of abandoned plant from ratepayers. Further, it states that if the Commission denies its request, we run the risk of discouraging infrastructure investment by utilities.

Discussion

The instances of the Commission granting a utility rate recovery for abandoned plant are rare and only done in extraordinary circumstances. The Commission's general principle is to only allow recovery in rates of the

[62] DRA in its brief states MPWMD did not begin work on its expanded EIR until April 2003. According to DRA, the invoices attached to Cal-Am's rebuttal show that from this point onward, Cal-Am was charged for only 40% of MPWMD's EIR costs because MPWMD had chosen to expand the EIR to cover other alternatives. Therefore, DRA questions whether any of the Carmel River Dam project costs here are associated with reviewing the other alternatives, including those now in the Coastal Water Project.

reasonable and prudently incurred costs for investments that are found to be used and useful in providing service to ratepayers. The standard of review cited by both Cal-Am and DRA for a utility's ratepayers to share in the costs of abandoned projects is the criteria set forth in D.84-05-100, and later cited by the Commission in D.89-12-057 and D.96-09-039. In these decisions, the Commission found that in periods of great uncertainty for utility planners, it could be appropriate for ratepayers to bear some of the costs incurred for a project which is ultimately canceled if the utility demonstrates that it has exercised reasonable managerial skill in (1) identifying, assessing, and to the extent possible, quantifying the risks relevant to its ability and obligation to maintain adequate and reasonable service ("identifying relevant risks"), (2) analyzing projects such that the choice of project reflects an overall strategy to minimize costs, consistent with quality and dependability of service ("analyzing particular projects"), and (3) frequently reviewing its project commitments and overall supply strategy ("reevaluations").[63] In discussing the exception to our used and useful standard, we stated:

> The exception is the product of the period of dramatic and unanticipated change, initiated most notably for utility planners by the oil embargo of 1973, and extending for almost a decade. The period was characterized by great uncertainty in the energy industry, both as to demand growth and availability of supply. During such a period, a reasonable utility management can still reduce risk, but not necessarily to a level at which the shareholder may fairly be expected to absorb all the costs of canceled projects. During such a period, the ratepayer should participate in the increased risk confronting the utility.

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[63] D.84-05-100, 15 CPUC 2d at 123 and 124.

> But the ratepayer does not become the utility's underwriter in a period of high risk. At all times, the shareholder will bear some of the risks of abandoned projects. The utility should bear a major part of the risk in order to provide proper management incentives. Also, the ratepayer's participation is limited to those abandoned projects, or those portions of projects, for which the utility demonstrates to us that it has exercised reasonable managerial skill. We emphasize that the utility bears the burden of proof of reasonableness, not only with respect to the planning and conduct of a given project, but also regarding the cancellation, which must have occurred promptly when conditions warranted. Finally, a perception merely of generalized and ill-defined risk will not suffice to invoke this exception to the "used and useful" principles. The utility will have to demonstrate that the project which it ultimately abandoned was reasonable throughout the project's duration in light both of the relevant uncertainties that then existed and of the alternatives for meeting the service needs of its customers. (D.84-05-100, 15 CPUC 2d 123, 126.)

We should apply these standards here. We first examine the requirement that a cancelled project is only eligible to be considered for cost recovery from ratepayers if it was planned during a period of dramatic and protracted uncertainty and unusually high risk. Cal-Am has actively pursued projects to obtain additional water supply for the past 15 years, beginning with the proposed Canada de la Segunda reservoir project, amid protracted uncertainties of supply availability and high risk. This uncertainty continues today with the Coastal Water Project, which has yet to be reviewed and approved.

We find that the issuance on July 6, 1995 of SWRCB Order 95-10, which found that Cal-Am did not have legal right to approximately 10,730 acre-feet annually of water it was diverting from the Carmel River, followed by the defeat in November 1995 of MPWMD's Los Padres Dam project, constitute a dramatic and unanticipated change. The water Cal-Am was found to be illegally diverting

constituted approximately 69% of the water being supplied by Cal-Am to its customers. Order 95-10 required Cal-Am to diligently proceed in accord with a time schedule to obtain the right to additional water supplies or face enforcement action. The order listed three options for Cal-Am to obtain new water supplies, two of which relied on MPWMD's Los Padres Dam project. Cal-Am has operated under Order 95-10 for over ten years, thus meeting the criteria of protracted uncertainty and unusually high risk.

We next examine whether Cal-Am applied reasonable managerial skill to the costs it is seeking to recover for the Carmel River Dam project. Cal-Am is requesting recovery of $3,646,452 it spent for mostly environmental studies and preliminary work to secure project approval. We use the three criteria adopted in D.84-05-100 and used as precedent in D.89-12-057 and D.96-09-039.

1. Identifying Relevant Risks. This criterion requires the utility to show it has identified, assessed, and to the extent possible, quantified the risks relevant to its ability and obligation to maintain adequate and reasonable service. In its rebuttal testimony, Cal-Am states that the Carmel River Dam project was the most cost-effective and environmentally benign water supply project under the facts and circumstances that existed when Cal-Am undertook the project. It was a project that had already completed the environmental review and permitting process and could therefore be put in place in the shortest time possible.[64] Cal-Am states there were no other feasible alternatives at the time, and the record supports this. This fact is critical due to the requirement of Order 95-10

[64] In September 1994, the New Los Padres Dam's EIR was certified, and on July 6, 1995, the SWRCB issued D.1632, which summarized the environmental work done and granted MPWMD the water rights to support the diversion to storage required by the project.

that Cal-Am actively pursue additional water supply. Cal-Am did consider the potential listing of steelhead and the redlegged frog as "threatened" under the ESA and relied on the SWRCB's assessment in D.1632 and its own continuing work with MPWMD, California Department of Fish & Game, National Marine Fisheries Service (now known as NOAA Fisheries), the U.S. Fish & Wildlife Service, and U.S. Forest Service.

When environmental concerns grew after MPWMD issued its Draft Supplemental EIR on the Carmel River Dam project, Cal-Am states that due to Order 95-10, it had to continue with the project until it was certain there was a viable alternative. We accept this as reasonable management behavior given that Cal-Am had to work with the SWRCB in order to avoid enforcement action and to work with the Commission to identify other alternatives under the 1999 Plan B requirements of Senate Bill 1182. We also find persuasive DRA's Table 13-2 "Summary of Carmel River Dam Costs by Category, Vendor, and Year" which shows that while Cal-Am continued the Carmel River Dam project, its cost outlays declined in 2002 and 2003, with the largest category of costs being payments to MPWMD. (Exhibit 88.)

2. *Analyzing Particular Projects.* This criterion requires that the utility's choice of projects reflect an overall strategy to minimize costs, consistent with quality and dependability of service. Cal-Am asserts that when it proposed the Carmel River Dam project, it was the most cost-effective and environmentally feasible means of meeting the requirements of Order 95-10. This is borne out by the original New Los Padres Dam EIR which was certified in September 1994, and the Carmel River Dam draft EIR issued by MPWMD in November 1998. For the Carmel River Dam EIR, although the Court of Appeals later required a

supplemental report on the narrow issue of viticulture, the Court stated the rest of the EIR fully complied with the California Environmental Quality Act.

While several events going forward affected the viability of the project, particularly increased environmental concerns, another feasible project was not clearly established until after the Commission completed the Plan B process and Cal-Am was able to analyze the Plan B report published in August 2002. While DRA is correct that Cal-Am does not provide formal cost studies, it did actively participate and support the Commission's Plan B process. The record supports a finding that Carmel River Dam was the most cost-effective alternative and that another alternative did not clearly emerge until the completion of the Plan B process.

3. Reevaluations. We require that utility management have reviewed at least annually its project commitment and overall supply strategy. While Cal-Am did not document a formal annual review process, it did testify to regular meetings with key agencies and constituents and an on-going reevaluation of the feasibility of the project. A key concern raised by DRA is whether Cal-Am's management properly assessed the political feasibility of the project after the Monterey constituents of MPWMD rejected the Los Padres Dam project by 57%. Cal-Am did not provide the evidence necessary to sustain its claim that its survey showed voters would favor a similar project if it was done by Cal-Am rather than MPWMD and if the "growth" portion of the project were instead dedicated to providing extra water for public trust resources.[65]

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[65] Cal-Am did not have in its possession the full survey when it made these assertions. It was able to obtain a copy on the last day of hearing. The survey was voluminous and Cal-Am's request to enter it as a late filed exhibit was opposed. By ALJ ruling, a schedule was established that provided DRA an opportunity to review the material,

(Footnote continued on next page.)

However, we find persuasive Cal-Am's testimony that key agencies, the SWRCB, the Commission, and MPWMD, all supported Cal-Am pursuing the Carmel River Dam project when it first made its decision and that support continued over the period in question except for MPWMD, which requested that Cal-Am withdraw its application in January 2002. The record is not as clear as to whether Cal-Am should have abandoned the Carmel River Dam project earlier than August 2003. Certainly, the issues of environmental and political infeasibility that are cited in Cal-Am's direct testimony were present well before 2003. In response, Cal-Am asserts that due to the requirements of Order 95-10, it did not have the option to withdraw the Carmel River Dam project until it had approval for another alternative. In examining this assertion, we look at the language the Commission used in discussing this project in its 2003 decisions, both D.03-02-030 and D.03-09-022. In neither decision do we express concern that Cal-Am has yet to abandon the Carmel River Dam project. This supports Cal-Am's position that its actions through August 2003 were viewed as reasonable by key agencies.

We find that operating under Order 95-10, and later the additional requirements of the Plan B legislation, has meant Cal-Am's management had less control than a utility normally has over the timing of the Carmel River Dam project. Given these constraints, we find Cal-Am's management has acted in a reasonable manner.

In summary, based on the requirement of Order 95-10 for Cal-Am to always be actively pursuing a water supply project, the initial cost-effectiveness

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prepare testimony, and cross-examine. Shortly thereafter, Cal-Am withdrew its request.

of the project, the environmental approvals through 1999, and the support of key agencies for its actions, we find Cal-Am acted reasonably in pursuing the Carmel River Dam project and then in waiting until it had approval for an alternate project, the Coastal Water Project, to cancel the project.

Therefore, Cal-Am has shown that Carmel River Dam is an abandoned project eligible to be considered for rate recovery because its management acted reasonably, not only with respect to the planning and conduct of the project, but also regarding the cancellation. We see close consideration of the Carmel River Dam project as a necessary step in the road that Cal-Am, Monterey district residents, and state and local governmental agencies are taking to address the drought cycles and shortage of water on the Monterey peninsula. Thus, we find that the costs Cal-Am incurred for the Carmel River Dam project, $3,646,452, are reasonable and should be recovered from ratepayers.

