STATE OF CALIFORNIA ARNOLD SCHWARZENEGGER, *Governor*

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

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May 8, 2007

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Ratesetting

TO PARTIES OF RECORD IN APPLICATION 06-07-002

This is the proposed decision of Administrative Law Judge (ALJ) Bemesderfer, previously designated as presiding officer in this proceeding. It will not appear on the Commission's agenda for at least 30 days after the date it is mailed. This matter was categorized as ratesetting and is subject to Pub. Util. Code § 1701.3(c). Upon the request of any Commissioner, a Ratesetting Deliberative Meeting (RDM) may be held. If that occurs, the Commission will prepare and publish an agenda for the RDM 10 days beforehand. When the RDM is held, there is a related ex parte communications prohibition period. (See Rule 8.2(c)(4).)

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 25 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 and hard copies of comments should be sent to ALJ Bemesderfer at kjb@cpuc.ca.gov and assigned Commissioner. The current service list for this proceeding is available on the Commission's website at www.cpuc.ca.gov.

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

ANG:tcg

Attachment

Decision **PROPOSED DECISION OF ALJ BEMESDERFER** (Mailed 5/8/2007)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of VALENCIA WATER COMPANY (U-342-W), a Corporation, for an Order Authorizing It to Increase Rates Charged for Water Service in Order to Realize Increased Annual Revenues of $2,402,000 in a Test Year Beginning July 2007, $708,000 in a Test Year Beginning July 2008, and $660,000 in an Escalation Year Beginning July 2009, and to Make Further Changes and Additions to Its Tariff for Water Service.	Application 06-07-002 (Filed July 3, 2006)

(See Appendix A for List of Appearances.)

OPINION ON APPLICATION FOR GENERAL RATE INCREASE

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OPINION ON APPLICATION FOR GENERAL RATE INCREASE

I. Summary

We approve a stipulation entered into between Valencia Water Company (Valencia or Applicant) and the Commission's Division of Ratepayer Advocates (DRA) which settled all but ten of the contested issues in this case.

With regard to the contested issues, we approve:

(a) Applicant's request for $1,700,000 to construct a demonstration water softening plant;

(b) rate increases to realize increased annual revenues of $2,402,000 in a test year beginning July 1, 2007; $708,000 in a test year beginning July 1, 2008; and $660,000 in an escalation year beginning July 1, 2009;

(c) a capital structure consisting of 69% common equity, 3.05% preferred stock and 27.95% long-term debt;

(d) a rate of return of 11.75% on common equity for the Test Years 2007-2008 and 2008-2009;

(e) all salary increases described in the application whether previously granted or proposed;

(f) all outside service expenses described in the application whether previously incurred or anticipated;

(g) an income tax deduction for interest based on actual rather than imputed interest expense;

(h) an allowance of $103,000 for Test Year 2007-2008 to implement water conservation programs of the California Urban Water Conservation Council;

(i) creation of a Base Revenue Memorandum Account; and

(j) use of 2006 Energy Branch escalation factors for calculating Test Year expenses that were the subject of the stipulation but for which the parties did not agree on a specific amount.

Valencia is a Class A water corporation serving approximately 28,300 customers and headquartered at 24631 Avenue Rochefeller Valencia, CA 91355.

II. Procedural History

In accordance with the Commission's Rate Case Plan for Class A Water Companies,[1] Valencia filed its proposed General Rate Case (GRC) application at the beginning of May 2006. On May 31, DRA delivered to Valencia a deficiency letter, identifying a series of perceived deficiencies in the proposed application. After addressing each of these items and revising the proposed application as appropriate, Valencia filed its application on July 3, 2006, including a total of 22 exhibits and other requisite attachments. The application was served on potentially interested parties and was noticed in the Commission's Daily Calendar for July 7, initiating a 30-day protest period. The only protest submitted was that of DRA, filed August 1, 2006.

A prehearing conference was held on October 2, 2006. On October 4, 2006, the assigned Administrative Law Judge (ALJ) issued a ruling directing Valencia to file a response identifying the portions of its GRC application in which the issues on a checklist in Water Division Director Kevin Coughlan's July 19th letter to all Class A California water companies were addressed; and further directing Valencia, to the extent its application had not addressed an issue on the checklist, either to address the issue or to show good cause why the issue need not be addressed in this GRC. DRA served its reports on Valencia's results of operations and on Valencia's cost of capital on October 10, 2006. On October 13,

[1] Rulemaking to Evaluate Existing Practices and Policies for Processing General Rate Cases and to Revise the General Rate Case Plan for Class A Water Companies, D.04-06-018, Appendix (Rate Case Plan).

2006, Valencia submitted a letter accompanied by supplemental testimony in response to the ALJ's order. DRA filed a reply to the letter on October 20, 2006. A Public Participation Hearing (PPH) was held in the City of Valencia on the evening of October 23, 2006 and Valencia responded to the DRA staff reports by serving the rebuttal testimony of six witnesses on October 25, 2006.

Following the service of rebuttal testimony, the parties turned their attention toward the possibility of settling some or all issues presented in this GRC. Valencia and DRA held settlement discussions beginning October 31, and continuing through November 8, resulting in the parties' agreement in principle on a stipulation as to most issues that previously had been contested by DRA but identifying certain issues as still in dispute. Negotiation of the precise terms of the proposed stipulation were not completed until just after the close of evidentiary hearings on November 28, 2006. The terms of the stipulation between Valencia and DRA were submitted into evidence as Exhibit 39.

Evidentiary hearings in this GRC were held November 27 and 28, 2006, at the Commission's offices in Los Angeles. Seven witnesses appeared for Valencia and four for DRA, each adopting his or her previously circulated prepared testimony, in some cases offering additional direct testimony, and responding to cross-examination. The prepared testimony of five additional witnesses for Valencia and two additional witnesses for DRA was received without appearances or cross-examination. A total of 55 exhibits were received into evidence in the course of the hearing, with two additional exhibits submitted thereafter (Exhibit 39, the Stipulation; and Exhibit 40, a Valencia exhibit regarding earnings growth for DRA's comparable group of companies).

Opening briefs were filed on January 22, 2007 and reply briefs on February 5, 2007.

III. Joint Stipulation

Valencia and DRA signed a Joint Stipulation (Stipulation) on November 28, 2006, providing for agreement on most, but not all of the differences between them.[2] Paragraphs 2.1 through 9.1 as well as Paragraphs 10.4 and 10.5 of the Stipulation describe the basis for the stipulated outcomes to which Valencia and DRA have agreed. In particular, Paragraphs 3.3 and 3.4 indicate the parties' agreement that Purchased Water expense and Purchased Power expense should be calculated using the "latest available rates" being charged to Valencia by its suppliers at the time the decision tables are calculated to accompany the final decision in this GRC. Valencia and DRA show these expenses in the Comparison Exhibit, filed concurrently with their reply briefs, based on the latest available rates as of that date. Paragraph 4.6 indicates the parties' agreement that Valencia should be authorized to replace its current billing system with an investment not to exceed $400,000 to be included in rate base by advice letter or in Valencia's next GRC.

Paragraphs 10.1 through 10.3 of the Stipulation describe the unresolved issues that were addressed at the evidentiary hearings, except that the Escalation Factors issue was not specifically addressed in the Stipulation.[3] Paragraphs 10.4 and 10.5 of the Stipulation address aspects of Regulatory Commission expense for which the parties agreed to certain procedures in the event that certain contingencies were to arise.

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[2] Exhibit 39 (Joint Stipulation), ¶1.6.

[3] The Escalation Factors issue was identified only shortly before the Stipulation was signed, for reasons noted at Tr. 288:25-289:14 (Statement of Valencia counsel).

Paragraph 10.4 addresses Valencia's request for $400,000 in Regulatory Commission expense for potential additional costs required to respond to issues raised by any intervening parties in this GRC. The parties agreed that if no such intervenors had raised additional issues by the end of the evidentiary hearings, this $400,000 should be removed from Valencia's Regulatory Commission expense. However, the parties further agreed that Valencia should be authorized to establish a memorandum account to track any future expenses resulting from an application for rehearing, petition for modification, or other participation by intervenors in this GRC.[4] No third-party intervenors having participated in this GRC, we remove $400,000 of proposed Regulatory Commission expense from the GRC application and authorize a memorandum account for the purpose noted above.

Paragraph 10.5 of the Stipulation removes Valencia's requested recovery of $62,727 of past intervenor compensation payments from this GRC provided Valencia is able to recover these expenses by advice letter. Advice letter recovery of those payments was approved by the Commission on December 26, 2006, and became effective January 1, 2007. Accordingly, the requested recovery of $62,727 is removed from this GRC.

IV. Compliance Filings

Valencia made several compliance filings in connection with this GRC Application for which it seeks our approval, including findings that:

- Valencia has complied with all Department of Health Services safe drinking water standards during the period since its last GRC in 2002,

[4] Exhibit 39 (Joint Stipulation), ¶10.4.

- Valencia's Water Management Program as submitted in this GRC is adequate for the Commission's purposes, and
- Valencia may adopt a revised tariff formula for calculating the costs of recycled and untreated water purchased by Valencia from Castaic Lake Water Authority and resold to Valencia customers.

