BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

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

COMMENTS OF
CALIFORNIA WATER ASSOCIATION
ON PROPOSED RULES IN
APPENDICES B AND C TO DECISION 10-10-018

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October 28, 2010

SUBJECT INDEX

Page

I. INTRODUCTION 1

II. APPENDIX B – RULES FOR ACCOUNTING FOR GOVERNMENT CONTAMINATION LOAN FUNDS 2

A. Rule 1 2

B. Rules 3 and 5 4

C. Rule 4 5

D. Rules 6 and 7 6

E. Rules 8 and 9 6

F. Rules 10 and 12 7

G. Rule 15 8

H. Rules 16, 17, 18, 19 and 21 8

III. APPENDIX C – RULES FOR ACCOUNTING FOR CONTAMINATION PROCEEDS FROM DAMAGE AWARDS, SETTLEMENTS, GOVERNMENT ORDER, OR INSURANCE 9

A. Rule 1 10

B. Rule 2 10

C. Rule 3 11

D. Rule 7 12

E. Rule 9 13

F. Rules 10, 11, 12, 13 and 15 14

IV. REQUEST FOR EVIDENTIARY HEARINGS 15

V. CONCLUSION 16

APPENDIX B (Revised)

APPENDIX C (Revised)

TABLE OF AUTHORITIES

Page

CALIFORNIA PUBLIC UTILITIES COMMISSION CASES

Re San Gabriel Valley Water Company,
Decision 07-04-046 3

Rulemaking for Considering Policies and Guidelines re Allocation of Gains from Sales of Energy, Telecommunications, and Water Utility Assets,
Decision 06-05-041 ..... 6, 8, 11, 13

Rulemaking to Develop Rules and Procedures re Investments Financed by Contamination Proceeds,
Decision 10-10-018 ..... 1, 3, 11, 15, 16

CALIFORNIA PUBLIC UTILITIES COMMISSION RULES AND RULINGS

Administrative Law Judge's Ruling, R.09-03-014,
issued October 14, 2010 1

General Order 103-A 7, 9

FEDERAL STATUTES AND REGULATIONS

Internal Revenue Code
Section 168(i)(9) 13

U.S. Treasury Regulations
Section 1.167 12

CALIFORNIA STATUTES

Public Utilities Code
Section 789 ..... 5, 10, 11
Section 790. ..... 3, 5, 6, 8, 10, 12, 13
Section 790(c) 11
Section 851 ..... 8, 14

OTHER AUTHORITIES

Matheny, R., *Taxation of Public Utilities* (Matthew Bender & Co. 2010) 13

BEFORE THE PUBLIC UTILITIES COMMISSION
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COMMENTS OF
CALIFORNIA WATER ASSOCIATION
ON PROPOSED RULES IN
APPENDICES B AND C TO DECISION 10-10-018

Pursuant to Administrative Law Judge ("ALJ") Weatherford's Ruling issued October 14, 2010, in the above-captioned proceeding, California Water Association ("CWA") hereby submits its comments on the proposed rules in Appendices B and C to Decision 10-10-018, which would apply to accounting for government contamination loan funds and to accounting for contamination proceeds from damage awards, settlements, government order, or insurance, respectively. CWA's suggested revisions to Appendices B and C are attached to these comments.

California American Water Company, California Water Service Company, Golden State Water Company, Park Water Company, San Gabriel Valley Water Company, Suburban Water Systems, and Valencia Water Company all join in the comments of CWA.

I.

INTRODUCTION

There are numerous deficiencies in the proposed rules in Appendices B and C. Specific problems with specific rules will be addressed below. Three generic problems will be addressed at the outset. First, the proposed rules evidence what CWA considers to be an

excessive Commission concern to prevent any possibility of utility gain in connection with obtaining and applying funds obtained from government loans or, with a few very limited exceptions, from contamination claims – to the point of positively discouraging utilities from pursuing such sources of funds. Second, many of the proposed rules do not take into account the likelihood that projects will, in many cases, be funded in part from government loans or contamination claim proceeds and in part by shareholder investments. CWA proposes revisions to many of the rules to provide for such cases.

Finally, the proposed rules do not reflect the adopted decision's provision, in Ordering Paragraph 4, for including proceeds from contamination claims, when initially received from the funding source, in a memorandum account until expenditures of such proceeds are made. CWA proposes that provision be included in both Appendix B and Appendix C for the use of such memorandum accounts.

II.

APPENDIX B – RULES FOR ACCOUNTING FOR GOVERNMENT CONTAMINATION LOAN FUNDS

The proposed rules to account for funds derived from contamination-related government loans ("government loan funds") are flawed both in concept and in detail and require revisions in order to make them practical. CWA will provide these needed revisions on a rule-by-rule basis.

A. Rule 1

Rule 1 sets forth a series of procedures that would apply to all government loan funds, illustrated by use of a set of stated assumptions. There are several significant problems, ambiguities, and inaccuracies in Rule 1, as proposed.

Rule 1 assumes an Administrative Fee of $4,500 that would be included in the Loan Amount and Paragraph a) provides that the Administrative Fee should be amortized over the life of the loan. In some instances, government agencies issuing loans require that

administrative fees be paid up-front by the loan recipient, separately from the Loan Amount. Under such circumstances, the utility should be allowed to recover the administrative fee either directly at the outset or by amortization, with the unamortized amount to be charged to Account 146 (Other Deferred Debits) and included in rate base. CWA suggests revisions to Rule 1.a) to address this concern.

Paragraph a) would require that loan proceeds be deposited, upon receipt, in a "separate bank account." This requirement is unnecessary from both a cost and workload standpoint, and the Commission has previously rejected it under similar circumstances. In a 2007 San Gabriel Valley Water Company ("San Gabriel") decision reviewing a staff audit of various funds received by San Gabriel and arguably subject to Public Utilities Code Section 790, the Commission rejected a staff proposal to require San Gabriel to establish separate bank accounts for Section 790 proceeds, observing that the audit report "exalts form over substance" and "[w]e should not add workload and costs to no benefit." *Re San Gabriel Valley Water Co.*, Decision 07-04-046, at 89-90. CWA agrees with this Commission position and requests that these new rules not require separate bank accounts for loan funds.

Paragraph c) indicates monthly Accounts Receivable of $5,850 but Paragraph d) indicates monthly collections of $5,499. The difference apparently recognizes an assumed uncollectible amount. If so, provision should be made for recording the uncollectible amount.

Paragraph e) and Paragraph f) appear to be inconsistent. Six times the monthly loan surcharge collection of $1,739 is $10,434, which exceeds the $10,050 indicated as the semi-annual payment of principal and interest. How is the difference of $384 to be accounted for and why is it required?

