Decision **PROPOSED DECISION OF COMMISSIONER BOHN**
(MAILED 8/3/2010)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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

INTERIM DECISION ADOPTING RULES FOR ACCOUNTING TREATMENT OF CONTAMINATION PROCEEDS ARISING FROM GOVERNMENT GRANTS AND PROPOSING COUNTERPART RULES FOR GOVERNMENT LOANS AND DAMAGE AWARDS

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INTERIM DECISION ADOPTING RULES FOR ACCOUNTING TREATMENT OF CONTAMINATION PROCEEDS ARISING FROM GOVERNMENT GRANTS AND PROPOSING COUNTERPART RULES FOR GOVERNMENT LOANS AND DAMAGE AWARDS

1. Summary

This decision sets out policies, a framework for analysis, rules and proposed rules to govern the accounting and ratemaking treatment variously of local and federal government grants, public loans and damage awards (see below for the various sources) received by an investor-owned water utility following contamination of its water supply. It resolves issues regarding the inclusion or exclusion of replacement plant in rate base, serving the dual objectives of assuring a fair and reasonable allocation of proceeds between ratepayers and shareholders, and assuring that ratepayers only pay a return on used and useful plant in service funded by shareholders.

The decision extends to local and federal government grant-funded plant the rules previously adopted by the Commission which treat state government grant proceeds that fund replacement plant as Contribution in Aid of Construction (CIAC). Rules for accounting treatment of local and federal government grants are adopted in the decision and set out in Appendix A. The decision concludes that government loan proceeds, as well as proceeds from damage awards, settlements, government orders (i.e., proceeds derived via government order from public or private funding sources) or insurance, that fund replacement plant should be treated as CIAC rather than being included in rate base and earning a rate of return. Proposed rules for accounting treatment of government loans are in Appendix B. Proposed rules for accounting treatment of damage awards, settlements, government order and insurance proceeds are in Appendix C.

After the contaminated plant is replaced, remediation has occurred, and all recoverable costs have been determined, the remaining amount of contamination proceeds arising from damage awards, settlements, government order and insurance proceeds may be shared between ratepayers and shareholders on a case-by-case basis under a framework for analysis provided in this decision (Table 2 and Appendix D). The decision provides that, where appropriate in the individual case, the Commission may provide incentives, e.g., in the form of increments in rate of return, in the cost of capital proceeding for Class A water utilities and in the General Rate Case (GRC) for Classes B, C and D water utilities, for above normal risks associated with a utility seeking recovery of contamination proceeds from polluters. The decision also allows for utilities to seek compensation in the GRC, on the basis of an approved memorandum account obtained through an advice letter filing, for the responsibility over the ownership, operation and maintenance of replacement plant that is not accounted for in CIAC treatment.

With the issuance of this interim decision the rulemaking proceeding remains open for the limited purpose of receiving comments and, if needed, conducting one or more workshops considering rules appropriate for the accounting of contamination proceeds from government loans, damage awards, settlements, government order or insurance as CIAC. (See Appendices B and C for proposed rules.)

2. Background

2.1. Overview

This rulemaking was initiated to establish standardized rules and policies to govern the accounting and ratemaking treatment of government loans and damage awards received by an investor-owned water utility as a result of

contamination of its water supply. Given the current lack of standardized rules that govern contamination-related proceeds, the Commission found it imperative that clear rules and pathways be laid out regarding the inclusion or exclusion of replacement plant in rate base, in order to assure a fair and reasonable allocation of proceeds between ratepayers and shareholders, and that ratepayers only pay a return on used and useful plant in service.

2.2. Prior Decisions

Over about eighteen years, the Commission has considered numerous cases in which an investor-owned water utility received various types of funds as a result of the contamination of its sources of water. Each of these proceedings, none of which were precedential, resulted in a unique outcome based on the specific circumstances of each case. The Commission also conducted generic proceedings that focused on the gain on sale of utility property and the receipt of state government grant funds.

The following brief review illustrates some of the various ways in which the Commission has addressed the allocation and ratemaking treatment of contamination proceeds in the past, and serves as a backdrop for the decision here.

2.2.1. Selective Case Examples

In 1993, the Commission approved a settlement for Great Oaks Water Company (Great Oaks), which split 50/50 the contamination proceeds

invested in plant in service: half to Contribution in Aid of Construction (CIAC)[1] and half to rate base (which earns a rate of return).[2]

In the 2003 matter of Bakman Water Company (Bakman), the Commission approved various funding mechanisms for the repair of contaminated wells, including: (1) a loan from the Department of Water Resources under the Safe Drinking Water Bond Act, a portion of which was recorded in rate base and the balance was not recorded in rate base; (2) lawsuit damages from E&J Gallo totaling $300,000, of which $75,000 were used to reimburse the utility for legal fees and $225,000 were recorded in CIAC;[3] and (3) lawsuit damages from Shell Oil Company, with half of these net proceeds recorded in CIAC.[4]

In the 2004 matter of Southern California Water Company (now Golden State Water Company), the Commission gave some contamination proceeds to the ratepayers to compensate them for higher water rates that were due to the contaminated groundwater, and approved the balance for use in infrastructure improvements that would be rate based.[5]

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[1] Plant recorded in CIAC is not included in rate base and, therefore, does not earn a rate of return.