None of these compliance filings was objected to by DRA and accordingly, we will approve them as part of this decision.

V. Discussion

A. Water Quality Improvement Program

Valencia's water supply from groundwater wells contains concentrations of calcium and magnesium ranging between 300 and 700 parts per million (ppm).[5] According to the Applicant, water is considered very hard if the combined concentrations of calcium and magnesium exceed 300 ppm. In response to numerous customer complaints about this problem, Valencia proposes to construct a demonstration project to evaluate a remedy for the hardness of its groundwater supplies.

Valencia's customers receive a blend of imported water from the State Water Project (SWP), purchased water from Castaic Lake Water Agency (CLWA) and local groundwater pumped from company-owned wells. Valencia blends the hard water from its groundwater wells with softer water from the SWP and the CLWA in order to deliver a more uniform and consistent water quality for its customers. This blending reduces the hardness of the water delivered to

[5] Applicant Exhibit 8.

Valencia's customers but does not result in overall hardness levels generally acceptable to consumers.

Testimony at the evidentiary hearing established that all of Valencia's customers currently pay a high price for hard water. Some have absorbed the price in the form of corroded plumbing and damaged appliances, while others have installed self-regenerative water softeners in their homes and businesses. These devices extract the dissolved minerals in the water in the form of calcium and magnesium chloride. Valencia's Chief Executive Officer testified that 11,000 to 12,000 of Valencia's residential customers currently spend, on average, $50 per month or more for water softening in addition to paying their water bills.[6] Other evidence including correspondence from Valencia customers supporting the water softening project suggests that the average Valencia customer incurs between $300 and $900 a year in direct and indirect costs as a result of the extreme hardness of the water.[7]

Although the in-home water softeners substantially reduce hardness levels in water used for drinking and washing, the water softening devices periodically discharge the captured calcium and magnesium chlorides into the sewer system. This additional chloride loading to local wastewater treatment plants causes high chloride discharges into the Santa Clara River. The Los Angeles Regional Water Quality Control Board currently is reviewing the total maximum daily load for chloride in the Santa Clara River and is in the process of setting new discharge limits for chloride that may require the Santa Clarita Valley Sanitation District of

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[6] Exhibit 8 (DiPrimio), at 2.

[7] *Id.* at 34.

Los Angeles County (Sanitation District), owner of the existing wastewater treatment plants, to install very expensive treatment equipment[8] and a brine line to remove the chlorides before effluent is discharged to the river. One possible alternative being considered by the District to reduce chloride loading to the Santa Clara River is Valencia's wellhead water softening project.[9]

Kennedy/Jenks Consultants conducted a Wellhead Softening Feasibility Study (Feasibility Study) for the Applicant in April 2006. The Feasibility Study describes the hardness problems characterizing Valencia's water supplies, evaluates several candidate softening technologies and recommends, based on cost and non-cost factors, the choice of pellet softening as the treatment process most appropriate for Valencia.[10] The Feasibility Study also recommends, in order to confirm consumer acceptance of centralized softening and to refine project costs, that Valencia construct a demonstration plant. The Feasibility

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[8] Evidence at the hearing established that a new treatment plant that would reduce chloride discharges in the river to acceptable levels could cost as much as $447 million. Exhibit 8 at 34. The technology that would be employed in such a plant would be the so-called "reverse osmosis" process, in which hard water is forced through a membrane that filters out the chlorides and disposes of the resulting brine by piping it through a dedicated line to a disposal site.

[9] Exhibit 8 (DiPrimio) 2. As discussed more fully below, DRA objects to the construction of the demonstration water softening project in part because Valencia customers would be charged for conferring a benefit on non-Valencia customers, i.e., the downstream users of water from the Santa Clara River.

[10] *Id*. (Takiichi) 1-3 and 9-29. The Applicant's expert testified that pellet softening would not completely eliminate dissolved minerals in the treated water but would reduce them enough that the blended water received by Valencia's customers would be acceptably soft. To further soften the water would require the use of the reverse osmosis process and would not be cost-effective.

Study estimates the capital cost for the demonstration plant at $1.7 million, with an annual operation and maintenance cost of $170,000.[11]

The Feasibility Study includes an analysis of the projected economic benefits of a system-wide water softening project. This analysis concludes that the benefits to Valencia's customers from softening all the groundwater could be as high as $23.8 million per year – consisting of $2.6 million in savings from reduced water softener use and $21.2 million in avoided wastewater treatment costs.[12] For reasons discussed below, we believe this estimate must be revised.

Valencia's request for authorization to build the demonstration water-softening project was supported by state, county and local government officials and customers of the water company. Most significant, no Valencia customer opposed the request. However, DRA did oppose the request and it is to its opposition that we now turn.

DRA opposes having ratepayers finance water quality improvement projects that do not result in direct health benefits and asserts that Valencia's water softening project fits that category. DRA sees a lack of customer support and argues that ratepayers should not be asked to pay for non-essential aesthetic enhancement projects.[13] Interpreting survey results as indicating that most customers do not own water softeners and do not favor paying more for softer water, DRA sees no compelling argument for allowing the project.[14]

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[11] *Id*. at 4, 37-44.

[12] *Id*. at 4, 37-44.

[13] Exhibit DRA-7 (Gomberg), at 4-12.

[14] *Id.* at 4-13 to 4-14.

DRA denies that other water purveyors in the Santa Clarita area consider water softening a priority or that Valencia's project will provide environmental benefits. DRA also doubts Valencia's claim that the project could save $21 million in avoided wastewater treatment costs. DRA argues that Valencia ratepayers might end up having to pay for both Valencia's water softening project and an advanced wastewater treatment plant.[15]

DRA sees the environmental problem of self-regenerating water softeners as a regional problem, requiring a regional solution. DRA does not want Valencia's ratepayers to bear the cost of Valencia investing in an uncertain solution to the problem and would prefer to see other alternatives pursued.[16]

Based on Valencia's data showing that the demonstration softening project will require a 2.2% increase in customer bills, DRA calculates that a 45% increase in customer bills would be needed to fund full deployment of a water softening program. DRA concludes that the cost of full deployment outweighs the benefits. Having decided that the overall project is unreasonable, DRA considers the demonstration project unreasonable as well. DRA fears that allowing the demonstration project to go forward would increase pressure to approve the entire project, to which DRA is opposed.[17]

Hard water is clearly more than an aesthetic problem. The record establishes that the scale from hard water clogs pipes, hot water heaters, washing machines and dishwashers, necessitating frequent repairs and replacements. The

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[15] *Id.* at 4-14 to 4-15. DRA introduced no evidence to rebut the cost savings estimated in the Kennedy-Jenks study.

[16] *Id.* at 4-16 to 4-17.

[17] *Id.* at 4-18 to 4-19.

damage done by hard water is a principle reason that nearly half of Valencia's customers incur the substantial extra monthly costs associated with in-home water softening devices. If softening the water at the source is cheaper than softening water in the home, all Valencia customers will benefit from switching to pre-softened water.

If Valencia pre-softens the water it delivers to its customers and those customers disconnect existing home water softeners (or don't buy additional home water softeners), Valencia's customers will be conferring a benefit on people and businesses downstream. The Santa Clara River will have fewer chlorides discharged into it than it would if Valencia didn't build the water-softening plant. Softer water in the river will reduce the need for brine removal downstream, to the benefit of downstream residents and businesses. But is this unintended benefit to third parties sufficient reason to deny the application for a permit to build the demonstration plant? We think not.

Rather than seeking immediate approval to build a full-scale plant, Applicant prudently proposes to test the recommended water softening technology on a pilot basis before deciding whether to propose building a full-scale plant. The demonstration project will establish how effective pellet softening is in removing dissolved minerals from the groundwater, how costly it is and whether a less costly alternative would produce satisfactory water quality. Valencia's project will also provide data to other upstream water companies and to the Sanitation District that can be used to develop a region-wide response to the water hardness problem.

To analyze the costs and benefits of wellhead water softening to Valencia ratepayers, it is necessary to make certain assumptions. The first of these concerns the proportion of the cost of in-home water softening that can be

attributed to customer dissatisfaction with the aesthetic qualities of hard water. Among the 11 to 12 thousand customers estimated to be operating home water softeners, we assume that some are doing so primarily to eliminate unsightly deposits on glassware and automobiles, to get cleaner clothing from their washing machines or for other reasons. Others, we assume, are softening the water primarily to avoid corroded pipes and damaged appliances. Unfortunately, the company's customer survey did not attempt to distinguish between these reasons for installing home water softening equipment. Since those customers who have installed home water softeners are paying $50 a month or more to operate them, $50 a month appears to be a reasonable estimate of the total cost of hard water to the average Valencia customer. In the absence of record evidence regarding the allocation of that cost between aesthetic and economic problems, we will assume that half the cost ($25 a month per customer) is a reasonable estimate of the unavoidable economic burden imposed by hard water on the average Valencia customer. This equates to an annual cost of approximately $8.5 million[18] to Valencia ratepayers which could be avoided by wellhead water softening.

[18] $300 per customer times 28,3000 customers = $8,490,000.