The $7,725 semi-annual interest expense indicated in Paragraph f) implies an interest rate exceeding 10%, which, of course, is grossly excessive for a government loan.

The $2,325 semi-annual payment of principal indicated in Paragraph f) is not sufficient to pay off the loan in 15 years. $2,325 times 30 equals $69,750, which is $80,250

short of the principal loan balance of $150,000. This gap presents an important issue to which the Commission has yet to give attention. Who bears the risk to cover such a shortfall that may occur in the repayment of a government loan? Considering that Decision 10-10-018 is intent on assuring that all benefits of such a loan are reserved for ratepayers, any shortfall in loan repayment that the utility has to cover should be immediately recoverable in rates.

Paragraph h) indicates Government Loan Amortization Expense of $10,000 per year to amortize 15-year government plant, but it is unclear whether this requires a new account number. CWA recommends accounting for this amortization expense as a debit to Long-Term Debt – Government Loan. In addition, the amortization of plant investment should not be charged to expense in the income statement. Instead, CWA recommends the following accounting entry:

CIAC – Plant in Service – Gov't Loan	$10,000	
Accumulated Amortization – Plant in Service Gov't Loan		$10,000

Deferred charges – $300 per year per Paragraph h) – should be amortized as part of the semi-annual payment of principal and interest addressed in Paragraph f). CWA suggests revisions to Rule 1.h) to implement these recommendations.

B. <u>Rules 3 and 5</u>

Rules 3 and 5 obviously are intended to ensure that the intended rate surcharge provides no "windfall" to the utility, but there is no provision for making the utility whole in the event that the calculated surcharge proves insufficient to cover debt service or repayment of principal on a government loan. As noted above, under the "ratepayers-get-all-the-benefits" regime, the rules should explicitly provide that any shortfall in debt service or repayment that the utility has to cover should be immediately recoverable in rates. CWA suggests additions to Rules 3 and 5 that provide this needed assurance.

C. Rule 4

Rule 4 would bar utilities from recovering gain on disposition of "government contamination loan-funded plant repaid through ratepayer surcharges." Not only is this proposed rule awkwardly worded (it would better read "…disposition of plant to the extent that it has been funded by government contamination loans…"), but also, and more importantly, it threatens a regulatory taking of the public utility's property. The Commission cannot lawfully ignore the utility's ownership of utility assets and dictate a disposition of those assets that deprives the utility of all property rights.

In addition, the Commission must recognize that the proposed Rule 4 conflicts with the Water Utilities Infrastructure Improvement Act of 1995, as codified at Section 789 *et seq.* of the California Public Utilities Code (the "Infrastructure Act"). In pertinent part, the Infrastructure Act, provides as follows:

> (a) ***Whenever a water corporation sells any real property*** that was at any time, but is no longer, necessary or useful in the performance of the water corporation's duties to the public, the water corporation shall invest the net proceeds . . . from the sale in water system infrastructure, plant, facilities, and properties that are necessary or useful in the performance of its duties to the public. . . .
>
> (b) All water utility infrastructure, plant, facilities, and properties constructed or acquired by, and used and useful to, a water corporation by investment pursuant to subdivision (a) shall be included among the water corporation's other utility property upon which the commission authorizes the water corporation the opportunity to earn a reasonable return.
>
> (c) This article shall apply to the investment of the net proceeds referred to in subdivision (a) for a period of 8 years from the end of the calendar year in which the water corporation receives the net proceeds. The balance of any net proceeds and interest thereon that is not invested after the eight-year period shall be allocated solely to ratepayers.

Cal. Pub. Util. Code, §790.

The Commission has recognized the intention of the Legislature, in formulating the Infrastructure Act, to provide an incentive for water utilities to reinvest funds derived from sales

of no longer needed utility plant in new utility infrastructure. Thus, in its fairly recent "Gain on Sales" proceeding, the Commission noted that

> ***the Infrastructure Act [limits] Commission discretion*** in how it allocates gains on sale of real property, provided that water companies shall use the proceeds from sales of formerly used and useful utility real property to invest in new water infrastructure [footnote omitted]. Such proceeds may not be used to reduce rates or otherwise be returned to ratepayers unless the water companies fail to reinvest the proceeds within the eight-year period contained in §790(c).

Rulemaking for Considering Policies and Guidelines re Allocation of Gains from Sales of Energy, Telecommunications, and Water Utility Assets, Decision 06-05-041, at 63. Further, the Commission expressly recognized:

> a legislative intent to give water companies certainty on how to allocate their gains from the sale of real property. Recognizing the need for infrastructure investment, the difficulty for water companies of acquiring capital in the market, and the varying approaches the Commission has taken on the subject, the Legislature created a bright-line rule. Thus, water utilities must invest net proceeds from the sale of formerly used and useful real property in new water infrastructure. They need not refund such proceeds to ratepayers, but they may not pay the funds out to shareholders in the form of dividends or other earnings either.

Id. at 65.

The one major limit in the scope of the Infrastructure Act is that it applies only to proceeds from sales of real property. However, to the extent that a utility has invested government loan funds in real property that was, but is no longer, necessary and useful for utility purposes and thereafter derives proceeds from sale of that property, the ratemaking treatment of those proceeds is controlled by Section 790. Accordingly, CWA proposes revisions to Rule 4 to comply with these legal requirements.

D. <u>Rules 6 and 7</u>

Minor revisions are proposed for Rules 6 and 7. The types of expenses addressed by proposed Rule 6 may affect one or more than one utility district, and a revision is proposed to reflect that fact. A revision to Rule 7 is proposed to eliminate use of the term "imputed," which has connotations of artificiality, in the context of revenue requirement calculations.

E. Rules 8 and 9

Proposed Rule 8 would require the filing of a Tier 3 advice letter to implement an accounting procedure to exclude from future rate case revenue requirements any expenses for which a government funding agency authorizes a utility to devote loan proceeds. This means that the Division of Water and Audits ("DWA") would have to draft a resolution for Commission review and adoption in order to allow the utility to implement such an accounting procedure. CWA believes this to be an overly bureaucratic and cumbersome approach to a simple task, which can more simply and effectively be accomplished by a Tier 2 advice letter subject to review by DWA and interested parties, but taking effect after 30 days unless suspended or rejected by DWA.

Rule 9 presents the same problem. The proposed rule would require a Tier 3 advice letter for extending the time for starting or concluding a construction or study project funded by a government loan. Why a Commission resolution should be required in all such cases is not apparent, and in CWA's view, not necessary. The Tier 2 advice letter procedure will fully suffice.