[2] *Great Oaks Water Company,* Decision (D.) 93-04-061, 49 CPUC2d 116 and D.93-09-077, 51 CPUC2d 366.

[3] Resolution W-3785.

[4] D.03-10-002.

[5] D.04-07-031.

In the 2006 Fruitridge Vista Water Company (Fruitridge Vista) matter,[6] in which the Commission approved a settlement, funding came from five sources: (1) a California Department of Public Health (CDPH) Drinking Water Treatment and Research Fund loan; (2) a State Revolving Fund zero interest loan; (3) a 20-year loan from the City of Sacramento; (4) special facilities fees to be paid by specified existing developers and future developers; and (5) ratepayers. Fruitridge Vista was allowed to rate base the $1.98 million loan from the City of Sacramento. Under the settlement, if Fruitridge Vista is able to recover damages from polluters, it may rate base up to $5 million of the plant funded with the proceeds from the lawsuit invested in lieu of the above-listed funding.

By 2007 and 2008 decisions,[7] the Commission authorized the allocation of $8.4 million of net contamination proceeds received by San Gabriel Valley Water Company (San Gabriel) from the County of San Bernardino, in a settlement of an inverse condemnation suit, as follows: ratepayers (67%) and shareholders (33%). Replacement plant was recorded as CIAC.

2.2.2. Generic Proceedings

While the two generic proceedings summarized next did not deal with the specific type of proceeds involved here, they have provided some general guidance for our decision here.

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[6] D.06-04-073.

[7] See D.07-04046 and D.08-04-005 (correcting errors in the former).

In a 2004-2006 rulemaking on how to account for the gain on sale of utility property,[8] the Commission in part considered whether that rulemaking was the appropriate proceeding to address contamination proceeds. The Commission determined that since contamination proceeds received from a third party do not involve sales of real property, the Infrastructure Act does not apply and the contamination proceeds are not gains on sale.[9]

In a contemporaneous rulemaking,[10] however, the Commission adopted rules that govern the accounting and ratemaking treatment of all state grant funds received by investor-owned water utilities.[11] Those rules preserve the public interest integrity of state grant funds by ensuring that water utilities not be able to profit in any way through the receipt of state grant funds.

2.3. Procedural History

The Order Instituting Rulemaking (OIR)[12] was opened March 12, 2009, and identified seven issues for purposes of a preliminary scoping memo. The Commission directed that all investor-owned water utilities, and several other interested entities, be served with the order. The OIR invited any person or

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[8] Rulemaking (R.) 04-09-003.

[9] D.06-05-041. The decision drew a distinction between developer CIAC and contamination proceeds CIAC, indicating, at 69, that gains on sale of assets recorded under the former were to be reinvested in new water infrastructure on which a reasonable rate of return could be earned.

[10] R.04-09-002.

[11] D.06-03-015.

[12] Order Instituting Rulemaking on the Commission's Own Motion to Develop Rules and Procedures to Insure 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.

representative of an entity interested in monitoring or participating in the proceeding to request status on the service list. Interested parties were invited to file opening comments by June 1, 2009, which seven parties did.

The proceeding was assigned to Commissioner John Bohn and Administrative Law Judge (ALJ) Gary Weatherford on March 16, 2009.

On May 1, 2009, ALJ Weatherford issued a ruling granting motions for party status. On June 4, 2009, ALJ Weatherford ruled that parties could serve reply comments by July 1, 2009. He also modified the timetable to provide for a scoping memo in August 2009, and a Division of Water and Audits (DWA) workshop on September 22 and 23, followed by a DWA workshop report on October 22, and by party comments on that report on November 18, 2009.

In a Ruling and Scoping Memo of August 21, 2009, Commissioner Bohn provided for the contingency of extra workshop discussions, which occurred on October 8, 2009. He also moved the deadlines for the filing of the workshop report to November 11 and for the opening and reply comments on that report to December 16, 2009, and January 21, 2010, respectively. On November 12, 2010, ALJ Weatherford reset the deadline for the Workshop Report to November 25 and for the opening and reply comments to January 5 and February 2, 2010, respectively. The Workshop Report of November 25 was filed on December 9, 2009. On December 23, 2009, in an e-mail response to an e-mail request on behalf of the California Water Association, the January 5 opening comments deadline was extended to January 12, 2010. Reply comments were received in a timely fashion on February 2, 2010.