We next turn to consideration of the specific method and timing of that cost recovery. In D.84-05-100 at page 127, we stated that the Commission's policy is to not allow carrying costs, AFUDC, on cancelled projects for which we have granted cost recovery unless peculiar circumstances of the project warrant otherwise. In D.84-05-100 we found one project, the Montezuma project, should be allowed all accumulated AFUDC carrying costs because ratepayers derived substantial benefits from the project in the form of profits from the sale of coal reserves, even though the project never produced electricity.[66] For the other

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[66] After allowance of PG&E's direct and carrying costs, a balance of approximately $19.3 million remained from the gain on the sale. This balance was allocated entirely to ratepayers. The Commission found that while the allocation of the gain differed from prior decisions, in this proceeding an exception was made because ratepayers were being allocated over $40 million in costs related to the cancelled projects.

abandoned projects found to meet the criteria for ratepayer recovery, the Commission authorized cost recovery, amortized over four years, of direct project costs but not accumulated AFUDC. Both the Montezuma project and the other abandoned projects granted cost recovery were placed in PG&E's ERAM account, which earns interest at the 90-day commercial paper rate.

In D.96-09-039, the Commission granted Southern California Edison Company (SCE) recovery of the direct costs of the Kramer-Victor transmission line, with no recovery for any accumulated AFUDC. We directed the direct costs be amortized over a four-year period. In D.97-01-047, we found that D.96-09-039 did not contain a factual showing that the costs SCE sought to recover were reasonable. On rehearing, in D.00-06-054, we accepted a settlement between SCE and The Utility Reform Network (TURN) whereby SCE would reduce the $10.937 million entry in the memo account by $2.15 million. We transferred the balance to the Transition Cost Balancing Account (TCBA). The TCBA earns interest at the 90-day commercial paper rate.[67]

Consistent with the case law discussed above, we direct Cal-Am to remove the Carmel River Dam project from CWIP. The amount in CWIP includes AFUDC interest accrued prior to the project being placed in ratebase, which should be removed before the balance is placed in a separate account that shall earn interest at the 90-day commercial rate. The use of a short-term carrying charge for the Carmel River Dam project is appropriate because, unlike the San Clemente Dam project, Cal-Am does not need to obtain additional financing,

[67] The TCBA was first adopted in the Preferred Policy Decision, (D.95-12-063), as modified by D.96-01-009, and carried forward in D.96-12-088. In D.98-05-045 we reaffirmed the use of the 90-day commercial paper rate for the TCBA.

and as Cal-Am is being given full recovery of its direct costs, there is no investor equity risk to be compensated for in the carrying charges. The electric cases provided for a four-year amortization, while Cal-Am requests six years. We find the shorter, four-year period preferable and adopt it.

Cal-Am proposes to recover the costs through a meter surcharge. Cal-Am's proposal differs from the electric cases, where costs are recovered through commodity rates. Cal-Am's methodology removes any timing risk associated with fluctuating levels of customer usage. No party provided testimony on this point. We find Cal-Am's proposal reasonable, and adopt it.

3. Inclusion of ESA Fines in Special Request 5

Cal-Am requests recovery of both ESA compliance costs, to include annual compliance costs for the San Clemente Dam, and any fines imposed for failure to comply with ESA requirements. It states fines would be due to claims related to damage done to the steelhead and red-legged frog in conjunction with Cal-Am's operation of its Monterey water production system.

DRA and MPWMD oppose this request. Both testify that Cal-Am has considerable management control over whether the regulatory agencies enforcing ESA requirements impose fines and that "even entertaining the possibility of passing fines through to ratepayers is extraordinary".[68] DRA notes Cal-Am's testimony that it has negotiated an agreement with the US Fish and Wildlife Services covering the redlegged frog (an agreement that has been renewed regularly), and that with respect to the steelhead, NOAA has entered agreements with Cal-Am previously and indicates it is willing to do so again.

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[68] D.98-08-036, 81 CPUC 2d 648, 653.

Cal-Am's issue with NOAA is the level of mitigation Cal-Am is willing to do, and this is again within the utility's control, not the customers.

We agree with DRA and MPWMD that Cal-Am has not shown that we should deviate from our policy of not allowing recovery of fines. The record shows that it is within Cal-Am's management control as to whether Cal-Am incurs ESA fines. We will grant memorandum account treatment only for ESA compliance costs.

On whether annual ESA compliance costs for the San Clemente Dam should be tracked in this memorandum account or in a separate account, we will track ESA compliance costs with other San Clemente costs. MPWMD asserts these costs may not have been reasonably incurred, and DRA states that the nature of the San Clemente ESA activities is distinct from other traditional ESA compliance activities. The record is unclear whether these are operating costs being booked elsewhere already or are capital costs already included in Cal-Am's project cost estimates. Therefore, Cal-Am should book all San Clemente Dam related costs into one memorandum account where the Commission can conduct a comprehensive reasonableness analysis.

4. Special Request 8 – Memorandum Account for SWRCB Fines

Cal-Am seeks authority to establish a memorandum account for SWRCB fines for this GRC period. It seeks first to recover these fines through the WRAM account under Special Request 4, but as discussed earlier, this request should be considered separately, as has been our practice since we established the original criteria for recovery of SWRCB fines in D.98-08-036. Cal-Am states that under MPWMD's Ordinance 92, and the various programs it mandates, Cal-Am and MPWMD have established a plan that, if adhered to by the customers, will

assure compliance with Order 95-10. To complement Ordinance 92, Cal-Am also requests here an emergency rate tariff to take effect on short notice. Therefore, Cal-Am argues, if water production limits are exceeded, it is because customers chose not to adhere to the various conservation and rationing programs and they, not Cal-Am should be responsible for fines.

In D.98-08-036, the Commission authorized Cal-Am to establish a memorandum account for fines imposed for exceeding SWRCB Order 95-10 in water years 1997-1998 and 1998-1999. In that decision, the Commission stated that recovery of the fines would be allowed subject to review of Cal-Am's system management (including its implementation of existing conservation programs and minimization of system losses) to ensure that Cal-Am takes all reasonable steps to avoid over-pumping. Further, the Commission stated that Cal-Am's shareholders would have to absorb some portion of the fines, to the extent that Cal-Am reasonably could have avoided the over-pumping. Lastly, D.98-08-036 states that the Commission would consider in the next GRC whether to continue the memorandum account.[69] In D.00-03-053 and D.03-02-030, the Commission reviewed Cal-Am's request and renewed authorization for the memorandum account subject to the same conditions originally established in D.98-08-036.[70]

For the first time, DRA and MPWMD oppose Cal-Am's request. Both parties state that Cal-Am now has all the tools necessary to avoid over-pumping and should be held responsible for operating its water system in a manner to avoid any fines.

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[69] 81 CPUC 2d 648, 652.

[70] D.03-02-030, mimeo. at page 51 states: "Our D.98-08-036 was carefully crafted, and we will once again authorize what we did there, but update it to apply to SWRCB fines incurred through the effective date of our order in Cal-Am's next GRC.

DRA states the Commission recognized in D.98-08-036 that even entertaining the possibility of passing fines through to ratepayers is extraordinary, and that decision required Cal-Am management to operate the system as best it can to avoid such fines. The Commission also made clear that allowing the recovery of fines was a temporary measure, expected to be of brief duration, until MPWMD could adopt its rationing plan, Ordinance 92.[71] DRA reviews the expanded tools that Cal-Am now has available, comments on those it has not fully utilized, and finds that Cal-Am should be held responsible for fully utilizing these tools and for operating its water supply system to avoid overproduction.

MPWMD details the provisions of Ordinance 92 and the revised Ordinance 119 Expanded Water Conservation and Standby Rationing Plan. MPWMD supports Special Request 15, which would add all provisions of Ordinance 119 to Cal-Am's tariff; however, MPWMD testifies that if the Commission compares the management tools available in 1998 to those now in place, it must conclude that a memorandum account to track SWRCB fines is no longer warranted.

Discussion

Consistent with our findings in D.98-08-036, 81 CPUC 2d at 653,we find here that Cal-Am now has the management tools necessary to operate its Monterey water system and it should "assume full responsibility for managing water supply in compliance with the cutback requirement." The record shows that Cal-Am can, and should, do more to ensure conservation. First, under Stage 1 of Ordinance 92, landscape water audits are supposed to be conducted on

[71] D.98-08-036, 81 CPUC 2d 648, 653.

all large residential users, large irrigators, and properties with dedicated landscape meters to set water budgets. Ordinance 92 required these audits to be completed within 180 days, or by August 28, 1999, yet after six years only 13% have been done.[72] By not having conducted these audits, Cal-Am cannot require these customers to curtail their usage during Stage 3 periods. Second, there are over 1,000 commercial account audits that Cal-Am has not done, as discussed below (Rate Design). As the record reflects, the Commission has approved all of Cal-Am's requests for conservation programs, emergency rate measures, and compliance costs. Cal-Am determines the financial requests it makes in its application and cannot claim that ratepayers should bear the cost of SWRCB fines if it fails to operate its water system in a prudent manner.

Cal-Am has argued that further emergency rate measures are no longer necessary in order for it to be able to comply with SWRCB Order 95-10, and we agree.[73] We take notice that MPWMD has the authority to impose a water moratorium if needed, and Ordinance 119 provides the ability to more rapidly respond to a water emergency.[74] Therefore, we deny Special Request 8.

5. Special Request 13 – Rate Design

The Monterey district has a special per-capita rate design adopted in 2000 to address the unique water supply and operating problems in Monterey. The district is in an area subject to drought on the average of every seven years and is

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[72] MPWMD/Pintar, 5 RT 668-669.

[73] In D.04-07-035, the Commission directed Cal-Am to file an application within 90 days for a moratorium on new hookups and expansions. In Cal-Am's subsequent application it stated that a moratorium is no longer a necessary step. (See D.05-04-005, mimeo. at page 4.)

[74] MPWMD opening brief, page 24.

also subject every year to the water production limits set by the SWRCB in Order 95-10. In D.00-03-053, our decision on the test year 2000 GRC, we adopted a normal increasing block design for normal times and a per-capita conservation rate design for periods when Cal-Am was likely to violate its SWRCB water production limit. For residential customers, the per-capita rate design has five sharply ascending blocks; for other categories, there are two ascending blocks. To protect Cal-Am from revenue loss due to conservation, the Commission adopted a WRAM.