These changes are proposed in Rules 8 and 9.

F. Rules 10 and 12

Proposed Rule 10's blanket prohibition against participation of a utility or its affiliate companies in engineering or installing facilities for projects funded by government loans is inefficient, impractical, and unnecessary. With respect to a loan-funded project of modest scale, it is certainly inefficient for a utility to have to conduct a third-party procurement request for proposals for tasks that it normally performs in-house with existing staff. The prudence of the utility's procurement decisions on such matters is routinely reviewed in the general rate case context, and there is no reason why such review would not be appropriate and sufficient with respect to projects funded by government loans.

If the utility is to be excluded from engineering or constructing plant funded by government loans, one might argue that such projects should be exempted from the construction, operation, and maintenance standards of General Order 103-A. A better approach, as CWA recommends, is to delete Rule 10. Obviously, the exclusion of a utility's affiliates from participating in the competitive bidding process open to all other third-party suppliers, as prescribed by proposed Rule 12, is anti-competitive (especially given the other restrictions in this rule), and it also should be deleted.

G. Rule 15

Proposed Rule 15 would require utilities to give 45 days' notice to the Directors of DWA and the Division of Ratepayer Advocates ("DRA") prior to disposing or encumbrance of loan-funded plant. The requirement as to disposition of plant would be inconsistent with the 30-days notice procedure that the Commission mandated in the "Gain on Sales" proceeding for a water utility sale of Section 790 property that the company believes is no longer used and useful. *Rulemaking for Considering Policies and Guidelines re Allocation of Gains from Sales of Energy, Telecommunications, and Water Utility Assets,* Decision 06-05-041, at 75; *see also, id.* at 99 (Ordering Paragraph 19).

CWA proposes that the same 30-days notice procedure be applied to dispositions of property funded by government loans. Such Commission review would be for the same purpose stated in Decision 06-05-041, that being to "give the Commission an opportunity to assess whether Companies are selling off key portions of their asset base." *Id.* at 75.

CWA proposes to eliminate the reference in Rule 15 to encumbrance of loan-funded plant, since any encumbrance of public utility property still necessary or useful for utility service already requires prior Commission authorization pursuant to Public Utilities Code Section 851. CWA proposes to revise Rule 15 accordingly.

H. Rules 16, 17, 18, 19, and 21

These proposed rules are unnecessary and unjustified for the same reasons as Rule 4. The complex and costly calculations and procedures these rules would require will surely destroy water utilities' already challenged incentive to go to the substantial efforts required to obtain funding for needed projects through government loans. No good reasons for imposing these additional layers of bureaucratic requirements have been presented, let alone supported. These proposed rules should be deleted.

III.

APPENDIX C – RULES FOR ACCOUNTING FOR CONTAMINATION PROCEEDS FROM DAMAGE AWARDS, SETTLEMENTS, GOVERNMENT ORDER, OR INSURANCE

The proposed rules in Appendix C would apply to "all transactions involving contamination proceeds from damage awards, settlements, government order, or insurance ("Water Contamination proceeds"). Like the rules in Appendix B, the Appendix C rules are flawed both in concept and in detail.

One pervasive problem is that the Appendix C rules fail to distinguish between investment of Water Contamination proceeds in remediation and replacement plant as required to restore the utility's facilities and service to the standards required by General Order ("GO") 103-A and the investments of such proceeds beyond GO 103-A requirements. CWA proposes a definition of "Remediation and Replacement Plant" and revisions to proposed Rules 1, 2, 3, 5, 6 and 14 to address this distinction.

Another problem with the proposed Appendix C rules for Water Contamination proceeds is that they do not include the sort of "road map" for applying existing and new accounting rules to the investment of such proceeds that Rule 1 in Appendix B provides for investment of the proceeds of a government loan. CWA offers a proposed rule (designated as "Rule 0" in order to avoid renumbering all the other rules) which, based on reasonable assumptions, lists the accounting journal entries appropriate from the time a utility receives

Water Contamination proceeds, through investment of those proceeds along with other utility funds in utility plant, until the plant funded by such proceeds ceases to be necessary or useful for public utility service.

CWA will address its other concerns regarding the Appendix C rules on a rule-by-rule basis.

A. Rule 1

Rule 1 is one of the several proposed rules that does not take into account the fact that projects are, in many cases, funded in part from contamination claim proceeds and in part by shareholder investments. CWA proposes a simple revision to take account of such circumstances.

B. Rule 2

Rule 2, similarly to Rule 4 in Appendix B, would unlawfully bar utilities from recovering gain on disposition of plant funded by Water Conservation proceeds, thereby threatening a regulatory taking of public utility's property. The Commission cannot lawfully ignore the utility's ownership of utility assets and dictate a disposition of those assets that deprives the utility of all property rights.

In addition, the proposed Rule 2, like Rule 4 in Appendix B, conflicts with the Infrastructure Act, *supra*. Cal. Pub. Util. Code, §789 *et seq.* As noted above, the Infrastructure Act provides as follows:

> (a) ***Whenever a water corporation sells any real property*** that was at any time, but is no longer, necessary or useful in the performance of the water corporation's duties to the public, the water corporation shall invest the net proceeds . . . from the sale in water system infrastructure, plant, facilities, and properties that are necessary or useful in the performance of its duties to the public. . . .
>
> (b) All water utility infrastructure, plant, facilities, and properties constructed or acquired by, and used and useful to, a water corporation by investment pursuant to subdivision (a) shall be included among the water corporation's other utility property upon which the commission authorizes the water corporation the opportunity to earn a reasonable return.

> (c) This article shall apply to the investment of the net proceeds referred to in subdivision (a) for a period of 8 years from the end of the calendar year in which the water corporation receives the net proceeds. The balance of any net proceeds and interest thereon that is not invested after the eight-year period shall be allocated solely to ratepayers.

Cal. Pub. Util. Code, §790.

The Commission has recognized the intention of the Legislature, in formulating the Infrastructure Act, to provide an incentive for water utilities to reinvest funds derived from sales of no longer needed utility plant in new utility infrastructure. Thus, in its fairly recent "Gain on Sales" proceeding, the Commission noted that

> ***the Infrastructure Act [limits] Commission discretion*** in how it allocates gains on sale of real property, provided that water companies shall use the proceeds from sales of formerly used and useful utility real property to invest in new water infrastructure [footnote omitted]. Such proceeds may not be used to reduce rates or otherwise be returned to ratepayers unless the water companies fail to reinvest the proceeds within the eight-year period contained in §790(c).