On April 20, 2010, ALJ Weatherford issued a ruling inviting specific comments on the comparative cost to ratepayers of treating government loans as CIAC and placing them in rate base, and on the array of factors that should be

expected to guide cost allocation relative to contamination proceeds. Opening comments relative to that request were filed by May 12, 2010, followed on May 28, 2010, by reply comments. The Proposed Decision mailed on August 3, 2010. Opening Comments and Reply Comments were filed on September 9 and 20, 2010, respectively.

3. Issues Posed for Rulemaking

As set out in the August 21, 2009, Assigned Commissioner's Ruling and Scoping Memo, the issues within the scope of this proceeding are:

1. Whether the D.06-03-015 rules pertaining to the accounting and ratemaking treatment for state government grant-funded plant apply or ought to be extended to local and federal government grant-funded plant.
2. Whether new plant (replacing contaminated plant) funded by government loans should be included in rate base and earn a rate of return or be recorded as CIAC.

a. Should it matter whether the loan is interest-bearing or interest free, or whether the loan is short-term or long-term?

3. Whether new plant (replacing contaminated plant) funded by proceeds from damage awards, settlements, government order or insurance should be included in rate base and earn a rate of return or be recorded as CIAC.
4. Whether new plant (replacing contaminated plant) funded by government loan or proceeds from damage awards, settlements, government order or insurance should be valued at the residual book value of the contaminated plant or at the actual replacement cost, if the new plant is placed in rate base.

   a. If the new plant is valued at the actual replacement cost, should ratepayers pay a rate of return on the difference between the residual book value and the actual replacement cost?

b. If less than the actual replacement cost is included in the rate base, how should the reduction be reflected in the utility's accounts?

5. Whether the net amount of proceeds from damage awards, settlements, government order or insurance should be shared between ratepayers and shareholders after the contaminated plant is replaced and all recoverable costs (e.g., legal and replacement costs) have been determined.

   a. If shared, how should the proceeds be divided and on the bases of what criteria?

   b. Should it matter who paid what amounts in pursuit of the proceeds?

6. How, if at all, should past decisions of the Commission inform or influence the resolution of the foregoing issues?

In summary, the Commission's intention here is to address the "ratemaking consequences" of an investor-owned water utility's receipt of any "asset of value" (other than state government grants)[13] "intended to remediate or compensate for actual or threatened contamination of water supplies" available or used "to provide public utility water service."[14]

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[13] As noted in the OIR commencing this proceeding, R.09-03-014, at 3-4, state government grants were addressed by D.06-03-015 in an earlier rulemaking proceeding, R.04-09-002.

[14] The quoted portions of this statement come from page 2 of the Opening Comments of CWA in Response to Order Instituting Rulemaking, filed June 1, 2009, in this proceeding. We have deviated from CWA's generic scoping suggestion by excluding state government grant proceeds, a subject covered in D.06-03-015, from the reach of this rulemaking.

4. Workshop Content, Report and Related Commentary

4.1. Local and Federal Government Grant-Funded Plant

In the comments preceding the workshop sessions, the discussions during those sessions, the Workshop Report, and the comments on that report, the parties agreed that the rules established by D.06-03-015[15] for the accounting and ratemaking treatment of state grant-funded plant should apply to local and federal government grant-funded plant. D.06-03-015 concluded that state grants used to fund plant should be accounted for as CIAC except that a new designation, Account 266, was to be used rather than the CIAC account, Account 265, identified in the applicable Uniform System of Accounts for Water Utilities (Class A).[16]

4.2. Government Loan-Funded Plant

DWA's Workshop Report recommends that loan-funded new plant replacing contaminated plant should be treated as CIAC along the lines set out in the 1978 Commission Quincy decision, D.88973.[17] DWA concludes, as did the Quincy decision, that CIAC rather than rate base treatment best meets Commission objectives.[18] DWA further recommends that the Commission

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[15] Appendix A to D.06-03-015 contains "Rules for the Accounting of State Funds," the first of which provides that "[n]o return shall be earned by Commission regulated water utilities…on grant-funded plant."

[16] Account 265 (Contributions in Aid of Construction).

[17] The Quincy proceeding involved a state loan under the California Safe Drinking Water Act.

[18] The DWA Workshop Report, at 5, paraphrases the four policy objectives articulated in the Quincy case as follows:

> 1) Allows for the benefits associated with government loans or publicly furnished capital to flow to customers in the most direct fashion possible;

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consider a form of compensation, in the investor owned utilities' (IOU) cost of capital proceedings, for their efforts in pursuing these types of loans for the benefit of their customers, and to account for any additional liability associated with these types of loans and the IOUs' responsibility over the operation and maintenance of the replacement plant that may not be fully accounted for by the CIAC ratemaking treatment method.