Soon after D.00-03-053 was issued, Cal-Am exceeded its production limit and the conservation rate design became effective. Subsequently, the Commission granted Cal-Am's petition for modification of D.00-03-053 and the per-capita rate design became permanent. In D.03-02-030, the last GRC, we reaffirmed this rate design but expressed our intent to consider eliminating the WRAM in the next GRC if revenues were found to be more predictable.[75]

Because it faced losing the WRAM mechanism, Cal-Am proposed a different rate design in this proceeding, one that is less customer specific and complex but still retains a conservation emphasis. For residential customers, Cal-Am proposes compressing the current 12 categories of customers, based on a water budget formula which considers persons per household, lot size, and the number of large animals, into three categories, and eliminating occupancy consideration after the first block definition. While establishing a water budget for residential customers is relatively simple, Cal-Am testifies it has performed few water audits on its commercial accounts because they are time- and labor-intensive. Therefore it proposes a change to a rate structure based on

[75] Id. at page 39.

meter size. If the Commission rejects this recommendation, Cal-Am requests we authorize sufficient staff to complete the existing commercial audit backlog. For its four subsystems, Cal-Am proposes to transition them over the next six years to the same rate design so that there is a regional approach to pricing and ratemaking.

DRA objects to Cal-Am's proposal, recommending instead that the Commission continue the current per-capita rate design and WRAM. It testifies that Cal-Am's proposal negates the advantages of the per-capita rate design, is less logical and intuitive, and provides less conservation incentive for small households. DRA also recommends that the current rate structure be maintained for the subsystems as these systems draw from a different water aquifer and there has not been a need established for change.

MPWMD supports portions of Cal-Am's proposal. It supports eliminating a residential per capita allocation after the first block as this should save water and facilitate compliance with SWRCB Order 95-10. Further, it agrees with Cal-Am that this modification will place less emphasis on occupants and more emphasis on outdoor water use. For these reasons, it supports Cal-Am's residential rate design proposal. For commercial customers, MPWMD states that this proceeding has revealed a significant problem that requires an immediate remedy. Specifically, Cal-Am has not conducted the required audits to prepare water budgets for over 1000 commercial accounts. These accounts are basically being billed at a flat rate and, therefore, MPWMD supports moving to a rate structure based on meter size. Should the Commission deny this request, monies should be made available to hire auditors to establish water budgets.

MPWMD opposes Cal-Am's proposal to transition Hidden Hills, Ryan Ranch, Bishop, and Amber Park subsystems toward consolidated pricing with

the Monterey district because these are small, independent systems with different water sources and production issues. Further, this consolidation would enable Cal-Am to fund subsystem improvements at main system customers' expense, an issue MPWMD has raised in this proceeding.

The DOD supports Cal-Am's rate design proposal because the proposed inverted block commercial rate would enhance conservation, and the revised residential categories would make it harder for individual residential customers to cheat the system.

Discussion

In reviewing residential rate design, we find that Cal-Am has not established good cause to deviate from the existing 12 categories. Testimony shows that the existing rate design has proved effective in reducing consumption in the Monterey district and that there is no evidence of significant customer cheating under the system. As Cal-Am's witness testified, the reasons the Commission gave in D.01-10-014 for retaining per-capita rates are still persuasive today, and this type of rate structure has been successfully implemented in other water-scarce communities as a more equitable way of coping with water shortages while preserving some amount of customer choice.[76]

However, we should give consideration to Cal-Am's and MPWMD's concern that per capita rate design should not be retained in the higher blocks as these levels involve outdoor rather than personal water use. In D.03-02-030, at page 72, we examined the steep blocks and found that only those customers who are the very lowest users fall exclusively into the first block. Without further analysis to review, we find it would be inequitable to move too quickly away

[76] Ex. 1, Chestnut, page 3.

from per capita allocation in the higher blocks. Therefore, we should adopt a more gradual shift here, with a reasonable interim step being to eliminate per capita allocation only in the third through fifth blocks to promote more conservation of outdoor water use.

For commercial customers, we find that the water audits should be completed in a timely manner, before the next summer. The Monterey district has unique water supply constraints that have caused the Commission to authorize over a million dollars a year in conservation programs and to adopt special memorandum accounts and emergency rate measures. In addition, Cal-Am is required under SWRCB Order 95-10 to actively pursue new sources of water supply, a very costly undertaking. It would not be appropriate to place commercial customers on a standard meter size schedule because Cal-Am has failed to perform over 1,000 individual water audits of its commercial customers. Further, it would not be fair for residential customers to continue to bear a disproportionate burden of the conservation rate design. As pointed out in D.03-02-030, at page 72, residential customers pay commodity rates ranging as high as 400% of the standard rate, while non-residential customers' highest rate tops out at 200% of the standard rate.[77]

Therefore, we direct Cal-Am to undertake water audits for all of its commercial customers in a timely manner. Cal-Am states it would need additional funding to do this. Before we approve additional funding, we need to establish what level of revenues has been provided in rates since 2000 for Cal-Am to do commercial water audits. If further funding is necessary, a memorandum account may be the logical ratemaking vehicle and should be

[77] Id. at 72.

explored. Based on the record here, we direct Cal-Am to file an advice letter within 30 days providing a specific plan to complete all commercial water audits prior to May 1, 2007. This advice letter should identify the revenues provided in customer rates since 2000 for Cal-Am to undertake these audits, the number of audits performed, and, if additional funds are required, propose a mechanism to fund them.

Finally, we address Cal-Am's request to consolidate over a six-year period the rate design of its four subsystems. We agree with DRA and MPWMD that good cause has not been shown for this change. Further, we have directed in an earlier section that Cal-Am present a detailed study in the next GRC of the capital improvements that have been done and are projected to be done over the next ten years. We find that it is premature to consider rate consolidation until the study has been done and reviewed. Therefore, we do not adopt Cal-Am's proposal.

V. Felton District Application

A. Contested Settlement Issues

1. Cost of Capital

Cal-Am and DRA propose a capital structure of 63% debt/37% equity and an ROE of 9.95% for the three GRC years. They state the ROE is 10 basis points higher than the settled amount for the recent Sacramento/Larkfield districts to recognize subsequent and forecasted increases in interest rates. Further, they state the ROE is 15 basis points lower than the ROE proposed in this proceeding for the Monterey district.

Felton FLOW contests the ROE portion of this section, recommending instead an ROE of 8.79% for both Monterey and Felton districts based on current financial market conditions, with an adjustment of 50 basis points for poor

service and widespread customer dissatisfaction in Felton; this would reduce the ROE for Felton to 8.29%. We have assessed Felton FLOW's cost of capital evidence under the Monterey district settlement and there adopted an ROE of 10.10%. Cal-Am and DRA propose a 15 basis point downward adjustment from Monterey's 10.10% ROE for Felton, to give recognition to the methodology used to determine synergy savings and amortization of the acquisition premium for the former Citizens' districts. Based on this, we find an ROE of 9.95% for the district is reasonable.

We turn now to Felton FLOW's request to lower the authorized ROE due to poor service. In support of this adjustment, it cites customer witnesses in the evidentiary hearings and at the PPH who provide specific examples of Cal-Am's poor response to customer concerns and complaints, the evidence presented of Cal-Am's imprudent management of construction projects, and the overwhelming support of the local community for the public acquisition of the Felton district. Further, Felton FLOW asserts that in the past the Commission has reduced the authorized ROE of utilities that have failed to provide adequate service.[78]

In cases where the Commission has reduced a utility's ROE, we have found offenses or actions contrary to statute, order, rule, instruction, or express policy, as explained in re *Southern California Edison Company* (1991) 42 CPUC 2d 645, 738, D.91-12-076. For a water utility, we applied this standard in D.04-07-033 to reduce California Water Service Company's ROE by 50 basis points for its

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[78] Felton FLOW cites to *Re G.T.E. of California,* (1980), 4 CPUC 2d 428 (D.92366), *Re Washington Water and Light Company,* (1972), 73 CPUC 2d 284, 301-302, (D.79919), and *Re Citizens Utilities Company of California,* (1995) 62 CPUC 2d 244, 265, (D.95-11-024).

pattern of violating statutory and decisional requirements by acquiring three water systems without authorization, and in two of the water systems charging unapproved rates.[79]

We do not find that the evidence presented here establishes statutory or rule violations, or a pattern of behavior contrary to stated Commission policy. While the record establishes a need to more closely monitor Cal-Am's customer service quality, it does not support a finding of poor service quality. Therefore, we do not find that a reduced ROE is warranted.[80]

As discussed under the Monterey settlement, Cal-Am's proposed capital structure for the Felton district is reasonable and provides benefits to Felton customers. Likewise, the 6.37% cost of debt proposed for the three GRC years is reasonable and supported in the record.

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[79] In D.04-07-033 we also imposed a $75,000 fine for the violations. We found the fine and the reduced ROE serve distinct purposes. "The fine punishes five distinct violations and deters other utilities from similar misconduct. The reduced ROE mitigates the harm done to Salinas District customers, but more importantly provides an incentive for Cal Water's management to better coordinate its business objectives with its obligations as a public utility." (Mimeo. at 18.)

[80] We address customer service concerns again in Section V.A.8.

We adopt the following cost of capital for the Felton district for 2006, 2007, and 2008:

	Ratio	Cost	Weighted Avg. Cost
Debt	63.0%	6.37%	4.01%
Equity	37.0%	9.95%	3.68%
Total	100.0%		7.69%

2. O&M Expenses, A&G Expenses, and GO Allocation

Felton FLOW requests the Commission disallow any increase in Cal-Am's combined O&M, A&G, and GO expenses due to the fact that DRA's analysis in Exhibit 109 shows these combined expenses for test year 2006 under the proposed settlement are 73.34% higher than the recorded expenses for these accounts in 2000. Felton FLOW states that the escalation in these accounts far exceeds the rate of inflation, and RWE, AWW, and Cal-Am should be required to meet the commitments they made at the time of the merger proceeding to implement efficiencies and economies of scale that would reduce these costs.

Felton FLOW also urges us to disallow 5% of the employee-related costs included in the proposed settlement for O&M, A&G, and GO for Felton because of political activities included in these accounts.[81] Felton FLOW introduced evidence showing Cal-Am's president Paul Townsley, its Monterey/Felton district manager Steve Leonard, AWW's director of external affairs Kevin Tilden, and various other employees at the senior executive level as well as the Felton

[81] Felton FLOW also recommends a similar 5% reduction to GO expense for the Monterey district.

district level participated in meetings and a wide range of political initiatives intended to undermine the efforts of Felton FLOW, Public Citizen, and public agencies and officials to facilitate the public acquisition of the Felton district.[82]

We will first address Felton FLOW's proposal to allow no expense increases and then address its proposal for a 5% reduction. In recommending no increase in O&M, A&G, and GO expenses, Felton FLOW bases its recommendation on DRA's Exhibit 109, Table 1. This table contains discrepancies, two major ones being that it does not reflect the proposed settlement figures, which substantially lower A&G expenses for 2006, or the correct figure for GO expenses, which is substantially higher than shown even after excluding amortization of the Citizens' acquisition premium. In addition, the table shows the large percentage increases taking place in the years 2002-2004, the last GRC period, not 2005 and the upcoming test period. This table is not sufficient to support Felton FLOW's recommendation, therefore, we do not adopt it.