Rulemaking for Considering Policies and Guidelines re Allocation of Gains from Sales of Energy, Telecommunications, and Water Utility Assets, Decision 06-05-041, at 63. Further, the Commission expressly recognized:

> a legislative intent to give water companies certainty on how to allocate their gains from the sale of real property. Recognizing the need for infrastructure investment, the difficulty for water companies of acquiring capital in the market, and the varying approaches the Commission has taken on the subject, the Legislature created a bright-line rule. Thus, water utilities must invest net proceeds from the sale of formerly used and useful real property in new water infrastructure. They need not refund such proceeds to ratepayers, but they may not pay the funds out to shareholders in the form of dividends or other earnings either.

Id. at 65.

The one major limit in the scope of the Infrastructure Act is that it applies only to proceeds from sales of real property. However, to the extent that a utility has invested Water Contamination proceeds in real property that was, but is no longer, necessary and useful for utility purposes and thereafter derives new proceeds from sale of that property, the ratemaking

treatment of those new proceeds is controlled by Section 790. CWA proposes revisions to Rule 2 to comply with legal requirements.

C. Rule 3

Proposed Rule 3 still reflects the Proposed Decision's misconception, since cured by revisions included in Decision 10-10-018, that it makes sense to treat Water Contamination proceeds as CIAC as soon as they are received by the utility, far in advance of their being invested in utility plant and even farther in advance of that plant being placed in service. Accordingly, proposed Rule 3, if implemented according to its terms, would impose massive immediate reductions in rate base on any water utility unlucky enough to receive Water Contamination proceeds, with such impairment of rate base to be diminished only as and to the extent that plant funded by the Water Contamination proceeds eventually may be placed in service.

This defect in proposed Rule 3 can be cured in part by inserting the phrase, "and invested in utility plant that has been placed in service" at the end of the first clause in the first line of the rule. In addition, the rule should provide for an initial credit to Account 242 (Other Deferred Credits), which will avoid reducing rate base. Then, once the plant has been completed and placed in service and the investment moved from Construction Work in Progress to Utility Plant, the same dollar value can be transferred from Account 242 to the appropriate CIAC account.

Another problem with Rule 3 is that Paragraphs 3.3 and 3.4 make no provision to account for possible gain on disposition of subject property in accordance with Section 790. CWA proposes to clarify the last sentence of Paragraph 3 .3 and to add a new Paragraph 3.5 that would require accounting for such gain consistently with the requirements of Public Utilities Code Section 790.

D. Rule 7

Proposed Rule 7 appears to be inconsistent with federal income tax rules, which allow utilities to deduct accelerated depreciation for tax purposes only if depreciation expense is normalized for ratemaking purposes. Flow-through of the federal accelerated depreciation expense deduction for ratemaking purposes is expressly forbidden. Flow-through is allowed for state income tax deductions and so is used in the ratemaking calculation of state income tax expense. These rules require deferred taxes to be recorded on the utility's balance sheet rather than being passed through to ratepayers.

A failure to comply with the normalization requirements of federal income tax law would be likely to have disastrous consequences for both the utility and its customers. Specifically, employing accelerated depreciation to calculate the federal income tax expense component of a water utility's revenue requirement for ratemaking purposes could deprive the utility of the benefit of accelerated depreciation for federal income tax purposes – and the resultant positive cash flow – not only with respect to the property in which Water Contamination proceeds may have been invested but with respect to ***all*** of the utility's property.[1] The negative impact of violating the IRS's normalization requirements would be huge for water utilities and their customers, resulting in a reduction of annual cash flow in the millions of dollars for the larger companies, which would have to be made up for by increased long-term debt, with the resulting interest expense increasing rates to ratepayers.

CWA proposes to revise Rule 7 in order to recognize the constraints of federal income tax law. The revised rule would require that any required flow-through of tax benefits be

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[1] *See,* R. Matheny, TAXATION OF PUBLIC UTILITIES (Mathew Bender & Co. 2010), at 8-40 to -41: "Taxpayers that do not use a normalization method of accounting for property subject to the normalization requirements face a harsh penalty – the loss of accelerated depreciation deductions for the taxpayer's public utility property. The taxpayer's remaining basis in public utility property must be recovered using straight-line depreciation following a normalization violation. Even after the violation is corrected there does not appear to be a mechanism, under either the Internal Revenue Code or its regulations, to allow the taxpayer to resume the use of accelerated depreciation." *See also*, Treas. Reg. §§ 1.167(l)-1(h)(2)(ii), Ex 5; 1.167(l)-3(a)..

consistent with the normalization method of accounting for public utility property that was established by Internal Revenue Code Section 168(i)(9).

E. Rule 9

Proposed Rule 9, similarly to Rule 15 in Appendix B, would require utilities to give 45 days' notice to the Directors of DWA and the Division of Ratepayer Advocates ("DRA") prior to disposing or encumbrance of plant funded by Water Contamination proceeds. As discussed above in the context of Appendix B, these requirements as to disposition of plant would be inconsistent with the 30 days notice procedure that the Commission mandated in the "Gain on Sales" proceeding for a water utility sale of Section 790 property that the company believes is no longer necessary or useful for utility service and therefore eligible for treatment as Section 790 property. *Rulemaking for Considering Policies and Guidelines re Allocation of Gains from Sales of Energy, Telecommunications, and Water Utility Assets,* Decision 06-05-041, at 75; *see also, id.* at 99 (Ordering Paragraph 19).

CWA proposes that the same 30 days notice procedure be applied to dispositions of property funded by Water Contamination proceeds. Such Commission review would be for the same purpose stated in Decision 06-05-041, that being to "give the Commission an opportunity to assess whether Companies are selling off key portions of their asset base." *Id.* at 75. .

CWA also proposes to eliminate the reference in Rule 9 to encumbrance of plant funded by Water Contamination proceeds, since any encumbrance of public utility property still necessary or useful for public utility service already requires prior Commission authorization pursuant to Public Utilities Code Section 851. CWA proposes to revise Rule 9 accordingly.

F. Rules 10, 11, 12, 13, and 15

Like the corresponding rules in Appendix B, these proposed rules are unnecessary and unjustified for the same reasons as Rule 4 in Appendix B and Rule 2 in Appendix C. The

complex and costly calculations and procedures these rules would require will surely destroy water utilities' already challenged incentive to seek, persevere in pursuing, and obtain Water Contamination proceeds. No good reasons for imposing these reels of bureaucratic red tape have been presented, let alone supported. These proposed rules should be deleted.

IV.