In its opening comments CWA, while indicating that the Quincy CIAC (surcharge) approach was available, urged adoption of what it calls the "conventional cost of capital approach" which would be "to treat a government loan just like a loan from a private financial institution, with the cost reflected in the utility's weighted cost of debt."[19] CWA thinks that the related utility plant should be treated like all other utility plant investments and placed in the rate base. Should the Commission be inclined to the CIAC/surcharge approach, however, CWA warns that a distinction needs to be drawn between large and small water companies due to the administrative burdens that go along with government loans.[20]

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2)Provides checks and balances to ensure that there are no unintended windfalls to the utilities;
3) Informs the customer as to the costs and benefits of projects financed by these types of funds to participate intelligently in the decision making process; and
4) Provides more assurance by avoiding cash flow deficiencies.

DWA bases its recommendation that government loans be treated as CIAC in part on the present worth analysis done by a witness from the Commission's Finance Division in the 1978 Quincy proceeding (D.88973) that showed greater benefits for the ratepayer under CIAC. (Workshop Report, at 8-9, including Table 2.)

[19] June 1, 2009 Opening Comments of CWA in Response to Order Instituting Rulemaking, at 6.

[20] Id. at 8.

Park Water Company (Park) recommends that government loans be recorded as long-term debt and the related utility plant be rate based.[21] Park argues that "the benefit of the lower interest typically applied to government loans would flow through to the ratepayers through a lower overall cost of debt, and therefore lower return on rate base, which is the result of incorporating the debt cost of the government loan into the company's cost of debt."[22] Park appears willing to see a water utility have the option to take either the CIAC or the long-term debt approach, with CIAC being the default.[23]

Class B Fruitridge Vista Water Company (Fruitridge Vista) believes Class B, C or D water utilities should be allowed to rate base plant funded by a government loan,[24] citing burdens associated with such loans, such as "[m]andatory provisions in State contracts" that "put the company at great risk."

Both the Division of Ratepayer Advocates (DRA) and The Utility Reform Network (TURN) support the CIAC ratemaking approach, but they differ on the related issue of whether a water utility's efforts in securing, administering and assuming the liability of the loan, and the operation and maintenance demands of the replacement plant, ought to be considered subsequently in a cost of capital proceeding. DRA would support consideration

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[21] June 1, 2009 Opening Comments of Park, at 2-3.

[22] Ibid.

[23] July 1, 2009 Reply Comments of Park, at 1-2.

[24] May 28, 2009 Opening Comments of Fruitridge Vista to Issues Raised in Order Instituting Rulemaking, at 2. The reference to Class B, C or D utilities was made in the context of damage awards but under a subheading covering government loans. Ratebasing government funded plant is recommended by Fruitridge Vista in its July 1, 2009 Reply Comments, at 3 (unnumbered), without regard to water utility size or class.

of a one-time incentive award, whereas TURN sees no need for a specific incentive, arguing that no reward is in order for activities that it sees as coming within a utility's general obligation to serve.

The IOU parties[25] and the ratepayer advocate parties disagree over the comparative cost to ratepayers between the two types of ratemaking treatment approaches for replacement plant funded by government loans: 1) including the plant in rate base (cost recovery through depreciation) and 2) treating the loan proceeds as CIAC (recovery of loan payments through surcharges). CWA offered a hypothetical example, involving a utility with a $4 million rate base, that factored the actual cost of a government loan into the utility's cost of capital with the purported results of avoiding both shareholder windfall and the administrative cost of separate loan accounting.[26] DRA criticized CWA's example as being "overly simplified" and offered a variant hypothetical containing more factors.[27] When the ALJ later invited the parties to revisit those estimates[28] DRA revised its calculations slightly but stood by its position that surcharging would serve ratepayers better than would rate basing.[29] Under

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[25] Use of "IOU parties" abbreviation in this decision refers to California Water Service Company (Cal Water), San Gabriel, California-American Water Company(Cal-Am), Park, and Fruitridge Vista, and CWA (which also represents water utilities that are not directly or formally parties in this proceeding).

[26] June 1, 2009 Opening Comments of CWA in Response to Order Instituting Rulemaking, at 7.

[27] July 1, 2009 Response of the Division of Ratepayer Advocates, at 1-5. DRA added to its variant, which included surcharge calculations for comparative purposes, assumptions concerning accumulated depreciation reserve, annual depreciation rate, property tax rate, net-to-gross multiplier, loan life and a fixed annual loan payment. DRA, at 4-5, also cited D.08-09-002 (approval of zero-interest Safe Drinking Water State Revolving Fund loan for California Water Service) as an instance where the surcharge approach was chosen.