We turn now to Felton FLOW's proposal for a 5% reduction in each expense category to reflect Cal-Am's inclusion of political and lobbying activities by its employees. In its rebuttal, Cal-Am states that the consulting firm Moriah Group and Felton district's community relations manager, Evan Jacobs, were paid entirely from shareholder funds and that Kevin Tilden's time spent drafting proposed condemnation legislative changes related to the Felton district was less than 10% of his total time, and therefore not reportable under state lobbying laws. In addition, Cal-Am asserts that while a small amount of Leonard's and Tilden's time is spent on Felton condemnation issues, often even that small

[82] See Exhibits 6-12.

amount of time is primarily spent providing a service to ratepayers by responding to information requests.[83]

Based on Cal-Am's statements and the evidence of record, we find that Cal-Am did not separately record as shareholder expense all political activity and lobbying efforts by its employees. While the majority of Cal-Am's extensive campaign against Measure W is excluded from its rate request, Felton FLOW has established that Cal-Am has included in its request the time district and corporate personnel spent attending meetings on the Measure W campaign and Tilden spent drafting legislation. Therefore, an adjustment should be made, as Commission policy is clear that political and lobbying activity should not be included in customer rates.

Because Cal-Am and AWW employees did not separately track this activity, we must estimate the dollar adjustment. Felton FLOW's proposed 5% reduction is reasonable and should be adopted for O&M expenses, A&G expenses, and the Felton district allocation of GO expenses.

We turn now to evaluation of Cal-Am's and DRA's proposed settlement for these expense categories.

a) O&M Expenses

In its report, DRA states it has reviewed the O&M accounts for accuracy and tracked costs moving between accounts; in addition, DRA reviewed various invoices, and adjustments and believes that Cal-Am has properly removed duplicative, inappropriate and non-recurring charges from historical O&M information. DRA's estimated total for O&M expenses is $171,400. Cal-Am's original total exceeds this estimate by $1,600, with the difference attributable to

[83] Exhibit 14, page 7.

the purchased power cost, which in turn relates to differing estimates on total water production.[84] In the settlement, the parties state there are no outstanding issues and agree to use the latest purchase power rates by PG&E. The attached tables reflect $172,800 for this category. We should adopt the proposed settlement's O&M expense amount less a 5% deduction to employee-related costs. Cal-Am must provide a table showing this adjustment in its compliance filing of rate tables.

b) Payroll and A&G Expenses

Section 4.5 contains the proposed settlement reached between Cal-Am and DRA for payroll and A&G expenses. For payroll expense, DRA agrees with Cal-Am that a fifth employee, the local customer service person, is necessary and an amount of $281,100 for 2006 payroll is proposed. In D.04-05-023, $235,300 was adopted for test year 2003. Felton FLOW does not directly address the need for a local customer service person but based on the level of consumer complaints, we find the proposed settlement reasonable on this issue.

The settlement proposes to separately collect the minimum ERISA pension payment of $64,100 through a 3% monthly surcharge on customer bills, reconciled with an annual advice letter filing for a surcredit or surcharge, depending on the balance in the balancing account. This is the same treatment proposed for Monterey and due to the wide swings in yearly ERISA minimums Cal-Am has experienced, we find this treatment reasonable.

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[84] Exhibit 90, Chapter 3.

For A&G expenses other than payroll and pensions, Cal-Am and DRA settle on $175,900 per year based on:

Cal-Am's original A&G	$306,700
Cal-Am's revised A&G	264,700
DRA's Original A&G	91,300
DRA's Revised A&G	142,500

In supporting the proposed settlement, Cal-Am and DRA refer to changes in expense categorization between A&G and GO. These changes do not explain the significant differences between the original and revised A&G expenses since the agreed-upon GO expense allocation is an increase of only $4,000 from DRA's original recommendation and $40,000 from Cal-Am's position.

While we place considerable weight on DRA's review and recommendation on this issue, the explanation provided by Cal-Am and DRA in the proposed settlement is inadequate because it does not address the substantial increase in this category from the amount authorized for test year 2003 in D.04-05-023.[85] In its report, DRA states that D.04-05-023 did not adopt a specific figure for Outside Services and that it was not able to fully analyze increases because of Cal-Am's transfer of expenses from GO and its transfer of many other expenses among A&G accounts, making analysis of historic expenses infeasible in the time allotted.[86]

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[85] In D.04-05-023, Appendix A, the Commission adopted $54,700 for test year 2003 in pensions, benefits, and other A&G. D.04-05-023 also adopted GO expenses of $91,300.

[86] Exhibit 90, page 4-4. In the proposed settlement, the parties agree to present all items of expense that are directly attributable to the Felton district in the A&G expenses and to present the American Water Service Company management expenses in the GO allocated expenses. Felton FLOW requests we disallow the cost of the compliance audit

(Footnote continued on next page.)

Cal-Am's comparison to present rates, Exhibit 63, Chapter 4, page 3 of 5, reflects that other A&G and Outside Services expenses in 2002 through 2004 were considerably higher than those adopted in D.04-05-023 for the same years. Reviewing the rates adopted in D.04-05-023, DRA's report, and the proposed settlement, we find that DRA's original A&G recommendation of $91,300, rather than the proposed $175,900 is supportable and reasonable. Therefore, we adopt this figure for other A&G.

As we discuss in the Monterey district section of this decision, we are concerned with the escalation of A&G and GO expenses, especially in light of RWE's plans to sell AWW and its Cal-Am subsidiary. Cal-Am presents testimony of projected savings that should come from RWE's Standardized Technology Enabled Process (STEP). Although projected savings from STEP over the next ten years are revised downward by its witness, Cal-Am explains that the RWE transaction was only completed in 2003 and a project the size and scope of the STEP program will take time to develop and implement.[87]

We intend to focus closely on the issue of A&G and GO expenses in the next GRC and we require Cal-Am to work cooperatively with DRA in providing the information necessary to fully analyze all A&G accounts. In the separate GO settlement, Cal-Am agrees that in connection with the 2009 GRC, DRA will retain an outside audit firm to review the GO operations and its cost allocations to the various ratemaking districts. Cal-Am will reimburse the Commission for

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required in this case. Cal-Am states that the cost is not included and the record supports Cal-Am on this issue.

[87] See Exhibit 86.

the cost of the audit and it may seek recovery for the audit costs through rates in its 2009 GRC proceeding.[88]

Cal-Am and DRA agreed to GO expenses of $129,700, which include $57,179 in amortization of the Citizens' premium and $17,804 in a credit from RWE savings, in the Felton settlement. These expenses will be discussed later as part of the GO settlement and the amount approved for Felton should be reduced 5%.

In summary, we adopt $172,800 for O&M, $281,100 for payroll expenses and $91,300 for other A&G expenses, with a 5% reduction made to each to remove political and lobbying activity. In addition, we find reasonable and adopt the proposed 3% surcharge for minimum ERISA pension payments, together with the proposed balancing account mechanism.

3. Taxes Other Than Income

Cal-Am and DRA state that all differences in this account were the result of differences in projected payroll expense and capital investment. Based on the settlement of other issues, new estimates are provided for Ad Valorem tax and payroll taxes. Due to other changes we make in the Felton settlement, we do not adopt these specific figures. Cal-Am should separately calculate the amounts based on the final decision and provide all interested parties and the Commission rate tables reflecting our adjustments, as discussed later in this decision.

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[88] The GO settlement further states in Section 5.6: "Administrative and General expenses that were previously part of GO allocations will also be audited. In addition, a review of Cal-Am's compliance with the Commission's affiliate transaction rules will be covered as part of the audit scope. This audit will allow the Commission to determine if Cal-Am's affiliate transactions and cost allocations are in the public interest and consistent with Commission decisions, rules, and policies."

4. Income Taxes

Cal-Am agrees with DRA that (1) interest for tax deduction purposes should be calculated based on total rate base times the projected annual weighted cost of debt and (2) differences in the revenue requirement because of tax law changes should be tracked in a memorandum account for later determination of distribution. These policies are reasonable and should be adopted.

As discussed earlier, the specific amount of income taxes set forth in the proposed settlement cannot be adopted due to other changes proposed in the settlement. Cal-Am should separately calculate the amounts based on the final decision and provide all interested parties and the Commission rate tables reflecting our adjustments, as discussed later in this decision.

5. Utility Plant in Service

a) Tools and Equipment

Cal-Am originally proposed $118,700 and DRA $42,000. The two parties settled on $77,000 for the 2005-2007 period based on using five-year averages except for 2005, when DRA agreed that Cal-Am needed a new generator. We find this amount reasonable.

b) Process Plant

Cal-Am originally proposed $110,000 but agreed in the settlement to use DRA's proposed $35,000, which is based on a five-year average for 2005. We find this amount reasonable.

c) Distribution Monitoring

Cal-Am agrees to defer its $300,000 request to a later rate case, as requested by DRA and Felton FLOW. We find this resolution reasonable.

d) Highway 9 Main

Cal-Am and DRA agree to $107,500 in rate base in 2005, the estimated final cost of this project. Cal-Am originally estimated $150,000 and DRA recommended $86,000. In support of its $86,000 recommendation, DRA testifies that a review of prior years' detailed cost records show that the Commission's approval of an existing $300,000 in rate base is too high and should be adjusted for this final phase.

Felton FLOW contests this portion of the settlement and recommends a 20% overall adjustment and then a $50,000 deduction in remaining costs due to Cal-Am's mismanagement of the construction project. Specifically, Felton FLOW testifies that (1) Cal-Am should not have started the project in the winter season and a 20% reduction should be made for the additional costs incurred as a result of this decision, and (2) ratepayers should not have to compensate the utility for the $50,000 in additional costs stemming from the California Department of Transportation (CalTrans) finding that Cal-Am needed to have an independent resident engineer on-site at all times during construction due to problems.

On the decision to begin construction in the winter season, Cal-Am testifies that it was ready to start in the summer but delayed to the winter because it thought traffic would be lighter. Felton FLOW provides evidence that contrary to Cal-Am's assumptions, traffic is relatively constant on Highway 9 throughout the year, but peak period flows are actually slightly heavier during the winter than the summer.[89] Further, by scheduling the project to start later, anyone familiar with the Santa Cruz Mountains could reliably predict that severe winter weather would adversely impact the project and very likely result in

[89] Exhibit 28.

construction difficulties, inconvenience to the public, potential safety hazards, delays in completing construction, and higher costs than during the summer. Felton FLOW presented testimony on the inconveniences experienced by customers, and the construction problems encountered.