REQUEST FOR EVIDENTIARY HEARINGS

CWA's and other parties' comments and proposed revisions to the proposed rules set forth in Appendices B and C to Decision 10-10-018 are just a first step toward molding those proposals into a workable set of accounting rules. CWA believes that workshops may be helpful to allow the water utilities' and other parties' accounting experts to participate in the creation of a well-designed set of accounting rules. However, the record created by a workshop process will likely be insufficient to support the detailed and precise analysis that is required to develop accounting rules sufficient to administer the complex legal and policy requirements relevant to the present subject matter.

The parties' and the Commission's experience in this proceeding already has established the complexity and controversy that can be presented by apparently simple analyses of the relative impacts for utilities and ratepayers of alternative accounting methods that may be applied to proceeds from government loans and contamination claims. In particular, there was substantial controversy over the comparative cost to ratepayers of the alternative CWA and DRA/TURN approaches to account for replacement plant funded by government loans, the workshop report provided an insufficient basis for resolving the controversy, and ALJ Weatherford thereafter invited the parties to revisit and reevaluate their competing estimates in further rounds of comments. This controversy over accounting analyses could have been more thoroughly, more efficiently, and more effectively have been addressed through testimony by the parties' accounting experts and cross-examination of those experts.

CWA believes that an evidentiary hearing process also would be valuable as a means of testing assumptions and expectations regarding the functioning of the accounting rules and procedures proposed in Appendices B and C.

V.

CONCLUSION

CWA respectfully urges the Commission to give careful consideration to the proposed accounting rules in Appendices B and C and also to the critique of and proposed revisions to those rules presented in CWA's comments. CWA further urges the Commission to establish a schedule for this proceeding that provides for submission of prepared testimony and evidentiary hearings to enable development of a record adequate to support the adoption of accounting rules that will allow Commission staff and the water utilities to implement effectively and fairly the novel and in some respects still problematic policies the Commission has adopted in Decision 10-10-018.

Respectfully submitted,

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October 28, 2010

APPENDIX B

PROPOSED RULES FOR THE ACCOUNTING OF GOVERNMENT CONTAMINATION LOAN FUNDS

These rules shall apply to all transactions involving government contamination loan funds (Govt. Loan Funds).

1. All government contamination loan funds shall be repaid by ratepayer contributions through surcharges similar to the accounting method used by the Commission for loans from the Safe Drinking Water State Revolving Fund as set forth in the Water Division's Standard Practice U-13-W and summarized in the example below:[2]

   Assumptions:

Total Loan Amount:	$154,500
Loan Proceeds to the Utility:	$150,000
Administrative Fee:	$ 4,500
Term of Loan:	15 years with semi-annual payments

   a) Utility receives loan proceeds from government. Proceeds are recorded both in a cash account and, if authorized by the Commission, in a memorandum account~~deposited in separate bank account~~. Set up the administrative fee as a prepaid asset to be amortized over life of loan.

	Debit	Credit
Cash in Bank	$150,000	
Deferred Charges	4,500	
Long-Term Debt-Govt. Loan		$154,500

   b) Plant is constructed with Government loan proceeds. Plant is to be depreciated over life of loan.

Plant in Service (Accounts 301-341)	$150,000	
Cash in Bank		$150,000

[2] Specific USOA account numbers will vary by utility.

c) Monthly billing of customers for ordinary revenue of $4,000 plus Government loan surcharge of $1,850 ($9.25 surcharge x 200 customers = $1,850.

Accounts Receivable - Customers	$ 5,850	
Water Revenue		$ 4,000
Govt. Loan Surcharge		1,850

d) Monthly collections of customer receivables from 188 customers. Consists of $3,760 of regular revenue and $1,739 of Government Loan surcharge revenue.

Cash in Bank	$ 5,499	
Accounts Receivable - Customers		$ 5,499

e) Government loan surcharge collections are transferred monthly to an account with a fiscal agent.

Special Deposits – Fiscal Agent	$ 1,739	
Cash in Bank		$ 1,739

f) Semi-annual payment of principal and interest to Government Agency by fiscal agent.

Interest Expense – Govt. Loan	$ 7,725	
Long-Term Debt – Govt. Loan	2,325	
Special Deposits – Fiscal Agent		$ 10,050

g) Credit of interest earned on surcharge collections deposited with fiscal agent.

Special Deposits – Fiscal Agent	$ 100	
Non-Utility Income - Interest		$ 100

h) Annual amortization of 15 year Government plant ($150,000 divided by 15 years = $10,000, $4,500 divided by 15 years = $300). Amortize in lieu of booking depreciation.

CIAC – Plant in Service – Govt. Loan	$ 10,300	
~~Amortization Expense~~		
Accumulated Amortization – Plant in Service – Govt. Loan		$ 10,000
Account 180 Deferred Charges		300

2. No return shall be earned by Commission-regulated water utilities (Utilities) on ~~government loan funded~~ plant to the extent that it is funded by government contamination loans repaid through ratepayer surcharges.

3. A rate surcharge shall be established which provides for a period of one year an amount of revenue approximately equal to the periodic payment which includes principal and interest. Any surplus surcharge revenue shall be refunded to ratepayers and any shortfall in debt service shall be recovered in rates. The annual adjustments to the surcharge shall be ~~done~~ made through a Tier 2 Advice Letter filing. In the Advice Letter filing, the utility may propose other beneficial uses of overcollected funds, such as early payments of loan principal, which reduce future ratepayer obligations.

4. No gain shall be recovered by utilities on the disposition of ~~government contamination loan funded~~ plant to the extent that it has been funded by government contamination loans repaid through ratepayer surcharges, except as provided by Public Utilities Code §790.

5. Capital charges for ~~this~~ a government contamination loan shall be offset by a quantity surcharge which shall last as long as the loan. The charges shall not be intermingled with other utility charges; special accounting requirements, including ~~and~~ a refund condition and a shortfall provision, are necessary to ensure that there are no unintended windfalls or losses to ~~private~~ utility owners.

6. Operating Expenses, Administrative and General Expenses, and Taxes associated with government contamination loan-funded plant, shall be allowed, if determined to be reasonable by this Commission. The reasonableness of these costs shall be determined in the general rate case that addresses the results of operations for the district or districts to which these expenses ~~occur in~~relate.

7. Any indirect benefits resulting from government contamination loan-funded plant such as reductions in operating expenses resulting from infrastructure improvements must be projected as cost savings ~~and imputed into~~in calculating the utility's~~ies'~~ revenue requirement.

8. Unless the utility has received authorization from the funding agency, government contamination loan funds shall not be spent on expenses. Loan Funds that are expended for expenses authorized by the funding agency must not be included in the determination of the Results of Operations and the forecast of future expenses in a general rate case. Within 45 days after a funding agency authorizes a utility to spend Loan Funds on expenses the utility must file a Tier ~~3~~ 2 advice letter filing that sets forth an accounting treatment to exclude such expenses from the Results of Operations and forecast of future expenses in a general rate case.