To calculate the avoided costs of reduced wastewater treatment requires another assumption. The home water softeners operated by Valencia customers contribute about 45% of the chlorides flowing into the wastewater stream from the upper Santa Clarita Valley.[19] The remaining 55% of the discharged chlorides come from water softeners operated by customers of other water companies. There is an inverse relationship between the amount of chloride discharge from upstream water company customers and the cost of building a new downstream wastewater treatment plant. If all upstream chloride discharges were eliminated, a new plant would be unnecessary. If none of the upstream discharges were eliminated, a new plant costing nearly half a billion dollars would be necessary.

If some, but not all, upstream discharges were eliminated, witnesses for the Applicant and DRA agree that the size of the downstream plant could be reduced. Unfortunately, the record is silent on the exact relationship between partial chloride discharge abatement and size reduction of the downstream plant. Recognizing that there is a minimum size for any such plant, we assume that if Valencia alone among the upstream water companies adopted wellhead water softening, thus eliminating 45% of the chloride discharge, the size of any future wastewater treatment plan would be reduced by 22.5%.

With these assumptions in place, it is possible to estimate the costs and benefits to Valencia ratepayers under different scenarios. The scenario of concern to us is one in which Valencia alone adopts wellhead water softening. On the assumptions we have made, would such an action be beneficial to Valencia ratepayers? The Kennedy-Jenks study estimated that eliminating the

[19] Tr. 221:19-222:21 (DiPrimio).

need for a new wastewater treatment plant would save Valencia ratepayers $21.2 million a year in avoided wastewater treatment costs. Reducing the size of the plant by 22.5% rather than eliminating it entirely would therefore save Valencia ratepayers $4.77 million a year (22.5% of $21.2 million). To these avoided costs, we add the previously calculated economic benefit from eliminating hard water at the wellhead of $8.5 million, for a total estimated annual benefit to Valencia ratepayers of $13.27 million from wellhead water softening, even if no other water company follows Valencia's lead.

On the cost side of the equation, the full-scale plant is estimated to cost $32.328 million to build and $6.6 million annually to operate. To the $6.6 million annual operating cost, we need to add approximately $3.3 million a year to amortize plant construction costs, for a total annual cost of wellhead water softening of $9.9 million. Thus even if Valencia alone chooses to adopt wellhead water softening, the projected annual savings to Valencia ratepayers are approximately $3.4 million ($13.3 million - $9.9 million).

Not surprisingly, given the favorable economics of the proposed project and its beneficial environmental effects, it has received wide support from the public bodies responsible for water supply and water quality in the Santa Clarita area. These expressions of support include a letter from State Senator George Runner and resolutions of support adopted by the City of Santa Clarita and the Santa Clarita Valley Sanitation District. At the Public Participation Hearing, various speakers supported the project and no one opposed it. We also note that the matter of chloride pollution of the Santa Clara River is the subject of SB 475, authored by Senator Runner and signed into law last year by the Governor, which provides financial incentives for homeowners to remove their water softeners.

For the above reasons, we find it to be in the public interest to approve the construction of the demonstration plant.

B. Valencia's Capital Structure

Valencia's capital structure is set forth in Section 2.5 of its Application. Valencia's last adopted capital structure, for Test Year 2004, was agreed upon as part of a settlement between Valencia and DRA and consisted of 34.71% debt, 3.79% preferred stock, and 61.5% common equity. Valencia asks that we base its rates on its actual capital structure, which, for Test Year 2007-2008, will consist of 27.95% debt, 3.05% preferred stock, and 69% common equity.[20]

DRA witness Mehboob Aslam testified that DRA recommends a capital structure consisting of 46.40% long term debt, 1.00% preferred equity, and 52.60% common equity.[21] Since the cost of long-term debt is substantially lower than the cost of common equity, the DRA recommendation would significantly reduce the overall rate of return on rate base and the overall return allowance for Valencia, as compared with a calculation of return requirements based on Valencia's actual capital structure.

Noting Valencia's citation[22] of a study, by Scott and Martin, that found statistically significant evidence that smaller firms seeking low-cost capital structures will have higher equity ratios than larger firms in the same industry, DRA witness Aslam denied that Valencia was a small company "in the true meaning of the term," because its parent company, Lennar Corporation, is

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[20] *See* Application, 9-11; *see also* Exhibit 1 (Conway/VWC), at 11-1 to -2.

[21] Exhibit DRA-12 (Aslam), at 1-1; *see also id.* at 1-2.

[22] Aslam refers to this citation as appearing in Valencia's application. In fact, it appears in Exhibit 4 (Zepp), at 29.

publicly traded and reported annual revenue over $13 billion in the year 2005, and because for investors, "it is the size of Lennar not that of Valencia which matters."[23] He also denied the relevance of the cited study, because it addressed "non-regulated" firms.[24]

According to Aslam, "DRA has two choices" – either to adjust Valencia's capital structure to one "more in tune with the other Class A water utilities in California" or to reduce Valencia's rate of return to "accommodate" a low financial risk due to increased reliance on equity. He chose the former approach as "more practical" and "less controversial." Based on data for four major Class A water companies in California, he calculated an average common equity ratio of 52.6% and imputed that ratio to Valencia.[25]

In choosing between Valencia's actual capital structure and DRA's recommended capital structure, we note that Valencia is a subsidiary of a publicly traded company, Lennar Corporation. Thus its actual capital structure is to some degree arbitrary and could be changed by the parent at any time, for instance, by injecting additional equity into the Applicant or using parent funds to retire the subsidiary's indebtedness, although there are sound economic reasons to doubt that the parent would actually take these steps.[26] On the other

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[23] Exhibit DRA-12 (Aslam), at 3-3.

[24] *Id*.

[25] *Id.* at 3-3.

[26] While the record is silent on the comparative costs of capital to parent and subsidiary, we note that Lennar is engaged in a risky and volatile business, speculative real estate development, while Valencia, as a regulated company, has a guaranteed rate of return on its capital and the legal ability to recover its costs through rates. It is not unusual for a regulated subsidiary to have a lower cost of capital than an unregulated parent in

Footnote continued on next page

hand, there is much to be said for basing a rate of return calculation on an applicant's actual capital structure rather than imputing an artificial capital structure in order to back into a rate of return. As Applicant's witness Zepp pointed out, a goal of rate-making is to approximate the economic returns that a regulated company would achieve in a competitive environment.[27] In the absence of evidence that the Applicant is manipulating its capital structure in order to achieve an artificially high rate of return, basing a rate of return calculation on its actual capital structure is consistent with that goal.

In response to DRA's contention that Valencia should not be considered a small company because its parent Lennar is a large public company, Applicant's witness Milleman testified that "Valencia is not Lennar." He noted that "if Valencia truly were viewed by the investment world as a real estate company, then DRA should be recommending rates of return applicable to real estate companies."[28] Instead, DRA compared Valencia to large publicly traded water utilities that are in a far less risky business than speculative real estate development. If Lennar sometimes earns a high rate of return, that is because "the speculative real estate industry demands a higher rate of return then the regulated water industry."[29] DRA invokes Valencia's large parent company to

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such a situation and it is unlikely that the parent would choose to replace lower-cost subsidiary capital with higher-cost parent capital.

[27] Exhibit 33 (Zepp), at 5.

[28] Exhibit 25 (Milleman), at 24.

[29] *Id.* at 24-25.

deny recognition of Valencia's small company risks, but ignores the greater market risks facing the parent company.[30]

Milleman also testified that comparing Valencia's capital structure with the capital structure of major water companies such as California Water Service Company or Golden State Water Company is inappropriate. Because these companies are large and geographically dispersed, "they are able to spread their risks. They are publicly traded and have ready access to capital. They have finance departments, legal departments, regulatory staffs, general office support, and other large-company resources. Valencia has two associates to cover these issues."[31] Milleman suggested that a more realistic approach would be to compare Valencia (28,300 connections) with Great Oaks Water Company (20,000 connections) or Class B water utilities (500 to 10,000 connections). We concur.

Our charge as regulators is to see to it that Valencia's customers continue to receive an adequate supply of good-quality water at a reasonable price. If, in an effort to keep water prices to consumers low, we provide Valencia with inadequate income by manipulating its capital structure or by any other means, we jeopardize the future adequacy and quality of the water supply. Accordingly, we choose to adopt Valencia's actual capital structure rather than DRA's imputed capital structure and we deem Valencia to have a capital

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[30] In a recent Form 8-K report filed with the Securities and Exchange Commission (SEC), Lennar reported a net loss of $195.6 million, or $1.24 per diluted share, for its 4th quarter ended November 30, 2006, compared to net earnings of $581.2 million, or $3.54 per diluted share, in the 4th quarter of 2005. Lennar Corporation, Current Report Form 8-K, filed January 17, 2007, Exhibit 99.1.

[31] Exhibit 25 (Milleman), at 27.

structure for this rate-making period consisting of 27.95% debt, 3.05% preferred stock,[32] and 69% common equity.[33]

C. Return on Common Equity (ROE)

Having established the proportion of the various components of the rate base, we turn now to the question of the rate of return that Valencia should be permitted to earn on the common equity portion of the rate base. DRA's expert Aslam submitted two studies of rates of return earned by a group of six "comparable" water companies that implied rates of return on Valencia's common equity of 8.40% and 10.53% respectively. Aslam took the average of those studies and recommended an ROE of 9.46%.[34] Applicant's witness Zepp criticized the methodology used by Aslam and submitted a study proposing an ROE of 11.75%.[35] In support of this recommendation, witness Zepp testified that small water companies like Valencia typically are capitalized with higher equity ratios than larger water companies and pay higher costs for their equity than do

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[32] DRA recommended a reduction from 3.05% of preferred stock to an imputed 1%. However, there was insufficient justification for this recommendation and it ignores the fact that preferred stock functions effectively like debt in that preferred dividends are essentially equivalent to bond interest that is periodically paid to the holder. Thus little, if anything, is gained from substituting one form of fixed-payment obligation for another.