[28] April 20, 2010 ALJ's Ruling Inviting Comments and Rescheduling Proposed Decision, at A-1.

[29] Comments of DRA to ALJ's Ruling Inviting Comments, May 12, 2010, at 2.

DRA's revised calculations, with rate-basing ratepayers would pay $189,000 more over the life of the investment, and $78,000 more over the term of the loan, than would occur using the CIAC/surcharge approach.[30] TURN backed DRA's position.[31] CWA pointed to what it considered "serious errors" in the details of DRA's calculations,[32] and Park agreed with CWA's position that DRA's calculations inflate the rate impact difference between the rate base and CIAC approaches.[33]

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[30] May 28, 2010 Reply Comments of DRA, at 3, fn 5, to April 20, 2020 ALJ Ruling

[31] Reply Comments of TURN to the ALJ's Ruling Inviting Comments and Rescheduling Proposed Decision, May 28, at 5. TURN alleged that its judgment took into account the "minor errors" that CWA had found in DRA's calculations. (*Id.* at 2.)

[32] May 12, 2010 Opening Comments of CWA in Response to ALJ's Ruling, at 3-6. CWA believes DRA's calculation over-extends depreciation expense, fails to take account of deferred income taxes, exaggerates the expense of the cost of capital approach, shows that the primary added cost (property taxes) to ratepayers of the cost of capital approach does not benefit shareholders and reveals that the back-loaded costs of the cost of capital approach could maintain near-term value if the utility borrowed periodically from a government lender. CWA also complains that DRA's calculation of the cost of ratebasing, showing no change in the rate of return to reflect the inclusion of government loan interest rates, is "a 'red herring,' aimed to distract attention from the very modest difference in cost to ratepayers, whether higher or lower, between the conventional cost of capital approach and DRA's preferred method of surcharge accounting." (*Id.* at 7.)

[33] May 28, 2010 Reply Comments of Park to Parties' Opening Comments on the ALJ Ruling, at 2-3. Park also criticized "an underlying assumption in the debate on this issue…that the utility is made whole through the CIAC/surcharge method…," explaining:

> The government loan, if it is treated as CIAC for ratemaking, will not be reflected as debt in the utility's ratemaking capital structure, so that for ratemaking purposes, during the period while the surcharge is in effect, the utility will appear to be less highly leveraged, have lower financial risk, and present less risk to holders of the utility's equity and deserving of a lower ROE [return on equity] than would actually be indicated. Since

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Finally, some of the IOU parties argue that the CIAC approach does not make the water utility whole, in part because there are costs and risks associated with the ownership, operation and maintenance of the new plant, whatever the source of that plant's funding, for which the water utility ought to be compensated in some way.

4.3. Plant Funded by Damage Awards, Settlements, Government Order or Insurance

4.3.1. General Positions of Parties

In response to examples of risk identified by the parties,[34] reproduced as Table 1 in section 4.3.2 of this decision, below, the DWA recommends that new plant funded by proceeds from damage awards, settlements, government order or insurance should be treated as CIAC because it believes that these risks are either mitigated through the existing cost recovery mechanisms or are within the ambit of an IOU's responsibilities as a regulated water utility.[35] DWA further does not support rate basing such new plant because of the greater costs ratepayers allegedly would face as a result and because of the water contamination related costs (litigation and expert witness expenses, and costs associated with the replacement facilities or water supply replacements) that may not be covered by the water contamination proceeds and would ultimately be the ratepayers' responsibility. DWA reaches that position

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> the plant constructed with the loan proceeds would be treated as CIAC, the utility would be recovering only O&M [operation and maintenance] costs through rates and would be accepting the risks of owning and operating those facilities without any compensation for that risk.

[34] Listed in the Workshop Report, at 12, Table 1.

[35] Workshop Report, at 10.

without respect to risks assumed by ratepayers and shareholders relative to the contamination occurrence and response.[36]

CWA wants new plant that replaces contaminated plant to be regarded as utility plant in service and placed in rate base. According to CWA:

> DRA mischaracterizes the facts and thereby ignores the crucial burden of proof that must be met to justify denying a return on investment of utility funds. No one has proposed that "damage awards" be rate-based or that water utilities earn profits on funds they did not invest. DRA's rhetoric ignores a crucial step in the cash flow related to contamination proceeds. In most cases, the utility receives one or more cash payments from parties responsible for a contamination incident. Those funds become the property of the utility. The utility then invests those funds in utility plant - possibly replacement plant or treatment plant required to remediate the contamination incident or possibly other, unrelated plant. The ratemaking issue presented does not concern rate-basing of "damage awards," but instead the rate-basing of utility investment in utility plant where the utility investment is made with funds derived from "damage awards." The funds invested in that utility plant are the utility's funds, regardless of the source from which they are derived. [Emphasis in original.]
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> In the case of contamination proceeds, if rate base treatment is going to be denied, the burden should rest on DRA or the Commission itself to justify a denial of normal rate treatment, which, in essence, would constitute a taking. If the reason for denying rate base

[36] (Ibid.) DWA does think that risks should be "considered in the IOU's cost of capital proceeding and in the Commission's evaluation of the allocation of water contamination proceeds between the ratepayers and the IOUs." (Ibid.)