9. In the event construction or study completion time limits are not established by the funding government agency, then the following provisions are reasonable and should apply:

   - Construction of the project must start within one year after execution of the funding agreement;
   - The project shall conclude within three years after execution of the funding agreement;
   - Utilities must seek Commission approval for extensions of time limits at least two months prior to the expiration of those limits or risk loss of undelivered funding; and
   - Extension requests may be submitted by a Tier ~~3~~ 2 advice letter~~ to the Commission's Division of Water and Audits Director~~.

10. ~~Neither utilties nor their affiliate companies and their shareholders should be allowed to engineer or install the facilities for government loan-funded projects~~[Deleted]

11. Water utilities shall use a competitive bidding process specified by the funding government agency when awarding contracts for the construction of government loan-funded projects. If the funding government agency does not require specific competitive bidding process the utility shall use the competitive bidding process set forth below in item #12.

12. In the event construction or study completion time limits are not established by the funding government agency, then the following provisions are reasonable and should apply:

    - A minimum of three competitive bids shall be required unless justification is provided showing why the minimum could not be met;
    - If the utility does not choose the lowest bid, it must provide a detailed justification explaining why it chose not to accept the lowest bid;
    - Utilities should be allowed to enter sole source contracts under special circumstances. If the utility chooses a sole-source contract, it must provide a detailed justification explaining why it did so.~~Utilities must seek by a Tier 3 advice letter filing a waiver for sole source contracts.~~
    - ~~Affiliate companies are not allowed to participate.~~[Deleted]

13. Water utilities may ~~not~~ only use Loan Funds for work done prior to the execution of the loan agreement ~~unless~~when the funding government agency has authorized this use or when prior consent of the Commission has been obtained. To the extent approval is given to use loan funds for work already performed such activity shall be accounted for pursuant to the accounting procedures set forth in this appendix for loan work not yet undertaken. At the time of the utility's next general rate case, the utility shall provide as part of its filing sufficient information for the Commission to review and determine the appropriate ratemaking treatment for any work performed that was not authorized by the funding agency.

14. These rules apply to all tangible property funded with Loan Funds. In determining the proceeds in each of the following types of sales, the cost of disposal shall be deducted from the amount received in arriving at the final amount received. In cases of intangible property, such as the intellectual property of a study, the utility shall request the Commission to individually review the matter in the utility's general rate case or, sooner if requested, by separate application.

15. In order to ensure that the Commission has prior review and approval over all government loan-funded plant transactions, water utilities shall ~~notify~~ provide written notice to the Director of the Division of Water and

Audits and the Director of the Division of Ratepayer Advocates ~~45~~ 30 days prior to the disposition ~~and encumbrance~~ of loan-funded plant.

16. ~~The following rule should apply to the transfer or sale of an asset, district, or total utility to another Commission-regulated water utility. If the asset to be sold or transferred has been paid for with Loan Funds in whole or part, the utility transferring or selling the asset may not receive compensation for the portion of the asset that has been funded with Loan Funds, and the purchasing utility shall record a non-rate base asset as a separate component of Account 265.2. The non-loan funded portion of the asset, if any, should sell or transfer at fair market value.~~[3][Deleted]

17. ~~When government loan-funded plant is sold to a publicly-owned water provider that will deploy the asset to provide water service to the public, the public interest integrity of the loan is preserved, and the rules governing the transaction from the selling utility's position would be the same as if the sale were to a utility.~~[Deleted]

18. ~~When government loan-funded assets are sold to an entity other than a utility or public water provider, such as private unregulated companies or cities or counties exercising eminent domain powers for purposes other than acquiring a municipal water system, the public interest integrity of the loan is not preserved. In these instances, the appropriate treatment is for the buyer to pay fair market value and for the selling utility to apply all proceeds received from the sale of the government loan-funded asset paid by ratepayer surcharges to the benefit of ratepayers.~~[Deleted]

19. ~~For plant wholly funded by Loan Funds, as well as for the partially funded portion of a plant, the utility must notify the Director of the Division of Water and Audits within 45 days after the utility signs a letter of commitment with the agency administering the loan and again~~

~~[3] For example, Utility A decides to sell one of its three districts (call it District X) to Utility B. District X includes government loan-funded plant with a depreciated value of $50,000. Valuation of the district shall not include the government loan-funded plant. Therefore, not only does Utility A not receive payment for the depreciated book value of the government loan-funded plant, it receives no gain on its disposition, either. Utility B must record the government loan-funded plant at the depreciated book value of the seller ($50,000) in Account 100-1 and Account 265.2. Since the selling utility did not receive payment for the government loan-funded plant, it receives no gain or reimbursement for the book value of the grant-funded plant. Since Utility B records the loan-funded plant it has acquired in Account 265.2 at its depreciated book value, no return is earned by it.~~

~~within 45 days after completing the loan agreement execution with the responsible agency. For any portion of plant that is paid for by non-government loan funds, the utility must obtain Commission approval in its general rate case or through separate application.~~[Deleted]

20. All utilities that receive Loan Funds must provide the following information regarding its loan-funded plant in its Annual Report to the Commission: (1) Amount of Loan Funds received, (2) Amount of Loan Funds spent in the year covered by the Annual Report, (3) Amount of ratepayer surcharges billed and received, (4) Amount of loan repaid by ratepayer surcharges and (5) Description of plant constructed with Loan Funds.

21. ~~When the "fair market value" valuation of a district or total utility is difficult or impossible to perform without the loan-funded plant, the government loan-funded plant must be deducted from the "fair market value" of the total utility that has been determined by the valuation. Since the value of the loan-funded plant in the valuation has most likely been inflated, the selling utility should inflate the depreciated book value of the loan-funded plant using the Handy-Whitman index.[4] This inflated value of loan-funded plant should be deducted from the "fair market value" of the utility. This "Adjusted Fair Market Value" would then be used to determine the reasonable purchase price of the utility.~~[Deleted]

(END OF APPENDIX B)

~~[4] The Handy-Whitman index is a widely recognized publication which reflects the costs of different types of utility construction.~~

APPENDIX C

PROPOSED RULES FOR THE ACCOUNTING OF WATER CONTAMINATION PROCEEDS

These rules shall apply to all transactions involving contamination proceeds from damage awards, settlements, government order, or insurance (Water Contamination proceeds.) and the use of such proceeds to fund remediation and replacement plant sufficient to meet the requirements of General Order 103-A (Remediation and Replacement Plant).