[33] From time to time, to keep water rates reasonable, we have imputed a capital structure that includes approximately one-third debt to some small water companies that are actually capitalized with 100% equity. See, e.g., *Great Oaks Water Company*, Resolution W-4594 (May 11, 2006) (Exhibit DRA-8), at 8. However, Valencia's rates are already moderate relative to the rates of comparable companies in the region and we do not believe that an artificial capital structure is necessary to insure continued reasonable rates.

[34] DRA 12 (Aslam) at 1-2.

[35] Exhibit 33 (Zepp), at 4.

larger water companies.[36] He explained that the higher costs of equity result from the higher risks typically incurred by small water companies. He identified two areas of "additional risk" facing Valencia: the additional regulatory risk of operating in California and litigation and other risks specific to Valencia.

Noting that DRA has recognized in other cases that "the business risk of a regulated utility consists primarily of regulatory risk," Zepp pointed out that "at least two institutions that evaluate regulatory risk indicate such risk is higher in California than in other states."[37] He discussed a number of reasons why Valencia and other California water utilities face above-average regulatory risk, including a relatively short three-year GRC cycle, constraints on forecasting future sales, and the potential for water quality lawsuits. He also noted that three of the six utilities in Aslam's "comparable group" do not operate in California and therefore do not face comparable regulatory risk.[38]

Zepp testified that Valencia faced additional company-specific risks due to its small size, the possibility of catastrophic events affecting its service area, and the active and continuing intervention of "no growth" advocates in regulatory and court proceedings affecting Valencia.[39] The constant contention over land development and water supply in the Santa Clarita Valley creates the risks that growth in future sales may be substantially below forecasts, that Valencia may incur unexpected legal costs and that litigation over perchlorate contamination

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[36] *Id*. at 5.

[37] Exhibit 4 (Zepp), at 15-16.

[38] *Id.* 16-19.

[39] *Id.* at 19-26.

may drain Valencia's resources.[40] Each increment of risk faced by Valencia that is not faced by larger water companies or companies located outside of California increases Valencia's cost of capital relative to such other companies. Zepp testified that these added risks increase the equity return required by Valencia by at least 90 basis points (0.90%) above the average ROE required by companies that do not face these risks.

Zepp's analysis of the cost of equity capital for Valencia, was received into evidence as Exhibit 4. It includes a study of the current cost of equity capital for a group of benchmark water utilities (the "comparable group"), using both Discounted Cash Flow (DCF) analysis and several variations of Equity Risk Premium analysis.

Applying a DCF analysis, which computes the cost of equity as the sum of expected dividend yield and expected dividend growth, Zepp calculated the cost of equity for the comparable group as falling in a range of 10.7% to 10.9%.[41] Removing one of the six companies, Connecticut Water Service, from the six-company benchmark group produced a slight increase in the benchmark equity range to one of 10.8% to 11.0%.[42]

Zepp then applied the Equity Risk Premium concept to calculate the cost of equity for the comparable group. The Equity Risk Premium is the difference between the utility's cost of equity and the interest rates paid on Treasury

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[40] *Id.* at 26-28.

[41] *Id.* at 6, 31-39.

[42] *Id.* at 39. Zepp explained that estimates of forward-looking growth for Connecticut Water are not available, and so for purposes of DCF analysis, growth rates must be determined from other sources and DRA's approach of relying on past data but not including past growth in stock prices produces understated results.

securities, which are essentially risk-free. He developed four different risk premium estimates, based on similar but distinct calculations. The first was an update and restatement of the risk premium analysis DRA presented in a November 2004 California-American Water Company (CalAm) GRC, producing an indicated cost of equity for the comparable group in a range of 10.6% to 10.9% (implying a cost of equity for Valencia of 11.5% to 11.8% when the 0.9% risk premium is added to the indicated ROE range for CalAm).[43] Zepp then substituted authorized ROEs for the earned ROEs as proxies for the cost of equity, which produced a range for the comparable group of 10.8% to 11.4% (implying a cost of equity for Valencia of 11.7% to 12.3%).[44]

On the assumption that costs of equity for water utilities move in the same direction as interest rates but by smaller amounts, Zepp performed a third risk premium analysis that produced a 10.7% cost of equity for the benchmark water utilities and implied an 11.6% cost of equity for Valencia.[45] A fourth risk premium analysis based on dividend yields and growth rates derived from published reports of the comparable group for the years 1999 through 2005 produced an equity cost range of 10.7% to 11.1% for the comparable group and implied an equity cost range of 11.6% to 12.0% for Valencia.[46] The combination of these four Equity Risk Premium estimates indicated a benchmark equity cost

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[43] *Id.* at 40-41.

[44] *Id.* at 41-42.

[45] *Id.* at 42-44.

[46] *Id.* at 42-44.

range of 10.5% to 11.4% and implied an equity cost range of 11.4% to 12.3% for Valencia.[47]

Based on these analyses, Zepp recommended that the Commission authorize an ROE of 11.75% for Valencia.[48]

DRA's analysis of Valencia's cost of equity was provided by Aslam in Exhibit DRA-12. Like Zepp, he applied two financial models, DCF and Equity Risk Premium, to a "comparable group" of six[49] publicly-traded water utilities, to estimate investors' expected ROE for Valencia.

The two experts differed slightly in their calculation of dividend yields for the companies in the comparable group. Zepp calculated average yields of 2.87% to 3.06% while Aslam calculated average yields of 2.78% to 2.84% for the same companies. For the other main element of DCF analysis, the earnings growth rate, the differences were far greater. Zepp relied solely on forecasts of earnings growth while Aslam combined historical growth rates with forecasted growth rates. The result of these different approaches is that while Zepp used an earnings growth rate at 7.59%, the average of two forecasts of earnings growth, Aslam used a growth rate of only 5.44%, the average of a 2.74% average historical growth rate and an 8.14% average forecast growth rate.[50] The 2.74% average historical growth rate used by Aslam was an average of six calculated historical averages, ranging from a five-year earnings growth rate of 0.24% to a

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[47] *Id.* at 6, 44.

[48] *Id.* at 54.

[49] Aslam's testimony refers to 7 publicly-traded water companies but his analysis used only the same 6 companies used by Zepp.

[50] *Compare* Exhibit 4 (Zepp), Tables 8 through 12, *with* Exhibit DRA-12 (Aslam), at 2-4 to 2-5 and Table 2-5, and Exhibit DRA-15 (Aslam), Table 2-5.

five-year earnings growth rate of 4.52%.[51] While Valencia questions the accuracy of Aslam's calculation of historical growth rates, the company primarily argues that the combining of historical growth rates with forecasted growth rates over-weights past data because analysts' forecasts have already taken those data into account.[52]

Aslam's Equity Risk Premium analysis compared historical ROEs for the comparable group with yields on 10-year and 30-year Treasury bonds, with the differences between those annual averages assumed to be the annual risk premiums. He then calculated ten-year and five-year averages of those risk premiums and added those averages to forecasted future interest rates, thereby showing four projected ROEs ranging from 10.27% to 10.75%, from which he derived an average risk premium ROE calculation of 10.53%.[53]

Aslam contested several aspects of Zepp's cost of capital analysis. In the area of company-specific risk, as discussed in the context of the capital structure issue, he claimed that Valencia should not be considered a small company, because its parent company is large.[54] He denied that regulatory risk is higher in California than in other states, noting favorable investor responses to changes at the Commission, and he downplayed the risks presented by "no-growth"

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[51] Exhibit DRA-15, Table 2-3.

[52] Exhibit 4 (Zepp), at 33-34. In support of this argument, Zepp cited a study finding that relying only on forecasts of earnings growth yielded better results in a DCF analysis.

[53] *See* Exhibit DRA-12 (Aslam), at 2-5 to 2-6 and Tables 2-6 through 2-8.

[54] *Id.* at 4-2.

opposition, water quality litigation, uncertainty about future growth, or other litigation.[55]

Aslam challenged Zepp's inclusion in his DCF analysis of "sv-growth" – sustainable growth that is expected from external sources, which can be expected when market price exceeds book value.[56] Aslam asserted that if the market to book ratio exceeds one, the authorized return must be greater than investors require, and so he opposed any recognition of "sv growth."[57]

Aslam objected to any method of risk premium calculation other than the comparison of earned ROE to low-risk Treasury bonds, which both he and Zepp employed. He opposed Zepp's use of authorized ROE – as distinguished from earned ROE – in a variant of his risk premium model. He also objected to Zepp's consideration that costs of equity for water utilities may move in the same direction as interest rates but by less, as well as his use of a composite DCF/risk premium model.[58]

DRA's case for an ROE below that recommended by Valencia's expert was unfortunately marred by a series of factual and methodological errors that rendered its conclusions of dubious value. The errors that came to light during the evidentiary hearings included:

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[55] *Id.* at 4-3 to 4-6.