> treatment is that the funds invested were "contamination proceeds," then the challenge should address the particular facts and circumstances, including the utility's initiative to pursue recovery of the proceeds and the relevant costs and risks borne by the utility and its ratepayers in connection with the contamination incident, its remediation, and the associated litigation or settlement efforts.[37]

For determining what portions ought to be rate based and what portions treated as CIAC, CWA offers three principles[38] summarized in the Workshop Report[39] as follows:

> 1) The investment amount should be limited to "net" proceeds received from polluters, after allowance has been made for the utility to recover any outstanding expenses incurred in securing those proceeds and for any taxes or fees (especially income taxes) that the utility will have to pay for those proceeds.
> 2) The extent to which the utility's shareholders and the utility's ratepayers have borne those costs and risks from the contamination problem that led to the payment or conveyance of assets by the polluters to the utility.
> 3) The utility's management decisions to pursue the polluters through [a] litigation or settlement process, and the success with which they have executed those decisions by deploying resources and achieving litigation or settlement awards.

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[37] February 2, 2010 Reply Comments of CWA on Workshop Report, at 2-3.

[38] See June 1, 2009 Opening Comments of CWA in Response to OIR, at 9-10.

[39] Workshop Report, at 10-11. The separate IOU parties generally supported these principles. Their individual positions are summarized in Appendix B of the Workshop Report.

DRA sees no distinction between damage proceeds and government grant or loan proceeds as funding sources for new plant. In its view all those sources compel that the new plant be treated as CIAC because no shareholder investment is involved. In short, the absence of shareholder investment in plant leads DRA to find no grounds for rate basing that plant.[40]

TURN finds that CWA's three principles (described above) neglect an overarching principle that "dealing with water contamination remediation and damage recovery from third parties is a regular part of operating as a regulated water utility" and a reasonable presumption that "some amount of the associated costs are included in rates."[41] TURN believes that any "risk that costs are not now and never will be included in rates is reflected in the authorized return on equity."[42]

4.3.2. Proportional Assumption of Costs and Risks: Competing Views

Perceptions of risk and of who, between ratepayers and shareholders, assume the greater costs and risks in contamination occurrences underlie the positions taken by the IOUs and to a lesser extent DRA in the rate basing vs. CIAC debate over damage award type proceeds. In its June 1, 2009 comments CWA compared three contrasting circumstances regarding contamination damage award proceeds, each of which could warrant

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[40] June 1, 2009 Opening Comments and Recommendations of DRA, at 3.

[41] July 1, 2009 Reply Comments of TURN on Issues Identified in Preliminary Scoping Memo, at 6.

[42] *Ibid*. Hereafter, "return on equity" will be abbreviated as ROE.

a customized approach in its judgment.[43] As summarized in the Workshop Report,[44] the sets of circumstances and approaches that CWA identifies are:

1) Where the "impact of a contamination problem has been reflected fully in rates charged to customers, through an allowance that fully covers the replacement cost of purchased water and another allowance that fully covers the legal costs of pursuing compensation from the polluters." Here [CWA concludes that] the "ratepayers will have shared a substantial portion of the risks and immediate costs arising from the contamination problem, and so a corresponding share of net proceeds invested in plant should be accounted for as CIAC."
2) Where the "contamination problem arises suddenly and the utility must respond to it without delay by acquiring new sources of water supply or constructing new facilities that are not provided for either by current rates or by an existing cost recovery mechanism and must undertake immediate legal action to forestall continuing pollution or hold the polluters accountable even though there is no allowance in the utility's present rates to cover such legal costs." Here [CWA concludes that]"the utility's shareholders are burdened by the considerable risks and costs with no assurance that any of the costs will be recoverable through rates, and so there will be no justification for treating as CIAC any more than a nominal share of net proceeds eventually recovered from the polluters."
3) Alternatively, "intermediate cases, involving a sharing of risks and immediate costs" are

[43] June 1, 2009 Opening Comments of CWA in Response to OIR, at 10-11.

[44] At 11.

> conceivable, such as where both a water quality memorandum account and a water quality litigation memorandum account exist and it can be concluded from that fact that "the risks presented by the contamination problem have been shared between ratepayers and shareholders," allowing "a consistent share of any net proceeds" to be "treated as CIAC."