0. From the time that a utility receives Water Contamination proceeds until the time that plant funded by such proceeds is no longer necessary or useful for public utility service, such proceeds shall be accounted for in the manner summarized in this rule by application of the following assumptions:

Assumptions:

Water Contamination proceeds to Utility (including Commission awarded 100% of net proceeds to Utility of $50,000):	$200,000
Utility participation from separate funds:	$ 50,000
Fair market value of Plant sold in the 20th year:	$100,000
Utility Plant depreciable life – Book:	30 years
Utility Plant depreciable life – Tax:	25 years
Federal income tax rate:	35%

a) Utility receives Water Contamination proceeds.

	Debit	Credit
Account 121-3 – Cash-Misc. Special Deposits	$150,000	
Account 120 – Cash-Checking Account	50,000	
Account 242 – Other Deferred Credits		$200,000

b) Plant is constructed with Water Contamination proceeds (including Utility's share of net proceeds) and additional $50,000 participation by Utility. As a result, Plant is funded 60% by Water Contamination proceeds ($150,000 divided by $250,000) and 40% by Utility ($100,000 divided by $250,000).

	Debit	Credit
Account 100-3 – Construction Work in Progress (CWIP)	$250,000	
Account 121-3 – Cash-Misc. Special Deposits		$150,000
Account 120 – Cash-Checking Account		100,000

c) Plant is placed in service.

Account 301-341 – Utility Plant in Service	$250,000	
Account 100-3 – Construction Work in Progress (CWIP)		$250,000

d) Record Water Contamination proceeds of $150,000 to Designated Account (Account 265-3 –Damage Award Contamination Proceeds), and net proceeds awarded to Utility of $50,000 to Misc. Credits to Surplus Account.

Account 242 – Other Deferred Credits	$200,000	
Account 265-3 –Damage Award Contamination Proceeds		$150,000
Account 401 – Miscellaneous Credits to Surplus		50,000

e) Annual depreciation of 30 year Plant ($250,000 divided by 30 years = $8,333 per year). Continue depreciating until sold in the 20th year ($8,333 times 20 years = $166,666). Record 60% (60% times $166,666 = $100,000) to Designated Account, and 40% (40% times $166,666 = $66,666) to Depreciation Expense Account.

Account 265-3 –Damage Award Contamination Proceeds	$100,000	
Account 503 – Depreciation Expense	66,666	
Account 250 – Accumulative Depreciation		$166,666

f) Balance of deferred income taxes in the 20th year at 35% tax rate (tax depreciation of $200,000 ($250,000 divided by 25 years times 20 years = $200,000) less book depreciation of $166,666 = $33,334 times 35% = $11,666).

Account 228 – Income Taxes Payable	$11,666	
Account 258 – Deferred Income Taxes		$11,666

g) As of 20th year, Plant is no longer necessary or useful and is sold at fair market value of $100,000. Net proceeds subject to Public Utilities Code Section 790 of $66,666 are recorded in Miscellaneous Credits to Surplus.

	Debit	Credit
Account 120 – Cash-Checking Account	$100,000	
Account 250 – Accumulative Depreciation	166,666	
Account 265-3 –Damage Award Contamination Proceeds	50,000	
Account 301-341 – Utility Plant in Service		$250,000
Account 401 – Miscellaneous Credits to Surplus		66,666

1. No return shall be earned by Commission-regulated water utilities (Utilities) on Remediation and Replacement P~~p~~lant funded by Water Contamination proceeds to the extent that it is funded by such proceeds.
2. No gain shall be recovered by utilities on the disposition of ~~plant~~ Remediation and Replacement Plant funded by Water Contamination proceeds, except as provided by Public Utilities Code §790.
3. When Water contamination proceeds are received by a utility, they shall be recorded both in a cash account and in a memorandum account. Once the proceeds have been invested in Remediation and Replacement Plant that has been placed in service, it must place these funds in a designated account, as specified in this order, and transactions associated with each account shall be restricted to the types of proceeds only. On the books of the company, it shall record the funds as a Debit to Account 121-3 – Cash-Miscellaneous Special Deposits and a Credit to ~~designated account as specified in this order~~Account 242 – Other Deferred Credits. As ~~the p~~Remediation and Replacement Plant funded by Water Contamination proceeds is being constructed, the utility shall record those dollars expended as a Debit to Account 100-3 - Construction Work in Progress (CWIP) and a Credit to Account 121-3 – Cash-Miscellaneous Special Deposits. When the ~~p~~Remediation and Replacement Plant has been constructed and placed in service, a second set of entries shall be recorded as a Debit to Account 100-1 – Utility Plant in Service and a Credit to Account 100-3 Construction Work in Progress.

The designated account (e.g., account 265.3, "Damage Award Contamination Proceeds") shall follow the following rules:

3.1 The respective account shall include only designated Water Contamination proceeds to that account.

3.2 The records supporting the entries to this account must be so kept that the utility can furnish information as to the purpose of the Water Contamination proceeds and shall be separated between depreciable and non-depreciable property.

3.3 Depreciation accrued on the depreciable portion of properties included in each respective account shall be charged to the designated account rather than to Account 503, Depreciation, the charges to each respective account shall continue until such time as the balance in the account applicable to such properties has been completely amortized. (See Utility Plant Instruction 3.F.1)[1]. The balance in the account applicable to non-depreciable property shall remain unchanged until such time as the property is sold or otherwise retired. At time of retirement of non-depreciable property, which was acquired through Water Contamination proceeds, the costs thereof shall be credited to the appropriate plant account and charged to ~~this account in order to eliminate any credit balance in~~ the applicable Water Contamination proceeds designated account ~~applicable thereto~~in order to eliminate balances in both accounts.

3.4 It is intended under the provisions contained in the preceding paragraph that the credit balance in the designated Water Contamination proceed account will be written off over a period equal to the actual service life of the property involved. The net salvage realized on the retirement of property funded by Water Contamination proceeds shall be recorded as a credit to Account 250, Reserve for Depreciation of Utility Plant.

---

[1] Utility Plant Instruction 3F. "Utility Plant contributed to the utility or constructed by it from contributions to it of cash or its equivalent shall be charged to the utility plant accounts at cost of construction. There shall be credited to the depreciation and amortization reserve accounts the estimated amount of depreciation and amortization applicable to the property at the time of this contribution to the utility. The difference between the amounts included in the utility plant account and the reserve accounts shall be credited to each respective account as specified in this order."

3.5 Any net proceeds from a sale of real property that once was but is no longer necessary or useful for utility service should be accounted for consistently with the requirements of Public Utilities Code Section 790.