[56] Zepp testified that some utilities in the comparable group have sold stock at prices above book value in recent years, thus achieving "sv growth," and that knowledgeable investors would expect such "sv growth" in the future. Exhibit 4 (Zepp), at 36. He explained that failure to recognize this type of growth results in serious understatement of the overall earnings growth rate. *Id.* at 37-38.

[57] Exhibit DRA-12 at 4-7 to 4-8.

[58] *Id.* at 4-8 to4-9.

- Aslam failed to note that a number of the utilities in the comparable group of publicly-traded water utilities had stock splits during the last ten years. Failure to correct for a stock split causes earnings in years subsequent to the split to appear lower than they are. This failure to note stock splits caused the dividend yield estimates in Aslam's original Table 2-2, the historic growth estimates in his original Table 2-3, and his DCF equity cost estimates to be understated. The failure to correct for stock splits is particularly egregious in light of the fact that DRA had already made those corrections in prior water company rate cases including the recent Park Water Company case, A.06-01-004. Making these corrections to Aslam's calculations increased the average DCF equity cost estimate for the comparable group from 8.06% to 9.31%.[59]
- Aslam used six years of data to calculate what he called a five-year average, and eleven years of data for his ten-year average.[60]
- Aslam's correction of his data for Aqua America to reflect a stock split in 2005 somehow caused the indicated earnings per share in 2005 to go down while leaving the indicated earnings in 2004 unchanged. The witness was unable to provide an articulate explanation of that anomaly. Nor could he explain discrepancies between his presentation of Aqua America's earnings per share and those presented by the DRA witness in the Park Water case.[61]

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[59] Exhibit 33 (Zepp), at 8; *see also*, Tr. 170:11-173:12, 176:24-177:19 (Zepp).

[60] Tr, 255.15—257.7.

[61] To help overcome this factual confusion, Valencia requested and was granted permission to submit a late-filed exhibit presenting earnings information for one or more of the "comparable group" companies. Valencia provided that information by late-filed Exhibit 40 to present a corrected calculation of earnings per share growth for Aqua America and San Jose Water based on their SEC Form 10-K filings for the years 2002, 2004, and 2005. The excerpts from SEC filings in Exhibit 40 reflect the effects of several stock splits for each of the two companies. Attachment 5 to Exhibit 40 extracts relevant earnings per share data from the SEC filings and displays those data, adjusts them to reflect recent stock splits, and thereby presents comparable earnings per share data for years 2000 through 2005 for the two companies. On this basis, Attachment 5 shows average annual growth in earnings per share over that five-year period as 7.8%

Footnote continued on next page

- Aslam used erroneous data in applying his risk premium equity cost model. Some of the factual data were contradicted by SEC filings by companies in the comparable group while other data were conceptually wrong, e.g., based on year-end equity rather than average equity. These errors were also egregious in light of the fact that DRA had used correct data in the recent San Jose Water case.

Incorporating the numerous required corrections into the DRA analysis results in virtually eliminating the difference between the company's requested ROE and DRA's calculated ROE. Rerunning the DRA analysis with restated and corrected data produced a range of required ROEs between 11.63% and 12.01%.[62] Valencia's requested ROE of 11.75% falls squarely in the middle of this range.

D. Payroll Expense

Valencia's forecast of payroll expense for Test Year 2007-2008 is based on its recorded payroll expense for calendar year 2006, which includes the salaries for three new positions created and filled in 2005 and 2006. The 2006 amount is routinely escalated to the test year, but the test year amount also includes payroll amounts for three positions proposed to be added in 2007 and 2008. DRA's

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for Aqua America and 15.5% for SJW Corp. (the parent company of San Jose Water). The Attachment 5 table shows that a single error in the most recent year for Aqua America resulted in a 5.6% understatement of its earnings growth rate, while a series of errors in SJW Corp. data produced an 11.0% understatement of the earnings growth rate for that company. These errors caused Aslam's calculation of 5-year earnings growth for the six-company "comparable group" to be understated by nearly 3%: (11.0% +5.6%) / 6 ≈ 2.77%. As summarized in Exhibit 40, at 3:

> "[T]hese substantial understatements of earnings growth for two of DRA's six comparable group companies contributed to a substantial error in Mr. Aslam's Discounted Cash Flow analysis and, consequently, a substantial underestimation of Valencia's cost of equity capital."

[62] Exhibit 33 (Zepp), at 12 and Rebuttal Table 6.

witness proposed to disallow the base year payroll expense to the extent of salary increases Valencia granted to certain employees in 2005 and 2006. He further proposed to disallow all payroll expense associated with the three new positions for which employees were hired in 2005 and 2006 and the three further positions for which Valencia plans to hire in 2007 and 2008.[63]

1. 2005 Salary Increases

Valencia granted salary increases in 2005 to certain of its employees, based on a salary survey conducted in 2004. DRA calculates payroll expense by using the recorded expense for 2004 as a base and then applying standard labor Escalation Factors to estimate payroll expense for Test Year 2007-2008.[64] By doing so, DRA excluded the salary increases Valencia granted in 2005 from the base on which DRA calculated payroll expense for the Test Year. DRA's RO Report provided three reasons for the proposed disallowance of payroll costs related to the 2005 salary increases. These were: (1) that Valencia "did not receive authorization from the Commission to implement the adjustment in payroll expenses"; (2) that "[t]he Commission was not given the opportunity to address this matter because [Valencia] failed to bring this matter before the Commission"; and (3) that Valencia's application "does not provide an explanation of the survey and the justification of implementing the adjustments to payroll expense."[65]

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[63] Exhibit DRA-7 (Matsuoka), at 3-4 to 3-9; Tr. 116:20-25 (Matsuoka); Exhibit 25 (Milleman), at 2.

[64] Exhibit DRA-7 (Matsuoka), at 3-5 to 3-6.

[65] *Id*.

DRA witness Matsuoka testified that Valencia should have sought approval from the Commission or from the Water Division prior to this GRC to recover, or at least to track, the increased expense associated with the salary increases granted in 2005, even though Valencia did not intend to seek recovery of such costs for the period prior to Test Year 2007-2008.[66] Absent such prior approval, Matsuoka testified that Valencia should not be allowed to request the recovery of salary increase costs in the future Test Year.[67] Although Matsuoka acknowledged that it was not within the Water Division's authority to tell Valencia whether to increase its employees' salaries, he insisted that "as far as estimating for future test years for a GRC, that amount remains questionable as a basis," and he questioned it.[68] He did not assert that it was an imprudent business decision for Valencia to grant the 2005 salary increases, but he emphasized that for ratemaking purposes it would be necessary to find the expenses reasonable. He agreed that the record developed in this GRC would provide the basis for that determination.[69]

It is not necessary for Valencia to obtain our approval before adjusting salaries even though, as noted by Matsuoka, Valencia needs to demonstrate that those salary increases were reasonable in order to recover them in rates. Valencia's salary survey compared Valencia's salaries to those offered by neighboring water companies. The survey showed that Valencia's salaries were below the low end of the salary range of the other companies surveyed. In

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[66] Tr. 117:20-119:25 (Matsuoka).

[67] Tr. 120:9-15.

[68] Tr. 121:1-14.

[69] Tr. 121:15-122:8.

response to this information, management adjusted Valencia's salaries to meet competition and prevent the loss of valuable employees.[70] This was a prudent decision undertaken on the basis of relevant information and Valencia is entitled to seek recovery of those increased salary costs in this GRC.

2. New Position Added in 2005 and 2006

DRA would disallow the salaries associated with three employee positions Valencia created in 2005 and 2006: a Conservation Coordinator and two Water Treatment Technicians. Valencia created these positions to ensure compliance with specific conservation and water treatment mandates.

a) Conservation Coordinator

In June, 2006, Valencia joined the California Urban Water Conservation Council (CUWCC) and signed the Memorandum of Understanding Regarding Urban Water Conservation in California (MOU). The Commission's Water Action Plan encourages water utilities to pursue water conservation through cooperation with other water agencies and provides for recovery of conservation expenses in their GRCs.[71] Valencia's RO Report explained in detail the work required to implement the CUWCC's list of 14 best management practices (BMPs) and the expenses associated with that work. In the case of BMP 12, which calls for the hiring of a Conservation Coordinator, Valencia noted that the administrative payroll cost of a Conservation Coordinator was "already part of its normal operations."[72] Valencia's Capital

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[70] Exhibit 28 (Data Request EYM-17), at 2 (Response to Request 3); *see also* Exhibit 25 (Milleman), at 2-3.

[71] Exhibit 1 (Milleman), at 3-2 to 3-3.

[72] *Id.* at 5-10.

Investment Plan provided a detailed discussion of the need for the new Conservation Coordinator, in order to achieve Valencia's conservation goals.[73]

Noting that Valencia created and filled the Conservation Coordinator position in 2006, DRA's RO Report proposed to disallow all Test Year payroll expense for the Conservation Coordinator because Valencia "did not make a request to the Commission for the position," the Commission "did not authorize the position into rates," and, while Valencia's workpapers include the expense for this position in its estimate, "the application does not contain a request for this position."[74]

As in the case of the 2004 salary survey, DRA does not challenge the wisdom of Valencia's decision to hire a Conservation Coordinator, nor the timing of that hire, nor the salary paid. Rather, DRA criticizes Valencia for not having obtained prior authorization from the Commission to create such a position and for not expressly requesting the position in this case.