On its request for a $50,000 adjustment, Felton FLOW testifies that this is the additional amount Cal-Am paid its contractor, Bestor Engineers, for the on-site engineer required by CalTrans. In support of this adjustment, Felton FLOW introduced Exhibit 113, a January 27, 2005 letter from CalTrans detailing the project's problems and requiring the on-site engineer. In Exhibit 114, Cal-Am's rebuttal witness confirms this figure.[90]

Based on the evidence presented, we find a $50,000 adjustment should be made to the Highway 9 project to reflect the construction deficiencies cited by CalTrans and Cal-Am's cost to remedy the problem. On the issue of a 20% overall adjustment, we find that while review today shows that Cal-Am erred in its scheduling, it acted on reasonable assumptions and managed to bring the project in below estimates. While residents did encounter a great deal of inconvenience due to the long weather delays, and safety issues did arise, this was largely due to an extremely wet winter. We also note that DRA decreased by $10,000 its original settlement amount to reflect final project costs.[91]

The evidence regarding problems with the main replacement project on Hillcrest Drive, particularly the road resurfacing and the two inch vertical pipe shows that the Santa Cruz Department of Public Works has regularly inspected and advised Cal-Am. The county has not issued any deficiency notices and we

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[90] Exhibit 114, page 5, line 5.

[91] Transcript at 1166, revised settlement filed October 21, 2005.

do not find cause to take additional actions here. Based on Cal-Am's testimony, we find its handling of a chemical accident at the Felton Water Treatment Plant was reasonable.

e) Main at Bull Creek

On this request for $193,000 in addition to 2005 utility plant, Cal-Am agreed to the request of Felton FLOW supported by DRA, that if Measure W passed, it would defer any further work on this project until a final resolution to the pending condemnation of the Felton water system. The parties agree that the currently expended amounts of $30,000 should be allowed in rate base.

6. Depreciation Expense and Reserve

Cal-Am and DRA agree that depreciation expense should be based on authorized level of plant in service. Cal-Am should adjust the figures used in the proposed settlement for changes made in this decision.

7. Rate Base

Cal-Am and DRA address working capital, deferred taxes, and GO allocation. Cal-Am accepts DRA's estimate of working cash for 2006 and 2007, the parties agree that deferred taxes should be based on authorized level of plant, and the level of GO allocation is based on the GO settlement.

We find the level of working capital reasonable, note that deferred taxes should be adjusted to reflect the changes to plant we adopt, and find that GO allocation should be based on the amount we authorize in our review of the GO settlement, later in this decision.

8. Customer Service and Conservation

Cal-Am and DRA have no issues in this category.

Felton FLOW objects, stating that the proposed settlement takes no account of the widespread customer dissatisfaction with the poor service provided by Cal-Am in the Felton district. It asserts that the numerous customer witnesses that testified regarding specific examples of Cal-Am's imprudent management of construction projects and poor response to customer concerns and complaints provide sufficient grounds for the Commission to reduce Cal-Am's return on equity. It specifically cites to the testimony found in Exhibits 26, 29, 31, and 32. Cal-Am cites to its response in rebuttal testimony to the testimony of ten Felton FLOW witnesses as support that it does not have service quality problems, and also it asserts that the complaint data provided by the national call center and the regional office do not show an unusual amount of complaint activity.

We recognize the widespread customer dissatisfaction brought before the Commission at the PPHs and in the evidentiary hearings. In addition to specific service quality complaints, customers are also very angry at Cal-Am's aggressive efforts to fight Measure W; the utility in its testimony recognizes the extremely strained relationship it has with the Felton community.

In reviewing the evidence presented by Felton FLOW and Cal-Am, we find cause exists to examine further if the national call center and regional offices are promptly answering and correctly handling customer calls. As we discussed in our review of the Monterey settlement in an earlier section of this decision, we have not received Cal-Am's written responses to customers testifying at the PPHs and direct that Cal-Am provided this as a compliance filing within 10 days. CSID and Water Division should review this material and, if appropriate, request further information from Cal-Am.

In the next GRC, Cal-Am should make a more comprehensive showing on its service quality for the Felton district. This showing should include additional data collected through better monitoring and reporting. Therefore, we direct Cal-Am to develop: (1) a new quarterly report that provides California-specific statistics, by district, from the national call center and that breaks out type of calls and final disposition of all complaints; and (2) a new quarterly report on all complaints received at district and regional levels and their final disposition. These reports should be developed within 60 days and filed on a quarterly basis with CSID and Water Division, and served on all parties.

We do not find the evidence supports a finding of overall poor service quality or an adjustment to Cal-Am's ROE. As the Felton community and Cal-Am proceed with negotiations for a municipal water system, Cal-Am should be extra vigilant in monitoring its Felton customer service quality and taking affirmative steps to establish better working relations with the community.

B. Action on Proposed Felton District Settlement

We do not find the proposed settlement as a whole reasonable in light of the whole record, consistent with the law, and in the public interest. Specifically, we find changes should be made to the allowed Highway 9 costs and other A&G expenses, and an adjustment made for lobbying activity to O&M, payroll, other A&G and authorized GO expenses. In addition, we require additional tracking and reporting of customer complaints at both the national call center and the regional offices. These issues are substantial and cause us to reject the settlement as a whole. Because the settlement was contested, we have a sufficient record to adopt different outcomes than those proposed in the settlement.

On all other issues except those specified above, we find that the resolution proposed by Cal-Am and DRA is reasonable and supported by the record; we individually adopt these proposals.

C. Issues Not Addressed in Proposed Settlement

1. Rate Design

In Special Request 1, Cal-Am proposes to eliminate the existing conservation discount program because it is difficult to administer and instead adopt a new rate design with an increasing three-block structure. Cal-Am testifies that the current rate structure is unusual and was likely chosen for computational convenience but needs to be replaced because it delivers inconsistent and often wrong price signals. Although the Felton district does not face the same water supply issues as the Monterey district, adopting a rate design that better promotes conservation is desirable.

DRA opposes Cal-Am's proposal, testifying that the current rate design better provides customers with incentives to curb usage and penalizes high usage customers. The current rate design provides Felton customers the following conservation discounts:

Bimonthly usage	Discount (applied to total bill)
10 units or less	20%
Up to 20 units	15%
Up to 30 units	10%[92]

[92] Transcript at 175 and 176. Cal-Am also testifies that the average Felton customer uses between 16 and 18 units on a bimonthly basis and thus, on average, receives a 15% discount.

DRA shows that under Cal-Am's proposal, the average customer could double its usage and not be penalized with higher rates. In seeking to adopt a rate design that would penalize high usage customers, Cal-Am is eliminating the current incentive for the average customers to conserve water. In addition, DRA cites Cal-Am's testimony to establish that the existing rate design does penalize higher use customers.[93] In a district that is experiencing very high rate increases, the existing conservation discount provides customers with a tool to help manage their water usage.

Felton FLOW does not take a position on this issue. At the PPHs, customers who testified on rate design strongly opposed Cal-Am's proposal, citing complexity and the loss of a conservation discount.

We find Cal-Am has not shown that its rate design proposal would be equitable and better promote conservation. The current rate design is accepted by the community and has an incentive for conservation by the average customer. Therefore, we do not adopt Special Request 1.

2. Low-Income Program

In its Special Request 2, Cal-Am requests that a low-income tariff be adopted in the Felton district and proposes a program that would provide customers whose household income is at or below 175% of the federal poverty level, an elimination of the monthly service fee or $7.50, whichever is lower. Cal-Am asserts that this proposal would provide approximately the same benefit as its PAR program in Monterey which eliminates the service fee.

DRA testifies it supports establishing a low-income program for Felton, especially in light of the large rate increases customers are experiencing, but

[93] Transcript at 179.

opposes Cal-Am's proposal because it is insufficient. Instead, DRA recommends the Commission adopt a low-income program for Felton that is similar to the program we recently adopted for San Gabriel Water Company's Los Angeles district in D.05-05-015. This program provides customers with a 50% discount on the monthly service charge and does not limit the benefit to any specific amount. DRA's proposal is presented in Exhibit 90, Chapter 13.

DRA states that the monthly service charge in Felton at the time it issued its report was $16.40. Since then, the Commission in D.05-09-004 ordered the rate increase adopted but deferred in D.04-05-023 to be implemented. This raised the monthly service charge to $28.16. If the Commission adopts the proposed settlement in this proceeding, the monthly service charge will rise to approximately $39.00. Felton customers also pay an $11.50 surcharge for their filter plant, financed through SDWBA bonds, and will pay a monthly fee to amortize the accumulated balance in the deferred rate balancing account ordered in D.04-05-023. Therefore, Felton customers will be paying over $50 a month before even using any water, and low-income customers under Cal-Am's proposal would be paying over $42.50 a month.

In assessing the revenue impact of adopting its proposal, DRA testifies that Cal-Am provided an initial estimate that 11% of Felton district customers would be eligible for a low-income program based on 2000 census data. However, Cal-Am noted that this number may not be completely accurate because 2000 census data is now five years old and the area defined as Felton in the census is much wider than Cal-Am's actual service territory. Cal-Am also reports that only 1.2% of the Monterey district customers are enrolled in its low income program. DRA calculates that if the Felton program enrolled as many as 75

customers (5.6% of total customers – nearly five times the Monterey rate), the cost would be under $1 per month for the other Felton customers.[94]

We find that DRA's low income program proposal is preferable to Cal-Am's proposal because it is modeled on the San Gabriel program we earlier adopted and it provides a more meaningful level of relief for customers. Therefore, we deny Cal-Am's Special Request 2 and adopt DRA's proposal.

3. On-going Municipalization Efforts

In its opening brief, Felton FLOW requests the Commission acknowledge the overwhelming support of the local community for the public acquisition of the Felton district and facilitate an expeditious transition to public ownership. It cites to the 74.8% of voters who approved Measure W and urges the Commission to facilitate a fair, equitable, orderly, and efficient transition to public ownership of the water facilities serving Felton. Specifically, it urges the Commission to either issue an order similar to the order requiring Cal-Am to divest the Felton district to a public agency with access to lower cost tax exempt financing, as it did in D.02-12-068 for Montara district, or in the alternative, to continue this proceeding for further consideration of alternatives for addressing the concerns of Felton district residents regarding rate shock, service, and future ownership of the Felton district facilities.

In its reply brief, Cal-Am asserts that it would be highly improper for the Commission to become involved in the municipalization efforts. It sees the process as still early and moving to future condemnation. Further, it states the Commission does not have the authority to approve the actual condemnation of public utility property. Finally, it distinguishes the situation of the Montara

[94] Exhibit 90, page 13-14.

district divestiture ordered in D.02-12-068 because the Commission found that: (1) the Montara District had unique and persistent problems with water quality, service, capacity, and rates; (2) the Montara Sanitary District was in a position to obtain low-cost tax-exempt financing to make long-overdue capital improvements; (3) Montara District voters approved a bond measure to acquire the Montara District facilities over 12 months before D.02-12-068 was issued; and (4) the Montara Sanitary District had filed a condemnation action in Superior Court. Cal-Am asserts that none of these facts applies to the Felton District. (D.02-12-068, *supra*, 2002 Cal. PUC LEXIS 909, *69-*71.)