3.A. In the event Water contamination proceeds result from a partial or interim disposition of a cause of action, the utility may elect, with the Commission's prior authorization, to defer booking these entries until completion of litigation and appeals. Such deferral shall not negatively impact ratepayers and shall require the utility to establish a memorandum account to record and accrue interest on relevant revenues, investments, and expenses.

4. Operating Expenses, Administrative and General Expenses, and Taxes associated with plant funded through Water Contamination proceeds shall be allowed, if determined to be reasonable by this Commission. The reasonableness of these costs shall be determined in the general rate case that addresses the results of operations for the district these expenses occur in.

5. Any indirect benefits resulting from ~~p~~Remediation and Replacement Plant funded by Water Contamination proceeds such as reductions in operating expenses resulting from infrastructure improvements must be projected as cost savings and imputed into the utilities' revenue requirement.

6. Depreciation on ~~p~~Remediation and Replacement Plant funded by Water Contamination proceeds must be calculated using the existing methodology detailed in the Commission's Standard Practice U-4. Water Contamination proceeds used to acquire land should not be amortized or included in this category as well as other non-depreciable property such as water rights.

7. ~~The~~ In calculating income tax expenses for ratemaking purposes, the utilities must ~~deduct~~ recognize depreciation expense deductions for income tax purposes and flow through to their customers any benefits derived from the tax deductions in the most direct fashion that is ~~possible~~consistent with the normalization method of accounting for public utility property established by Internal Revenue Code Section 167.

8. These rules apply to all tangible property funded through Water Contamination proceeds. In determining the proceeds in each of the

following types of sales, the cost of disposal shall be deducted from the amount received in arriving at the final amount received. In cases of intangible property, such as the intellectual property of a study, the utility shall provide as part of its general rate case filing sufficient information for the Commission to individually review the matter in the utility's general rate case or, sooner if requested, by separate application.

9. In order to ensure that the Commission has prior review and approval over all transactions associated with plant funded by Water Contamination proceeds, water utilities shall ~~notify~~ provide written notice to the Director of the Water Division and the Director of the Division of Ratepayer Advocates ~~45~~ 30 days prior to the disposition ~~and encumbrance~~ of plant funded by ~~the~~ Water Contamination proceeds.

10. ~~The following rule should apply to the transfer or sale of an asset, district, or total utility to another Commission-regulated water utility. If the asset to be sold or transferred has been paid for with Water Contamination proceeds in whole or part, the utility transferring or selling the asset may not receive compensation for the portion of the asset that has been funded by Water Contamination proceeds, and the purchasing utility shall record a non-rate base asset in Account 265-3. The non-grant portion of the asset, if any, should transfer at fair market value.~~[2][Deleted]

11. ~~When plant funded by Water Contamination proceeds is sold to a publicly-owned water provider that will deploy the asset to provide water service to the public, the rules governing the transaction from the selling utility's position would be the same as if the sale were to a utility.~~[Deleted]

12. ~~When plant funded by Water Contamination proceeds is sold to an entity other than a utility or public water provider, such as private unregulated~~

~~[2] For example, Utility A decides to sell one of its three districts (call it District X) to Utility B. District X includes plant funded by Water Contaimination proceeds with a depreciated value of $50,000. Valuation of the district shall not include the plant funded by Water Contamination proceeds. Therefore, not only does Utility A not receive payment for the depreciated book value of such plant funded by Water Contamination proceeds, it receives no gain on its disposition, either. Utility B must record the plant funded by Water Contamination proceeds at the depreciated book value of the seller ($50,000) in Account 100-1 and designated account, as specified in this order. Since the selling utility did not receive payment for the plant funded by Water Contamination proceeds, it receives no gain or reimbursement for the book value of such plant. Since Utility B records the plant funded by Water Contamination proceeds it has acquired in the designated account at its depreciated book value, no return is earned by it.~~

~~companies or cities or counties exercising eminent domain power for purposes other than acquiring a municipal water system, the public interest integrity of the plant funded by Water Contamination proceeds is not preserved. In these instances, the appropriate treatment is for the buyer to pay a fair market value and for the selling utility to retain all funds for the benefit of the ratepayer and submit an application for authority to apply such funds to the benefit of ratepayers~~[Deleted].

13. ~~For plant wholly funded by Water Contamination proceeds, as well as for the partially funded portion of a plant, the utility must notify the Director of the Water Division within 45 days after the utility receives the funds. For any portion of plant that is paid for by non-Water Contamination proceeds, the utility must obtain Commission approval in its general rate case or through separate application~~[Deleted].

14. All utilities that receive Water Contamination proceeds must provide the following information regarding plant funded by Water Contamination proceeds in its Annual Report to the Commission: (1) Amount of Water Contamination proceeds received, (2) Amount of Water Contamination proceeds spent in the year covered by the Annual Report, and (3) Description of Remediation and Replacement Plant and other plant constructed with Water Contamination proceeds.

15. ~~When the "fair market value" valuation of a district or total utility is difficult or impossible to perform without the plant funded by Water Contamination proceeds, the plant funded through these proceeds must be deducted from the "fair market vlaue" of the total utility that has been determined by the valuation. Since the value of the plant funded by Water Contamination Proceeds in the valuation has most likely been inflated, the selling utility should inflate the depreciated book value of the plant using the Handy-Whitman index.[3] This inflated value of such plant should be deducted from the "fair market value" of the utility. This "Adjusted Fair Market Value" would then be used to determine the reasonable purchase price of the utility.~~ [Deleted]

(END OF APPENDIX C)

~~[3] The Handy-Whitman index is a widely recognized publication which reflects the costs of different types of utility construction.~~

CERTIFICATE OF SERVICE

I, Jeannie Wong, hereby certify that on this date I served by electronic mail and by hand delivery, the foregoing **COMMENTS OF CALIFORNIA WATER ASSOCIATION ON PROPOSED RULES IN APPENDICES B AND C TO DECISION 10-10-018** on the parties in Rulemaking 09-03-014, below:

By electronic mail:

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By hand delivery:

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Administrative Law Judge
California Public Utilities Commission
505 Van Ness Avenue
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Hon. John Bohn
Assigned Commissioner
California Public Utilities Commission
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Executed this 28th day of October, 2010 in San Francisco, California.

/S/ JEANNIE WONG
Jeannie Wong

CALIFORNIA PUBLIC UTILITIES COMMISSION
Service Lists

PROCEEDING: R0903014 - CPUC - OIR TO DEVELO
LAST CHANGED: OCTOBER 14, 2010

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