While Valencia was not obligated by BMP 12 to designate a Conservation Coordinator until July 1, 2007, Valencia hired its Conservation Coordinator sooner because Valencia wanted to ramp up its conservation work as quickly as possible. Valencia's witness Milleman testified that the conservation work was too much for him to handle in addition to his other duties and that Valencia's ratepayers will bear none of the cost of compensating

[73] Exhibit 3 (DiPrimio), at 6.

[74] Exhibit DRA-7 (Matsuoka), at 3-7

the Conservation Coordinator prior to July 1, 2007.[75] Given that the Commission's Water Action Plan encourages water utilities to join the CUWCC and to implement the 14 BMPs, it would be perverse to deny Valencia recovery for the cost of doing so or to punish it for moving quickly to implement the BMPs. As with the salary increases for existing employees, Valencia had no obligation to seek prior approval to create a new employee position; nor is such approval a pre-condition for including the cost of the position in the calculation of revenue requirement for a future Test Year. The sole test for recovering the expense in future rates is whether the expense is reasonable. DRA does not argue that the budgeted salary for the Conservation Coordinator is excessive. Since this salary is not excessive and was incurred by the utility as part of its compliance with the Commission's Water Action Plan, we deem it to be reasonable and we approve its inclusion in Test Year rates.

b) Water Quality Technicians

DRA also proposes to disallow the payroll expenses associated with two Water Quality Technician positions Valencia created and filled in 2005. According to DRA, Valencia "did not make a request to the Commission for these two positions," the Commission "did not authorize these two positions into rates," and, while Valencia's work papers include the expense for this position in its estimate, "the application does not provide explanation and justification to support these positions."[76]

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[75] Tr. 97:18-98-10 (Milleman).

[76] Exhibit DRA-7 (Matsuoka), at 3-7; *see also* Tr. 128:11-28 (Matsuoka).

Once again we are dealing with positions that Valencia did not have to seek prior approval to create.[77] Whether or not the expenses may be included in Test Year rates turns on whether they are reasonable. Valencia witness Alvord explained that the need for additional Water Quality Technicians arose from a change in Valencia's operational environment. Valencia's water wholesaler, Castaic Lake Water Agency (CLWA), changed its disinfection method from chlorine to chloramines, obliging Valencia to hire two new Water Quality Technicians in 2005 "in order to meet additional sampling and flushing requirements associated with using the purchased chloraminated water."[78] Valencia conducted a number of studies to determine how to respond to CLWA's plans to switch to chloramine disinfection. These studies were compiled into Valencia's Chloramination Conversion Plan, which was submitted to and approved by the California Department of Health Services (DHS) in April 2005. Hiring the two Water Quality Technicians was part of the most cost-effective alternative considered in the Plan, which was provided to DRA in response to a data request. Had Valencia not hired the additional technicians promptly, the additional sampling and flushing requirements associated with use of chloraminated water could not have been achieved.

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[77] DRA witness Matsuoka admitted that the new positions were added after Valencia's last GRC decision, and that there was no procedure in place for Valencia to request Commission approval to create and fill the new positions until this GRC was filed. Tr. 129:1-10 (Matsuoka). Valencia could not have known about the need to create these positions when it filed its last GRC in 2002.

[78] Exhibit 26 (Alvord), at 2.

c) New Positions in 2007 and 2008

Valencia's estimate of payroll expense for Test Year 2007-2008 included estimated salaries for a new Customer Service Representative (CSR) to be added in 2006,[79] a new Field Service Coordinator to be added in 2007, and a new Operator, Level 1, to be added in 2008. DRA challenged the need for each of these positions, supporting only the conversion of an existing part-time CSR position to full-time. Valencia witness Milleman testified that Valencia's ratio of employees to customers is substantially lower than that of either of the other water service providers in the Santa Clarita Valley.[80] The new positions are designed to address this situation.

New Customer Service Representative. Valencia employs one Customer Service Manager, four full-time CSRs and one half-time CSR that was added in 2005 to cover for lunches and breaks for the rest of the staff. Except for that new half-time position, Valencia has added no new CSR positions since 1998 while the number of customer accounts has increased by approximately 50% in that time. Implementation of new technology, automation, and outsourcing have enabled Valencia to avoid adding new CSR positions, but the present staff are unable to keep up with the increased call volume and walk-in traffic from customers and vendors.[81]

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[79] In Exhibit 1, Valencia indicated that the new CSR would be added in 2006, but in a data response furnished to DRA on August 1, 2006, Valencia clarified its intention to hire the new CSR in January 2007, upon completion of a Data Center Relocation project, which had been delayed.

[80] Exhibit 25 (Milleman), at 7.

[81] *Id.*

DRA proposed to disallow the payroll expense for the new CSR position, claiming that Valencia failed to justify its proposal by documenting the increased call volume and increase in walk-in traffic. DRA also relies on evidence of customer satisfaction with Valencia's customer service as a basis to deny the need for an additional CSR – supporting only the conversion of the existing part-time position into a full-time one.[82]

Valencia admitted that it does not have a record of the number of customer calls or the amount of walk-in traffic handled by the existing CSRs and has not estimated the number of calls and walk-ins the new CSR will be required to handle. However, current CSRs are working to capacity and Valencia anticipates adding another 2,500 new customers during this three-year GRC cycle.[83] Witness Milleman testified that it is not Valencia's policy to wait until customer service is unacceptable before adding staff to address such concerns: "[w]e don't want to have to wait until we get a bunch of complaints telling us we're doing a bad job before we move to provide people and resources to provide that service."[84]

New Field Service Coordinator. The responsibilities of a new Field Service Coordinator, to be added in 2007, include additional programming and data entry into the billing system as the company continues to change out meters to the radio read style, data entry for the company's flushing and valve maintenance programs and as-built information, and updating of service area

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[82] Exhibit DRA-7 (Matsuoka), at 3-7 to 3-8.

[83] Exhibit 25 (Milleman), at 8.

[84] Tr. 98:13-22 (Milleman).

maps.[85] Valencia stated that the new Field Service Coordinator was needed to meet increasing field service demands for serving a customer base that has grown significantly since 2000. DRA witness Matsuoka argued that Valencia failed to provide detail of the increased programming and data entry into the billing system as a result of the change in meters or of the increased data entry workload for the company's flushing and valve maintenance or of the updating of service area maps, stating that the company should have "numbers . . . physical numbers in front of them which would aid them in making a business decision that they needed a new Field Service Coordinator or a Customer Service Rep or an Operator."[86]

Valencia witness Alvord testified that Valencia has installed some 6,000 radio meters since 2003, and likely will increase such installations as customer growth accelerates during 2008-2010 with the construction of new real estate developments. He also testified that, in response to Department of Health Services Draft Waterworks Regulations, "Valencia will be flushing dead end mains and routinely exercising water main valves," while installing new meters to meet anticipated customer growth and replacing 1,500 old meters per year.[87]

Operator Level I. The responsibilities of the additional Operator, to be added in 2008, are to help meet the increasing demands of the utility's operation and maintenance programs due to more stringent regulations – including DHS guidelines for exercising all valves 4" and larger and for routinely

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[85] Exhibit 1 (Johnson), at 5-2.

[86] Tr. 144:2-9 (Matsuoka).

[87] Exhibit 26 (Alvord), at 4.

flushing dead ends and fire hydrants.[88] Valencia explained that its need for an additional Operator position also results from past and anticipated future growth in Valencia's customer base.[89] DRA proposed disallowance of the payroll expense associated with the new Operator position, because Valencia "fails to justify its reason by providing a detail of the increase in stringent regulations."[90] Through its witness Matsuoka, DRA later focused on the "draft" status of the DHS regulations as the basis for the recommended disallowance.

As with the other payroll expense items, this dispute between the Company and DRA comes down to a dispute between those that would anticipate future problems and take steps to avoid or minimize them today, and those who would wait and see whether the anticipated problems materialize. We conclude that it is incumbent on Valencia to meet a high standard in operating and maintaining its valves and mains and it is wise for Valencia to be prepared for the likely adoption of draft DHS regulations.

In the exercise of its business judgment the utility has determined that additional staff positions are needed to implement new programs, maintain service levels and adequately manage future growth. DRA's objections to adding these positions have been mostly procedural and have not demonstrated that these positions are unnecessary or that proposed salaries are unreasonable.

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[88] Because the Operator position will not be filled until 2008, only 50% of the associated annual payroll expense is included in Valencia's Test Year 2007-2008 revenue requirement, but the full amount ($35,677) should be included in succeeding years.

[89] *See* Exhibit 31 (Matsuoka), at 2 and Attachment; *see also* Exhibit 26 (Alvord), at 6.

[90] Exhibit DRA-7 (Matsuoka), at 3-8 to 3-9.

Accordingly, we will approve inclusion of the appropriate portion of the payroll expense associated with those positions in the Test Year revenue requirement.