We recognize the customer dissatisfaction that exists in the Felton district and in this proceeding we have directly addressed cost of service, service quality, and rate shock. In considering Felton FLOW's request that the Commission facilitate negotiations between the parties on municipalization, we do not find a record here sufficient to order Cal-Am to divest the district. However, the Commission's policy is to strongly encourage parties to pursue alternative dispute resolution (ADR), either as a substitute or in tandem with formal litigation, and we encourage the parties to do so here. The Commission has trained ALJs and they are available, if both Cal-Am and Santa Cruz County request our assistance. Our ADR program is set forth in ALJ Resolution 185, issued August 25, 2005.

As part of the partial settlement, Cal-Am, at the request of DRA and Felton FLOW, agreed not to pursue any further work on the main at Bull Creek if Measure W passed. Felton FLOW has asked that we also prohibit Cal-Am from undertaking any additional projects that are not essential. Cal-Am responds that the Commission should not hamstring it from exercising its best judgment on how to maintain and operate its water system.

While Cal-Am asserts that public acquisition may never materialize or be long delayed, we nevertheless recognize the process has started with passage of Measure W. In formal condemnation proceedings, a public utility is often paid more than the cost of its rate base facilities. Therefore, we should be vigilant in overseeing future plant investment in the Felton district. We direct that Cal-Am file by advice letter for review and approval of any additional projects.

4. Rate Shock

Felton FLOW requests the Commission recognize the significant rate shock that would result in Felton if the proposed settlement is adopted and authorize measures to mitigate rate shock. In D.05-09-004, we authorized implementation of the rate increase adopted but deferred in D.04-05-023 but we directed that the undercollection in the balancing account related to D.04-05-023 be amortized over six years. We also said that we would consider in this proceeding "any proposals the parties may have advanced for tempering the effects of whatever rate increase is approved there."[95] Felton FLOW asserts that not only would a large rate increase here compound the recent large rate increase of D.05-09-004, but these increases are on top of already high rates in Felton. Therefore, the Commission should take significant remedial action. The specific measures Felton FLOW recommends are for the Commission to adopt its proposed rate adjustments in this proceeding and to order Cal-Am to divest the Felton district to a public entity.

Cal-Am states that the rate increase for the Felton district contained in the proposed settlement is approximately 32%, as shown on page 6 of the settlement. It states that this increase is reasonable in light of the costs of providing service in

[95] Id., mimeo. at 33-34.

Felton, and there is no need for the Commission to make any further special provisions to address alleged rate shock. Further, while D.05-09-004 results in a large additional recent rate increase, this is caused in large part by long intervals between authorized increases, not by wildly excessive rate awards.[96] In support of its position, Cal-Am cites to a 62.8% increase authorized by the Commission for Apple Valley Ranchos Water Company in D.90-02-045.

DRA joins Felton FLOW in requesting the Commission address rate shock and recommends that the Commission not implement the full rate increase here immediately. Instead, it recommends we apply our established policy of limiting rate increases to 50% of present rates in the first year after a decision increasing rates.[97]

We have adopted several of Felton FLOW's adjustments, but the rate increase for this GRC is still substantial. Combined with the recent increase from D.05-09-044, we are concerned with rate shock and impose a limit of 50% in the first 12 months. This limit should be calculated to include the rate increase effect of amortization of D.05-09-004's balancing account and also the deferred balance in this case from interim rates, and carry the same interest rate until recovered.

VI. General Office Rate Case

Cal-Am's corporate GO expenses are typically presented for our examination every three years with its Monterey GRC. The settlement sets the total dollars (including costs of the Western Region General Office of AWW and costs associated with the corporate office of Cal-Am) and allocation factors for

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[96] See D.05-09-004, mimeo. at 31.

[97] See Re Thomas H. and Peggy A. Porter dba Grizzly Park Water Company, 18 CPUC 2d 21.

Cal-Am's nine California districts over this GRC period.[98] The settlement also includes the synergy savings analysis for amortization of the Citizens' acquisition premium and the calculation of RWE savings. A major change in this proceeding is to include outside services, previously billed separately to each district, in GO expenses.

Felton FLOW contests this settlement, opposing any increase in GO corporate expenses and any amortization of the Citizens' acquisition premium on the grounds that RWE, AWW and Cal-Am have not met the cost savings commitments they made when they sought approval of the Citizens acquisition and RWE merger. Specifically, Felton FLOW cites to the increase of overall expenses at a rate greater than general inflation, the inclusion of lobbying expenses, the lack of substantial RWE net benefits, and the "impenetrable model" that Cal-Am and DRA claim demonstrates synergy savings from the Citizens' acquisition.

A. Salaries and Employee Expense, and Other GO Expenses

Cal-Am refers to its Western Region Service Company, headquartered in Chula Vista, California, as "Service Company" or "General Office". The GO expense items in Sections 5.2(a) through (t) of the proposed settlement include costs for nonregulated activities as well as regional costs for the other western states. In the settlement, and the underlying testimony of Cal-Am and DRA, California district costs are not specifically shown for each item. Rather, the eighteen categories of western regional expenses are totaled, capitalized

[98] The western region includes Arizona, California, Hawaii, New Mexico, and Texas. Costs are allocated on the percentage of customers in each district. The California districts represent 53.6% of the total.

expenses subtracted, and an allocation of 53.6% made to Cal-Am's seven California districts. The settlement proposes the California districts be allocated $3,265,300 for 2006, a reduction of $350,100 from Cal-Am's original request.[99]

The largest categories of expense are salaries and employee expenses. The settlement states that Cal-Am demonstrated to DRA's satisfaction that the increased salaries and employee expenses in its application are related to capitalized and non-regulated activities, and that these increased costs have been properly removed from the regulated charges. In addition, Cal-Am has agreed to remove two requested positions from its current request.

It is difficult to assess the reasonableness of the settlement because the California portion of individual expenses items are not available and comparison to prior years is difficult due to the 2004 reorganization. Cal-Am testifies that its restructuring occurred for two important reasons: (1) to ensure that all employees performing duties for more than one operating company (i.e., in Arizona, California, Hawaii, New Mexico, or Texas) are considered part of the General Office, and (2) to insure that there are no employees on the district level who are performing work for non-regulated entities.[100] As part of the settlement, Cal-Am agrees to a comprehensive audit of its GO allocations and methods in connection with its 2009 GO GRC.

We find that while Cal-Am's reorganization has created confusion in analyzing expenses in this proceeding, on a going-forward basis our review will be simplified by the restructuring. Further, DRA is a party representing

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[99] Monterey is allocated 24.4% of the total costs allocated to the seven California districts and Felton is allocated 0.80%. For 2006, $796,700 is proposed for Monterey and $26,100 for Felton.

[100] Exhibit 87, page 3.

ratepayer interests and it has reached agreement with Cal-Am on GO expenses only after extensive discovery and analysis, as shown in its underlying testimony. Relying on the informed consent of DRA, combined with the agreement for a comprehensive outside audit in connection with the 2009 GO GRC, we find that it is reasonable to accept the overall level of GO expenses allocated by the settlement to the California districts.

We direct Cal-Am as part of its 2009 GRC filing to show the California regulated amount for each expense category and to provide a comprehensive direct showing in support of any expense item that has increased at a rate greater than inflation and customer growth.

B. Outside Services and California Corporate Expenses

In the proposed settlement, Cal-Am and DRA agree to $8,031,500 in outside services and California corporate expenses to be allocated to the seven California districts in 2006.[101] This comprises $2,499,000 in corporate costs and $5,532,600 in outside services.

The settlement adopts the amount originally proposed by DRA for outside services. DRA's report reflects that it made adjustments to amounts originally booked by Cal-Am in each district's A&G expenses and adjusted these expenses downward to reflect an inflation-based increase for the years 2001 to 2006.[102] For corporate costs, the settlement reflects a reduction of $130,000 in the amount initially requested by Cal-Am.

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[101] The proposed allocation for these costs to Monterey is $1,959,700 and $64,300 to Felton, using the same allocation factors as those proposed for GO expenses.

[102] Exhibit 92, page 2-13.

Relying on the informed consent of DRA, combined with the agreement for a comprehensive outside audit in connection with the 2009 GO GRC, we find that it is reasonable to accept the California corporate and outside service expenses proposed in the settlement.

We direct Cal-Am as part of its 2009 GRC filing to show the California regulated amount for each expense category in California corporate and outside services and to provide a comprehensive direct showing in support of any expense item that has increased at a rate greater than inflation and customer growth.

C. Amortization of Citizens' Acquisition Premium

Cal-Am requests recovery of the Citizens' acquisition premium in its Monterey application at $968,600 per year and in its Felton application at $57,200 per year. This is based on a total 2006 premium amortization of $5,319,000, allocated 18.21% to Monterey and 1.07% to Felton. Cal-Am supports its request with only this statement:

> Decision 01-09-057 approved Cal-Am's purchase of Citizens assets and authorized the recovery of the acquisition premium. The portion of the acquisition premium included for the Monterey/Felton District was based on the determination of the amount and allocation derived in Applications 04-04-040 and 04-04-041 for the Sacramento and Larkfield District's general rate case filings, respectively.[103]

In its report, DRA recommends that Cal-Am's request for recovery of the acquisition premium be disallowed as savings resulting from synergies of the Cal-Am/Citizens merger have not been proven. DRA bases this recommendation on its analysis of forecasted GO expenses, which it asserts have

[103] For Monterey, see Exhibit 57 Chapter 6 and for Felton, see Exhibit 63, Chapter 6.

gone up at a rate greater than inflation on a per customer basis since the acquisition.[104]

On July 12, 2005, DRA served an errata report that deleted its earlier recommendation. DRA stated that determination of the amount to be recovered was part of its settlement in A.04-04-040/041 and that DRA accepts Cal-Am's estimate subject to revision if necessary upon the Commission's approval of the settlement.[105]

In the recent Sacramento/Larkfield GRCs, A.04-04-040/041, Cal-Am did present a table of synergy savings and DRA reviewed these and issued its report. The report proposed some adjustments, which the parties later resolved in a proposed settlement. In underlying testimony, both Cal-Am and DRA agreed that the premium for each year should be allocated to each district based on total customers, making the historic Cal-Am districts responsible for approximately 50% and the former Citizens districts 50%.

In D.05-09-020, the Commission adopted the proposed settlement, attached as Appendix A to that decision. In both the underlying settlement and the decision, the language clearly states that the agreement should not be construed as a precedent or statement of policy for current or future proceedings. The settlement also required that in future proceedings for the Sacramento and Larkfield districts, (1) Cal-Am will provide DRA a table similar to the one attached as Exhibit B to the settlement that shows material changes are not occurring in the revenue requirement of and on the premium or in the total

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[104] Exhibit 92, page 1-2.

[105] Exhibit 93, Page 1-2.

synergies, and (2) Cal-Am will file this table together with any additional requested information.