San Gabriel echoed CWA's call for an individualized assessment of where the cost and risk burdens lie with its own comment:[45]

> While dealing with contaminated water supplies imposes undeniable risks on both the water company and on the customers, the relative weight of those inherent risks can vary depending on the facts and circumstances of each case; e.g., who bears the risks and costs of remediation, litigation, liability, diminished property and water rights values, going-concern value, and utility plant that is rendered useless?

San Gabriel offered two case examples in support of its argument against a formulaic accounting approach. In the instance of the $182 million litigation settlement concerning the Baldwin Park Superfund site in San Gabriel's Los Angeles County Division, 94% or $171 million of the settlement has been categorized for remediation (treatment plants and 15 years of operation and maintenance costs) and 6% or $11 million is categorized as general damages. In that example, San Gabriel believes that:

> By any reasonable measure, allocating all of the general damages to the company - a mere 6% of the total - is more than a fair and balanced split given the facts and circumstances in this case in which customers are assured that the water supply they depend on will be

[45] June 1, 2009 Opening Comments of San Gabriel in Response to Order Instituting Rulemaking, at 1-2.

> fully remediated and their water rates will be shielded from the resulting costs.[46]

The related expenses have been tracked in a memorandum account and await, pending resolution of the litigation, a cost recovery determination by the Commission.

The other case example cited by San Gabriel, the Mid Valley Landfill litigation in its Fontana Water Company Division, involved a $14 million settlement in which 48% or $7.8 million was categorized for remediation (treatment plant and 15 years of operation and maintenance) and 42% or $5.9 million was categorized as general damages. In the last general rate case[47] the Commission reimbursed the operation and maintenance costs to the ratepayers and divided the balance of the settlement proceeds between the ratepayers (67%, in the form of rate base reduction) and the shareholders (33%). San Gabriel alleges that the allocation was done "without first accurately determining the amount of the net proceeds" and involved simply importing a ratio used in a rulemaking proceeding[48] concerning the allocation of sales gains from no longer needed utility property. San Gabriel, which bore litigation expenses without a memorandum account and allegedly was burdened by all of the income tax liability resulting from the settlement, believes the outcome was unfair and "illustrates the danger of relying on an arbitrary, fixed allocation formula."[49] In San Gabriel's view its two case examples show that "even if all the

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[46] Id. at 4.

[47] See D.07-04-046 as modified by D.08-04-005.

[48] See D.06-05-041 and D.06-12-043.

[49] June 1, 2009 Opening Comments of SGVWC in Response to Order Instituting Rulemaking, at 5.

general damage proceeds in these cases were allocated to the company, the customers remain shielded from the capital and operating costs of remediating contaminated water supplies."[50]

The array of risks perceived by the parties as surrounding contamination occurrences was summarized in the following table in the Workshop Report.[51]

Table 1
Examples of Risks and Risk Mitigation

IOUs **Examples of risks to the water utilities**	**DRA and TURN** **Examples of risks to ratepayers**
1. Loss of water resources/interruption of supply; 2. Lawsuits by parties claiming to be injured by contamination; 3. Countersuits by polluters, claiming utility is a responsible party; 4. Need to acquire/purchase new sources of supply; 5. Need to install new plant to deliver new supply or to treat contaminated supply; 6. Need to raise capital to fund above activities; 7. Damage to reputation and brand; 8. Diversion of management resources; 9. Opportunity cost of funds- Money being tied down that could be channeled towards projects with higher returns.	1. Many of the risks mentioned by the water utilities are addressed and utility is already compensated for in their ROE; 2. Utilities raise many of these contamination specific risks in asking for a higher ROE; 3. Ratepayer exposure to the contaminated water; 4. Negative impact on customers' property value; 5. Higher rates to pay for litigation, replacement water supply, and remediation costs; 6. Risk to the ratepayers that they may need to pursue their own lawsuit to seek damages; 7. Service interruption.

[50] Id. at 2.

[51] Appendix A, at 12.

10. Diminished value of water rights; 11. Litigation itself is a huge risk, if utility is a legal party to the case; 12. Legal responsibility for the costs of litigation and expert fees— water contamination costs are generally not forecasted in GRC; therefore the consequence of contamination falls on the utility until the next rate case cycle or beyond. 13. Regulatory risk associated with cost recovery.	