E. Outside Services Expense

Outside services expense includes primarily the cost of attorneys, accountants, and consultants who are not permanent employees of the utility but are retained to perform particular services, such as prosecution or defense of legal claims, financial audits, and special studies. The company and DRA disagree on the best method of estimating future outside services expense. Valencia proposes to use the most recent five-year average of payments made for outside services adjusted for inflation as the forecast of future expenses; DRA proposes to exclude from the calculation amounts paid by Valencia to outsiders in connection with litigation and other matters that have now concluded. Valencia's position is that while individual litigation matters come and go, the volume of litigation is relatively predictable. DRA's position is that "non-recurring" expenses are not properly included in the forecast of future outside expenses.

Because we base public utility rates on future test years, it is necessary for utilities to forecast customer growth, usage, capital additions, expenses, and other factors as part of their GRC applications. The goal is to make reasonable estimates that will allow the utility the opportunity to earn a fair return on its rate base. For operation and maintenance expenses, it has been the general practice to compute adopted amounts based on inflation-adjusted, trended, recorded expenses when such results appear to be reasonable. Exceptions are made for extraordinary expenses and changed circumstances that imply significant increases or decreases in forecasted future expenses.

Valencia calculated outside services expense for Test Year 2007-2008 by the conventional method of averaging the past five years' expenses and applying DRA's Escalation Factors to convert that average to a Test Year amount.[91] The amount included in Test Year revenue requirement excludes outside services costs associated with perchlorate litigation, which are separately tracked in Valencia's Water Quality Litigation Memorandum Account.[92]

DRA's witness Matsuoka excluded the majority of Valencia's base period outside services expenses, resulting in a recommended disallowance of more than two-thirds of Valencia's proposed Test Year expenses ($248,000 out of $380,000).[93] The basis stated for this disallowance was that particular elements of the base period expense record were "non-recurring."[94]

Company witness Milleman testified that, over the past five years, Valencia has had to incur more than $360,000 per year in outside services expense and that recent legislation (SB 610 and SB 221) requires Valencia to prepare and submit water availability assessments, creating a new and incremental risk of legal challenges and costly litigation.[95] Over the past decade Valencia has continually been challenged by various environmental activist

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[91] Tr. 148:9-23 (Matsuoka).

[92] Exhibit 1 (Milleman), at 5-7; Exhibit 25 (Milleman), at 12; *see also* Tr. 151:16-21 (Matsuoka).

[93] *See* Exhibit DRA-7 (Matsuoka), at 3-14 to 3-17; Tr. 148:24-28 (Matsuoka).

[94] *Id.* at 3-15 to 3-16.

[95] Exhibit 25 (Milleman), at 13. Notably, the recent legal challenge to Valencia's 2005 Urban Water Management Plan includes a new claim that Valencia has failed to give adequate consideration of the effects of global climate change. Tr. 98:23-99:14 (Milleman).

groups and has continually incurred substantial legal and consulting expenses to defend itself.[96] While Valencia so far has prevailed in these cases, it is prudent to assume that such challenges to its operations will continue to arise as an increasing population puts increasing demands on a finite water supply. Valencia's approach to budgeting for these predictable events is actuarial in nature; while the company cannot predict specifically which disputes will arise in a given GRC cycle, it can predict with some accuracy the general level of outside expense it will incur in dealing with the disputes that do arise.[97] In contrast, DRA's position confuses non-recurring events with non-recurring expenses and, if adopted by us, would almost certainly lead to an inadequate allowance for the expenses Valencia will incur in Test Year 2007-2008. Accordingly, we reject DRA's recommended disallowances.

DRA also recommended that Valencia consider requesting permission to track its expenses related to a recently initiated challenge to its 2005 Urban Water Management Plan (UWMP). The company opposed this recommendation. Having concluded that Valencia's future litigation costs (as reflected in the proposed Test Year allowance for Outside Services expense) are reasonably foreseeable, we see no reason to require a separate memorandum account for future recovery of expenses related to UWMP litigation. However, we note that if the UWMP litigation should prove to be extraordinary in scope or duration, we

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[96] A. Kidman and M. Hanif Nernat, "Win Some. Lose Some. Will It Ever End? The War Over Water Supply in the Santa Clarita Valley," CALIFORNIA LAW & POLICY RPTR., April 2005, at 179-83.

[97] In a similar fashion, a life insurance company cannot predict which of its insured will die in the next 12 months but can predict, with remarkable accuracy, how many of them will do so.

reserve the right to require memorandum account treatment of this expense category in the future, as we have done with the company's perchlorate litigation.

F. Interest Deduction

Having rejected DRA's proposed capital structure in favor of Valencia's actual capital structure, it follows that Valencia's income tax expense for Test Year 2007-2008 should be calculated based on the interest Valencia actually will pay.

G. BMP Implementation Costs

As noted above, Valencia joined the CUWCC and signed the MOU in June 2006, in response to the Commission's Water Action Plan, adopted in December 2005. Among Valencia's commitments in taking these steps was a duty to implement the BMPs prescribed in the MOU. Valencia submitted its best estimates of the costs to implement the BMPs in its GRC application, but subsequently learned that its costs of implementing BMPs 1 and 2 (concerning residential water audits and plumbing retrofits) would be far greater than the $23,000 estimate included in the Application. Through supplemental testimony addressing implementation of the Water Action Plan, Valencia requested an additional allowance of $80,000 to cover these costs as projected for Test Year 2007-2008.[98] The lowest competitive bid Valencia received for the work associated with implementing BMPs 1 and 2 was $103,000, as reported to DRA in a supplemental data response in September 2006. Valencia cannot postpone

[98] Exhibit 23 (Milleman), at 9-10.

implementing BMPs 1 and 2 until its next GRC without failing in its commitments as a CUWCC member.

The Commission's Water Action Plan encourages water utilities to participate in the CUWCC and to implement the BMPs, providing specifically for them to seek recovery of expenses related to these efforts in their GRCs.[99] In order to facilitate Valencia's prompt adoption of BMPs 1 and 2, we approve an allowance of $103,000 to cover implementation costs in Test Year 2007-2008.

H. Base Revenue Memorandum Account

In response to the Water Action Plan, Valencia has proposed a method of decoupling water sales from utility revenue, described as a Base Revenue Memorandum Account (BRMA).[100] The purpose of the BRMA is to eliminate financial disincentives for the Company to pursue demand side management, *i.e.,* water conservation, and to stabilize earnings over periods of increased or decreased water sales. The BRMA would be credited or debited on a monthly basis by the net reduction or increase, respectively, in pre-tax earnings, and would be processed in the same manner as other production cost memorandum (or balancing) accounts. DRA opposed consideration of Valencia's BRMA proposal at this time,[101] but Valencia urges that it be approved and implemented without further proceedings. Valencia's proposal responds to the Commission's invitation, in the Water Action Plan, to present proposals for decoupling water utility sales from earnings in order to eliminate current disincentives for

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[99] CPUC, Water Action Plan, adopted December 15, 2005, at 8.

[100] Exhibit 23 (Milleman/VWC), at 6-7.

[101] Tr. 59:3-9 (Statement of DRA Counsel).

pursuing conservation. Valencia's proposed BRMA is a simple and straightforward way to remove a major barrier to water conservation, and we approve it. We invite specific comments on the form and content of this account from DRA.

With regard to adjustments to the ROE that might occur due to the adoption of a revenue memorandum account, we are not precluded from addressing this in Valencia's next cost of capital or general rate case proceeding.

I. Escalation Factor Unspecified Test Year Expenses

The final disputed issue is the choice of escalation factors to be used in calculating test year expenses that were the subject of stipulation between Valencia and DRA but for which the parties did not agree upon a specific amount. This was recognized as a disputed issue only at the close of evidentiary hearings, when Valencia's counsel explained this difference between the parties as follows:

> [T]he company understood that the parties had agreed to use the most recent escalation factors in the DRA Energy Cost of Service Branch Escalation Memorandum of June 30, 2006, as DRA had referenced it in its RO report[,] for adjustment of all expense accounts that had not been the subject of specific negotiation in the settlement discussion, whereas it's the company's understanding that DRA intended to go with the company's calculation of escalation factors for those accounts which were based on the December 31, 2005, DRA Energy Cost of Service Branch Escalation Memorandum.
>
> And so there was a misunderstanding in that regard which leaves that as an issue that's in controversy, that is, which set of escalation factors to apply to those expense accounts with

> respect to which the negotiation between the parties did not result in [stipulation to] a specific number.[102]

DRA counsel agreed with that statement of the issue.[103]

All the accounts at issue in this regard are either payroll or operation and maintenance (O&M) expense accounts. It is standard practice for both DRA and the utilities to calculate a normalized average amount for each expense account or sub-account based on five years of recorded data, and then to escalate the calculated average using escalation factors published by the DRA Energy Cost of Service Branch (Energy Branch) to produce estimated Test Year expense amounts. It also is standard practice for DRA, in its RO Report, to update the escalation factors, using the factors most recently published by Energy Branch.

In this proceeding, DRA has taken the position that Valencia's expense amounts not be adjusted to reflect the most recent escalation factors. In the case of O&M accounts not specifically determined by stipulation, DRA applied the Test Year expense amount filed by the Company as a "ceiling" when escalating expenses. This effectively resulted in DRA not escalating these expense amounts by the most recent June 30th escalation factors.