We find that Cal-Am's reliance on the last GRC proceeding to support its showing here is weak. In addition, Cal-Am does not include the table referenced in D.05-09-020 or any other supporting documentation in its current filing. We direct Cal-Am within five days of our final decision to file supporting documentation for the Monterey and Felton premium amortizations.

Of additional concern, Cal-Am does not address here the requirement of D.01-09-057 to show that any new or increased GRC expenses are not erosions of earlier estimated synergies. We have, in our review of O&M, A&G, and GO expenses, looked at this requirement and made adjustments where Cal-Am did not meet its burden of proof.

Based on the above discussion, we find the amounts allocated to the Monterey and Felton districts to be reasonable. While the GO settlement contains 2006 allocations for each district in the attached tables, we clarify that pursuant to Ordering Paragraph 3 of D.01-09-057, Cal-Am must present documentation supporting its synergy savings calculation in each district GRC application, as well as a comprehensive GRC expense analysis.

D. RWE Savings

The settlement accepts Cal-Am's estimate of RWE expense savings of $1,023,204 for 2006. For Monterey, an allocation factor of 36.20% is proposed,

and for Felton an allocation factor of 1.74%.[106] The underlying testimony of Cal-Am and DRA supports this resolution. Therefore, we find it reasonable

E. Utility Plant in Service

Cal-Am and DRA reach a compromise in this section. Cal-Am agrees that it did not properly support its request for "ITS and Other Costs" related to infrastructure additions, and, therefore, these amounts should be excluded from consideration at this time. DRA agrees with Cal-Am that the STEP platform capital expenditures should be included in plant additions since no other cost savings can be developed without the base platform plant.

We find the above proposal is reasonable and adopt for 2005 $2,277,200 in plant additions, $1,537,000 for 2006 plant additions, and $1,633,800 for 2007 plant additions. The settlement also states that Cal-Am and DRA have no disagreement on depreciation reserves.

F. Action on Proposed GO Settlement

Based on our review of the settlement, we find the issues agreed to between Cal-Am and DRA to be reasonable in light of the whole record, consistent with the law, and in the public interest. Therefore, we adopt the GO rate case settlement.

In our review, we have also found several areas where we direct Cal-Am to make a more comprehensive showing in the 2009 GO GRC for GO expenses and in district GRCs for support for the amortization of the Citizens' acquisition premium.

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[106] Cal-Am's exhibits cited in the settlement show for Monterey $370,400 in 2006, $555,299 in 2007, and $626,454 in 2008. For Felton, the figures are $17,400 for 2006, $20,852 for 2007, and $22,170 for 2008.

VII. True-Up of Interim Rates Adopted in D.05-12-024

In D.05-12-024, we found it in the public interest to grant interim rate relief to Cal-Am for the Monterey and Felton districts. Consistent with Section 455.2, the interim rate increase is based on the rate of inflation as compared to existing rates for each district, is subject to refund, and will be adjusted upward or downward, back to January 1, 2006, based on the final rates adopted by the Commission in this decision.

Based on our decision today, there will be a surcharge for the period since January 1, 2006. Cal-Am should calculate this surcharge amount based on the actual loss or gain in each district's revenue, determined by applying the rate differential to the actual quantities of water sales and the actual number of customers.

For the Monterey district, Cal-Am should recover this surcharge over the following 12 months. For the Felton district, Cal-Am should recover the surcharge over a period consistent with our 50% rate cap. For both districts, Cal-Am should earn interest at the 90-day commercial paper rate on the surcharge balance.

VIII. Comments on Proposed Decision

The proposed decision was filed with the Commission and served on all parties in accordance with Section 311(d) of the Public Utilities Code and Rule 14.2 of the Rules of Practice and Procedure. Parties may file comments and reply comments pursuant to Rule 14.3.

A draft of the principal hearing officer's proposed decision contained a complete determination of all known issues but lacked attached rate tables. The proposed decision was circulated to the parties together with a ruling directing Cal-Am and DRA to provide assistance to the Commission's Water Division in

preparing the figures and appendices needed to complete the proposed decision. Other parties were permitted, but not required, to participate. A revised draft was mailed September 27, 2006 for rate tables. After completion of internal review, the proposed decision was filed and made available for comments as required by Section 311(d) and Rule 14.2.

IX. Assignment of Proceeding

John A. Bohn is the Assigned Commissioner and Christine M. Walwyn is the assigned ALJ in this proceeding.

Findings of Fact

1. This decision resolves Cal-Am's GRC applications for the Monterey and Felton districts and the corporate GO rate case.

2. On October 21, 2005, Cal-Am and DRA filed partial settlements for the Monterey district, the Felton district, and corporate GO expenses. MPWMD filed a timely protest to the Monterey settlement and Felton FLOW filed a timely protest to all three settlements.

3. The testimony and hearing record provide a comprehensive record for consideration of the settlements.

Monterey District

4. A capital structure of 56.6% debt/43.4% equity for the Monterey district in 2006-2008 is reasonable.

5. A cost of debt of 6.98% for the Monterey district in 2006-2008 is reasonable.

6. There is good cause to return to the use of a consolidated capital structure. Cal-Am should present a comprehensive showing in support of a consolidated cost of capital, to include a consolidated cost of debt, in its next district GRC filing.

7. A leverage adjustment for Cal-Am's return on equity is not warranted.

8. A return on equity of 10.10% for Monterey for the GRC period is reasonable based on the record and is fair because the return is commensurate with returns on investments in comparable companies and is sufficient to (a) assure confidence in the financial integrity of Cal-Am, (b) maintain its credit, and (c) attract necessary capital.

9. For ratemaking purposes only, unaccounted for water percentages of 8.5% for the main system, 9.0% for the Ambler/Bishop subsystems, and 10.0% for the Hidden Hills/Ryan subsystems are reasonable.

10. An amount of $37,200 for meter replacements over the GRC period is reasonable and should be adopted unless Cal-Am and DRA state the Commission may modify the proposed settlement to provide $120,000 over the GRC period, as recommended by Monterey Peninsula Water Management District.

11. An amount of $4.2 million for repair and replacement of Carmel Valley main segments 4, 5, 6, and 10 is reasonable.

12. Cal-Am should provide in its next Monterey GRC application a specific analysis of leakage in the Carmel Valley main system.

13. An expenditure of $750,000 is reasonable for improvements to the Bishop subsystem treatment plant as the improvements are necessary to maintain water quality. The advice letter process should be used due to the uncertain timing of the project.

14. We should direct Cal-Am to provide in its next GRC filing a full breakout of (a) all capital improvement projects undertaken in each of the four Monterey district subsystems since SWRCB Order 95-10, and (b) a breakout of estimated costs for additional capital projects planned over the coming ten years.

15. The establishment of a WRAM account to track emergency rate overcollections is reasonable provided that no SWRCB fines are paid from this account. The refund mechanism adopted in D.05-03-012 is reasonable because it allows overcollections to be quickly returned and directly rewards customers who avoid the emergency rates through prudent water usage.

16. Establishment of a memorandum account to track compliance with ESA requirements is reasonable. ESA compliance costs associated with the San Clemente Dam retrofit should be tracked in a separate memorandum account with all other San Clemente Dam retrofit costs.

17. A special conservation surcharge not to exceed $300,000 from Cal-Am to MPWMD, with special reporting requirements, is reasonable. Cal-Am should enter into a formal agreement with MPWMD, as detailed in this decision.

18. All current balancing accounts should be refunded in accordance with standard Commission policies.

19. Cal-Am should provide in its next Monterey GRC application a comprehensive showing of any changes in O&M expenses, payroll expenses, other A&G expenses, and allocated GO expenses that are greater than the rate of inflation.

20. To address customer service concerns in the Monterey district, Cal-Am should develop (a) a new quarterly report that provides California-specific statistics, by district, from the national call center and that breaks out type of calls and final disposition of all complaints; and (b) a new quarterly report on all complaints received at district and regional levels and their final disposition. These reports should be developed within 60 days of this decision and routinely filed on a quarterly basis with the Commission's Consumer Service and

Information Division and Water Division, with service on all parties to this proceeding.

21. Cal-Am's request to discontinue the RWE savings memorandum account at the time of a final decision in this proceeding is reasonable.

22. The step rate increases for Monterey should be based on the methodology proposed by Cal-Am and DRA.

23. We find the proposed Monterey settlement to be reasonable in light of the whole record and in the public interest.

24. The San Clemente Dam retrofit is a lengthy and uncertain project. All costs related to the project, including ESA compliance costs, should be tracked in a memorandum account until the Commission has the opportunity to fully review the completed project for reasonableness. The memorandum account should have a cost cap of $9,379,525 for 2004, $1,321,590 for 2005, $1,863,825 for 2006, and $11,433,000 for 2007 and accrue interest at the Allowance for Funds Used During Construction (AFUDC) rate prescribed under our USOA for energy utilities.

25. The Carmel River Dam project was planned during a period of dramatic and protracted uncertainty and unusually high risk for Cal-Am.

26. We find that operating under Order 95-10, and later the additional requirements of the Plan B legislation, has meant Cal-Am's management had less control than a utility normally has over the timing of the Carmel River Dam project.

27. Based on the requirement of Order 95-10 for Cal-Am to always be actively pursuing a water supply project, the initial cost-effectiveness of the project, the environmental approvals through 1999, and the support of key public agencies for its actions, we find Cal-Am acted reasonably in initially pursuing the Carmel

River Dam project and then in waiting until it had approval for an alternative project, the Coastal Water Project, to cancel the project.

28. We should not authorize Cal-Am to book ESA fines into a memorandum account as allowing recovery of fines generally is contrary to Commission policy, and the record shows Cal-Am's management has reasonable means to avoid ESA fines.

29. We should not authorize Cal-Am to book SWRCB fines into a memorandum account. The record shows that Cal-Am now has the conservation programs, emergency rate measures, and environmental compliance programs to operate its water supply system in a manner to avoid fines. Our earlier decisions to allow recovery of SWRCB fines were a deviation from one general policy on recovery of fines, and were a temporary measure, expected to be of brief duration, until effective rationing plans could be implemented by Cal-Am and MPWMD.

30. We should retain the existing rate design for Monterey with one modification: in residential rates for main system customers we eliminate the per capita allocation in the third through fifth blocks to promote more conservation of outdoor water use.

31. Cal-Am should complete all Monterey district commercial water audits before next summer.

Felton District

32. A capital structure of 63% debt/ 37% equity, a cost of debt of 6.37% and a return on equity of 9.95% for the Felton district for the three year GRC period is reasonable.

33. The record does not support lowering Cal-Am's return on equity due to poor service quality.

34. To address customer service concerns in the Felton district, Cal-Am should develop (a) a new quarterly report that provides California specific statistics, by district, from the national call center and that breaks out type of calls and final disposition of all complaints, and (b) a new quarterly report on all complaints received at district and regional levels and their final disposition. These reports should be developed within 60 days of this decision and routinely filed on a quarterly basis with the Commission's Consumer Service and Information Division and Water Division, and served on all parties to this proceeding.

35. The record establishes that Cal-Am's filing includes some political and lobbying activities by its employees. It reasonable to make a 5% reduction to employee costs included in operating and maintenance expenses, general and administrative expenses and allocated GO expenses to adjust for the inclusion of this activity in customer rates.

36. DRA's initial recommendation of $91,300 for administrative and general expenses other than payroll and pensions is reasonable.

37. A $50,000 reduction to Highway 9 project costs is reasonable in order to reflect the construction deficiencies cited by the California Department of Transportation and Cal-Am's cost to remedy the problem.

38. We do not find reasonable the Felton proposed settlement's treatment of Highway 9 project costs, administrative and general expenses, allocated GO expenses, and inclusion of political and lobbying activities by employees. In addition, we find additional tracking and reporting of customer complaints and a comprehensive showing of any changes greater than the rate of inflation for O&M expenses, payroll expenses, and other A&G expenses is required. We find

the outcomes for all other issues covered in the settlement to be individually reasonable and based on the record.

39. We should retain the existing rate design for Felton.

40. DRA's proposed low-income program is reasonable and meets our policy objectives.

41. We should address the issue of rate shock for Felton customers by applying our policy of limiting rate increases to 50% of present rates in the first year after a decision increasing rates. We should calculate this to include the rate increase effects of D.05-09-044.

42. Cal-Am should provide in its next Felton GRC application a comprehensive showing of any changes in O&M expenses, payroll expenses other than pension payments, other A&G expenses, and allocated GO expenses that are greater than the rate of inflation.

GO Rate Case

43. While Cal-Am's 2004 reorganization has created confusion in analyzing expenses in this proceeding, on a going-forward basis our review will be simplified.

44. We find that the record support for the GO rate case settlement is sufficient for a finding of reasonableness.

45. We direct Cal-Am as part of its direct showing in its 2009 General Office GRC filing to show the requested regulated expenses for each individual GO expense category and to provide a comprehensive showing in support of any items that have increased since 2006 at a rate greater than inflation and customer growth.

46. Cal-Am should file the supporting documentation for the Monterey and Felton districts' amortization of its acquisition premium.

47. In upcoming GRCs for California districts prior to 2009, Cal-Am should make a showing to support its request to amortize the Citizens' acquisition premium.

48. We find the outcomes for all issues covered in the settlement, such as GO rate base allocation and RWE net savings, individually reasonable and supported in the record.

49. The surcharge to true-up the interim rates authorized in D.05-12-024 for the Monterey and Felton districts should be based on the actual loss or gain in Monterey's revenue since January 1, 2006, determined by applying the rate differential to the actual quantities of water sales and the actual number of customers. For the Monterey district, the interim rate surcharge should be recovered over the following 12 months. For the Felton district, Cal-Am should recover the surcharge over a period consistent with the 50% rate cap adopted here. For both districts, Cal-Am should earn interest at the 90-day commercial paper rate on the surcharge balance.

Conclusions of Law

1. The standard of review for the settlements is set forth in Rule 12.1(d) of our Rules of Practice and Procedure. This rule provides, in general, that, prior to approval, the Commission must find a settlement "reasonable in light of the whole record, consistent with the law, and in the public interest."

2. The partial settlement for the Monterey district filed by Cal-Am and DRA meets our standard of review and should be adopted. The additional tracking and monitoring requirements we find reasonable do not conflict with any provision of the settlement and should also be adopted.

3. Consistent with the treatment we authorized for Cal-Am's Coastal Water Project in D.03-09-002, the San Clemente Dam retrofit project costs should be

removed from ratebase and placed in a memorandum account for later reasonableness review. The memo account should accrue AFUDC in the manner prescribed under our USOA for energy utilities.

4. Cal-Am has shown that the Carmel River Dam is an abandoned project eligible to be considered for rate recovery under the standards established in D.84-05-100, and later cited by the Commission in D.89-12-057 and D.96-09-039.

5. Cal-Am should remove the Carmel River Dam project from ratebase, remove all AFUDC interest accrued prior to the project being placed in ratebase, and place the balance in a separate account that should earn interest at the 90 day commercial paper rate and be amortized over four years as a meter surcharge.

6. The partial settlement for the Felton district should be rejected because it does not meet our standard of review. However, parts of the settlement are reasonable and supported by the record, and should be adopted as set forth in the foregoing opinion and findings.

7. The settlement for the General Office rate case filed by Cal-Am and DRA meets our standard of review and should be adopted.

8. We should adopt the rate tables and tariff sheets attached in the appendices to this decision for the Monterey and Felton districts and the GO rate case.

9. Today's decision should be made effective immediately.

O R D E R

IT IS ORDERED that:

1. The Monterey district rate tables attached as Attachment 1are adopted.
2. The Felton district rate tables attached as Attachment 2 are adopted.

3. The corporate general office (GO) rate tables attached as Attachment 3 are adopted.

4. Cal-Am is authorized to file in accordance with General Order 96, and to make effective on not less than five days' notice, the revised tariff schedules for Monterey and Felton that are attached as appendices to this order. The revised tariff schedules shall include all special requests adopted in this decision. The revised tariff schedules shall apply to service rendered on and after their effective date.

5. Cal-Am is authorized to file advice letters seeking Commission authorization for rate offsets in the Monterey district for the following capital projects when each has been completed and placed in service, no earlier than the year indicated and at costs not to exceed those indicated:

a. Forest Lake Tank #3, test year 2007, maximum cost of $4,575,000.

b. Segunda Tank, test year 2006, maximum cost of $2,150,000.

c. Arsenic treatment project, test year 2006, maximum cost of $3,530,000.

6. Consistent with the step rate increase language adopted for the Monterey and Felton districts, Cal-Am is authorized on or after the dates specified to file advice letters in conformance with General Order 96, with appropriate supporting workpapers, requesting the step rate increases. In accordance with the Commission's policy for approving step and attrition increases, if Cal-Am's earnings, based on the recorded test specified in the appendices, exceed its authorized return, the requested step or attrition increase shall be reduced to offset the earnings in excess of the authorized return in this proceeding.

7. Cal-Am shall present a comprehensive showing in support of a consolidated cost of capital, to include a consolidated cost of debt, in its next district general rate case (GRC) filing.

8. Cal-Am shall remove the Carmel River Dam project from ratebase, remove all allowance for funds used during construction (AFUDC) interest accrued prior to the project being placed in ratebase, and place the balance in a separate account that shall earn interest at the 90 day commercial paper rate and be amortized over four years as a meter surcharge.

9. Cal-Am shall develop (a) a new quarterly report that provides California-specific statistics, by district, from the national call center and that breaks out type of calls and final disposition of all complaints; and (b) a new quarterly report on all complaints received at district and regional levels and their final disposition. These reports shall be developed within 60 days of this decision and routinely filed on a quarterly basis with the Commission's Consumer Service and Information Division (CSID), and Water Division, and served on all parties to this proceeding.

10. Cal-Am shall file by advice letter within 30 days a specific plan to complete all Monterey district commercial water audits prior to May 1, 2007 and, if additional funding is required, a proposed funding mechanism. The advice letter shall identify the revenues provided in customer rates since 2000 for Cal-Am to undertake these audits, and the number of audits performed each year.

11. Cal-Am shall separately collect the minimum Employee Retirement Income Security Act (ERISA) pension payment for the Monterey and Felton districts through a 3% monthly surcharge on customer bills, separately reconciled for each district with an annual advice letter filing for a surcredit or surcharge, depending on the balance in the balancing account.

12. In the next Monterey and Felton GRC applications, Cal-Am shall include in its application a comprehensive showing of any changes that are greater than

the rate of inflation in operation and maintenance (O&M) expenses, payroll expenses other than pension payments, other A&G expenses, allocated GO expenses.

13. Cal-Am shall file by advice letter for any additional capital projects in the Felton district.

14. Cal-Am shall limit rate increases for the Felton district to 50% of rates prior to Decision (D.) 05-09-044 in the first year of this decision. This limit shall be calculated to include (a) the rate increase effect of amortization of the balancing account authorized D.05-09-044, and (b) the deferred balance in this case from interim rates.

15. The surcharge to true-up the interim rates authorized in D.05-12-024 for the Monterey and Felton districts shall be based on the actual loss or gain in Monterey's and Felton's revenue since January 1, 2006, determined by applying the rate differential to the actual quantities of water sales and the actual number of customers. For the Monterey district, the interim rate surcharge shall be recovered over the following 12 months. For the Felton district, Cal-Am shall recover the surcharge over a period consistent with the 50% rate cap adopted here. For both districts, Cal-Am shall earn interest at the 90-day commercial paper rate on the surcharge balance. Cal-Am shall file by advice letter within 10 days a compliance filing implementing the surcharges.

16. Cal-Am shall include in its next Monterey GRC application:

    a. A specific analysis of leakage in the Carmel Valley main system.

    b. A full breakout of all capital improvement projects undertaken in each of the four subsystems since State Water Resources Control Board (SWRCB) Order No. WR 95-10 (Order 95-10) and a detailed cost estimate of additional capital projects planned over the coming ten years for each subsystem.

c. A comprehensive showing of any changes that are greater than the rate of inflation in the expense categories of O&M expenses, payroll expenses (excluding pension payments), other administrative and general (A&G) expenses, and allocated general office expenses.

17. Cal-Am shall include as part of its direct showing in its 2009 General Office GRC filing the requested regulated expenses for each individual GO expense category and provide a comprehensive showing in support of any items that have increased since 2006 at a rate greater than inflation and customer growth.

18. Cal-Am shall file by compliance filing within 5 business days the supporting documentation for the amortization amount of the acquisition premium allocated to the Monterey and Felton district.

19. Exhibits 107 through 115 are entered into evidence.

20. Application (A.) 05-02-012 and A.05-02-013 are closed.

This order is effective today.

Dated _____, at San Francisco, California.

INFORMATION REGARDING SERVICE

I have provided notification of filing to the electronic mail addresses on the attached service list.

Upon confirmation of this document's acceptance for filing, I will cause a copy of the Notice of Availability to be served upon the service list to this proceeding by U.S. mail. The service list I will use to serve the copy of the Notice of Availability is correct as of today's date.

Dated October 6, 2006, at San Francisco, California.

/s/ JOYCE TOM
Joyce Tom

N O T I C E

Parties should notify the Process Office, Public Utilities Commission, 505 Van Ness Avenue, Room 2000, San Francisco, CA 94102, of any change of address to insure that they continue to receive documents. You must indicate the proceeding number on the service list on which your name appears.

********** SERVICE LIST for A0502012, A0502013 ********
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