DRA's approach is inconsistent with past DRA practice and with numerous past Commission decisions approving the standard practice. It also contradicts DRA's own statement, in its RO Report, confirming that Valencia used escalation factors published by Energy Branch in December 2005, while DRA used more recent escalation factors provided by Energy Branch in June

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[102] Tr. 288:25-289:14 (Statement of Valencia counsel).

[103] Tr. 289:23-24.

2006.[104] The effect of using the earlier escalation factors is to lower the estimated expenses of the Test Year. For the entire set of accounts to which this issue is relevant, the total impact of DRA's choice not to update its Escalation Factors is approximately $87,000.[105]

DRA has provided no reason for its departure from the long-standing practice of using updated Escalation Factors in Class A Water Company rate. Accordingly, we rule that such factors shall be used to calculate allowed amounts not otherwise specifically stated in this GRC.

J. Stipulated Memorandum Account

Pursuant to the stipulation between Valencia and DRA, Valencia is directed to establish a memorandum account to track any future Regulatory Commission expense it incurs as a result of an application for rehearing, petition for modification, or other participation by interveners in this GRC.

VI. Categorization and Need for Hearings

In Resolution ALJ 176-3176, dated July 20, 2006, the Commission preliminarily categorized this proceeding as ratesetting, and preliminarily determined that hearings were necessary.

VII. Comments on Proposed Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Pub. Util. Code § 311 and Rule 14.2(a) of the Rules of Practice and Procedure.

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[104] DRA attached the two Energy Branch memoranda presenting the June 2006 Escalation Factors as Appendix A to its RO Report, Exhibit DRA-7.

[105] The supporting calculations were attached as Attachment A to the Opening Brief of Valencia Water Company.

VIII. Assignment of Proceeding

John Bohn is the assigned Commissioner and Karl Bemesderfer is the assigned ALJ in this proceeding.

Findings of Fact

1. Valencia presently serves approximately 28,300 customers.
2. Water delivered to Valencia's customers contains between 300 and 700 ppm of dissolved minerals, principally calcium and magnesium.
3. A majority of Valencia's customers find the water unacceptably hard.
4. Eleven to twelve thousand of Valencia's customers operate in-home water softening devices at an average monthly cost of $50.
5. Home water softeners periodically discharge brine into the wastewater system and ultimately into the Santa Clara River.
6. Valencia customers contribute about 45% of the brine discharged into the river by all water company customers in the Santa Clarita Valley.
7. Without a significant reduction in brine discharges from home water softeners operated by customers of Valencia and the other water companies serving the Santa Clarita Valley, the Santa Clarita Valley Sanitation District (Sanitation District) will be forced to build new wastewater treatment facilities to remove the brine from the Santa Clara River.
8. New wastewater treatment facilities would cost up to $447 million dollars to build.
9. The cost of new wastewater treatment facilities will be passed on to customers of the Sanitation District.
10. Removal of the home water softeners would reduce the need for additional wastewater treatment facilities.

11. Pellet softening at the wellhead is the least expensive method of removing dissolved minerals from the water.

12. A demonstration pellet softening plant will cost $1.7 million to build and $170,000 per year to operate.

13. Softening all of Valencia's well water at the wellhead would save Valencia customers up to $3.4 million per year even if no other water company serving the Santa Clarita Valley softens the water it delivers to its customers.

14. Valencia's capital structure consists of 69% equity, 3.05% preferred stock and 27.95% long term debt.

15. Valencia is a small water company notwithstanding its ownership by a large real estate development company.

16. Small water companies typically have higher costs of capital than large water companies.

17. California water companies face greater regulatory risk than companies located outside California.

18. Valencia faces continually-threatened litigation and other company-specific risks.

19. An equity risk premium of 0.9% is appropriate for Valencia.

20. At the urging of the Commission, in June 2006 Valencia joined the CWUCC and signed its MOU.

21. The MOU commits Valencia to implement 14 BMPs.

22. Implementing the BMPs requires Valencia to hire additional employees.

23. In 2006, Valencia created the position of Conservation Coordinator to implement BMP 12.

24. In 2005, Castaic Lake Water Agency switched disinfectants from chlorine to chloramine.

25. Use of chloramine as a disinfectant imposed additional sampling and flushing requirements on Valencia.

26. In 2005, Valencia created two Water Treatment Technician positions to perform the additional sampling and flushing activities.

27. In 2005, Valencia conducted a competitive salary survey.

28. In 2005, Valencia increased certain employee salaries to match salaries being offered by competing water companies.

29. In 2007, Valencia will hire a new Customer Service Representative and a new Field Service Coordinator.

30. In 2008, Valencia will hire a new Operator, Level 1.

31. The new positions to be filled in 2007 and 2008 are in response to growth of Valencia's customer base.

32. Valencia has complied with all Department of Health Services safe drinking water standards during the period since its last GRC in 2002.

33. Valencia's Water Management Program as submitted in this GRC is adequate for the Commission's purposes.

34. Valencia's proposed revisions to its tariff formula for calculating the costs of recycled and untreated water purchase by Valencia from Castaic Lake Water Authority are appropriate.

Conclusions of Law

1. Valencia's construction of a demonstration pellet softening plant is in the public interest.

2. Valencia's capital structure for ratemaking purposes should be its actual capital structure.

3. A rate of return of 11.75% on common equity is supported by the record and in the public interest.

4. Valencia's 2005 salary increases were reasonable.

5. Valencia's estimate of future outside service expense is reasonable.

6. Additional positions created by Valencia in 2005 and 2006 were necessary and reasonable.

7. Positions Valencia proposes to create in 2007 and 2008 are necessary and reasonable.

8. Valencia's interest deduction for ratemaking purposes should be its actual interest deduction.

9. One hundred three thousand dollars is a necessary and reasonable expense to implement programs of the CUWCC.

10. A Base Revenue Memorandum Account is a reasonable means of removing disincentives to water conservation.

11. It is reasonable to use 2006 Energy Branch escalation factors to escalate Test Year expenses that were not the subject of the stipulation between Valencia and DRA.

12. Valencia's compliance filings regarding DHS safe water drinking standards, its Water Management Program, and its revised method of calculating the costs of recycled and untreated water purchased from CLWA are approved.

O R D E R

IT IS ORDERED that:

1. The earnings and rates for test year 2007 calculated in conformance with this decision and set forth in Appendices A through D are authorized. Valencia Water Company (Valencia) is authorized to file in accordance with General Order (GO) 96-A (or its successor), and to make effective on no less than five days' advance notice, a tariff containing the test year 2007 increase as provided in

this decision. The revised rates shall apply to service rendered on or after the tariff's effective date.

2. Subject to pro forma tests after the 2007 increases are effective, Valencia is authorized to file in accordance with GO 96-A (or its successor), and to make effective on not less than five days' advance notice, a tariff setting forth rates for years 2008 and 2009, calculated in conformance with this decision. The revised rates shall apply to service rendered on or after the tariff's effective date.

3. Valencia's request for an allowance of $1.7 million to create a demonstration water softening plant is approved.

4. For ratemaking purposes, Valencia's capital structure shall be set at 69% common equity, 27.95% long term debt and 3.05% preferred debt.

5. Valencia shall receive a return on common equity of 11.75%.

6. Valencia shall recover its 2005 salary increases as part of this general rate case (GRC).

7. Valencia shall recover the salary costs of a new Conservation Coordinator in this GRC.

8. Valencia shall recover the costs of two new Water Quality Technicians in this GRC.

9. Valencia shall recover the costs a new Customer Service Representative, a new Field Service Coordinator and a new Operator, Level 1 in this GRC.

10. Valencia may receive an allowance of $103,000 to recover the costs of implementing the best management practices of the California Urban Water Conservation Council.

11. Valencia shall establish a Base Revenue Memorandum Account.

12. Valencia shall use 2006 Energy Branch escalation factors to calculate Test Year expenses not covered by the stipulation between Valencia and Division of Ratepayer Advocates.

13. Valencia is authorized to increase rates charged for water service in order to realize increased annual revenues of $2,402,000 in a Test Year beginning July 1, 2007; $708,000 in a Test Year beginning July 1, 2008; and $660,000 in an Escalation Year beginning July 1, 2009.

14. Valencia has complied with all Department of Health Services safe drinking water standards since its last GRC in 2002.

15. Valencia's Water Management Program as submitted in this GRC is adequate for the Commission's purposes.

16. Valencia may adopt a revised tariff formula for calculating the costs of recycled and untreated water purchased by Valencia from Castaic Lake Water Authority and resold to Valencia customers.

17. Application 06-07-002 is closed.

This order is effective today.

Dated _____, at San Francisco, California

APPENDIX A

********** SERVICE LIST **********
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********* INFORMATION ONLY **********

(END OF APPENDIX A)

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 Notice of Availability of the filed document to be served upon the service list to this proceeding by U.S. mail. The service list I will use to serve the Notice of Availability of the filed document, attached as Appendix A, is current as of today's date.

Dated May 8, 2007, at San Francisco, California.

/s/ TERESITA C. GALLARDO
Teresita C. Gallardo