The DWA's general assessment of the risks enumerated above by the IOUs is set out in the Workshop Report.[52] The DWA believes that some of the risks identified by the IOUs (numbers 1, 4-6, and 9) fall within a regulated water company's responsibility, another is not specific to a water contamination occurrence (number 7), others (numbers 8, 11 and 12) are worthy of consideration in either an allocation of proceeds between ratepayers and shareholders or in cost of capital proceedings, and another (number 13) is adequately addressed by California's "robust regulatory environment" as characterized in a cited Commission cost of capital decision.[53]

The CWA challenged DWA's assessment of the risks identified by the IOUs by emphasizing that risks should be assessed on a case-by-case basis

[52] Workshop Report, at 16-17.

[53] D.09-05-019, at 31-32.

and that risks are only part of what underlies the need for IOUs to have an incentive for pursuing cost recovery against polluters.[54]

As can be seen from the column of risks to ratepayers in Table 1 above, DRA and TURN argue that many of the risks asserted by the IOUs are reflected in their approved return on equity and accounted for in existing rates.[55] The ratepayer advocates further see ratepayers assuming potential health, property value, service interruption and litigation expense burdens.

4.3.3. Suggestion that Complex Contamination Litigation Can Exceed Obligation to Serve

The IOUs repeatedly voiced the opinion that engaging in complex contamination litigation exacts extraordinary time and energy from a water company. The comments of Fruitridge Vista, which was awaiting trial in 2009 in a methl tertiary-butyl ether (MTBE) groundwater contamination lawsuit against Atlantic Richfield Oil and others that began in 1998, are illustrative:

> [Fruitridge Vista's] efforts to date have required years of dedicated time, effort and expertise that is required outside of and in addition to normal water business hours and operations. It is this extra and special time that determines success or failure. Therefore, it is not only monetary risk that should be considered. The personal risk and dedication of the utility should also be considered. If the Commission were to categorically find that the monetary funding were the only criteria for rate basing, it would only discourage the PUC regulated water utility from investing the enormous effort to recover [proceeds]. This would in turn affect

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[54] May 12, 2010 Opening Comments of CWA in response to ALJ's Ruling, at 10-11.

[55] DRA cited instances in the 2007-2009 period in which water IOUs referred to contamination as a risk factor in cost of capital proceedings. (See January 12, 2010 Opening Comments on Workshop Report by DRA, at 3-4.)

> the rate payer negatively in two ways. First, the rate payer would have to immediately pay for the expense of replacement water. Second, the resulting lack of rate base would result in less capital available to the company to provide improvements to the system…. [T]he financial impact of the rate basing pales in comparison to the perseverance, dedication, effort and time required to sue and recover damages for water pollution. Ratepayers do not share in that time and risk involved.[56]

In section 5.5.1 below we address the suggestion that contamination litigation can be so onerous that it tests or crosses over the boundaries of the obligation to serve.

4.4. Valuation of Replacement Plant

The parties appear to agree that new, replacement plant ought to be valued at its actual cost, not residual book value, if placed in the rate base. This is relevant for the one circumstance in which we determine in this decision that new plant funded by contamination proceeds should be rate-based, namely where an IOU uses some or all of the net proceeds it is allocated from damage awards, settlements, government order or insurance proceeds to invest in new, replacement plant. The actual cost approach is in accordance with the way the issue is addressed in the Uniform System of Accounts for Water Utilities and moots the accounting treatment sub-issues (previously scoped for this proceeding) concerning either any difference between book value and replacement cost or any reduction of replacement cost.

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[56] May 28, 2009 Opening Comments of Fruitridge Vista to Issues Raised in Order Instituting Rulemaking, at 3.

4.5. Sharing of Proceeds Remaining After Specified Expenses are Deducted

4.5.1. Qualified Consensus on Case-by-Case Approach

The Workshop Report recommends that the decision whether water contamination proceeds should be shared between ratepayers and utility shareholders "should be made on a case-by-case basis grounded on the facts of each case."[57] While there was notable consensus on this general point during the workshop and in the comments in this proceeding,[58] there was not consensus on the ancillary but very important issue of what portion of the proceeds (e.g., "net proceeds") should be subject to any sharing.

4.5.2. Competing Definitions of "Net Proceeds"

Under DRA's conception, net proceeds would be what is left from gross proceeds after litigation, remediation and "all other reasonable cost and expenses…that are the direct result and would not have to be incurred in the absence of such contamination."[59] That conception appears compatible generally with the way the sharing issue has been posed in this rulemaking.[60] In contrast, CWA views net proceeds as what is left over after deducting "expenses incurred

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[57] Workshop Report, November 25, 2009, at 18.

[58] DRA took the initial position that IOUs should not share in net proceeds from damage awards (June 1, 2009 Opening Comments and Recommendations of DRA, at 7), but modified that stance in its January 12, 2010 Opening Comments on Workshop Report by DRA, at 5-6: "DRA is willing to accept DWA's recommendation that those proceeds should be shared and that how those proceeds will be shared will be determined on a case-by-case basis. DRA accepts that recommendation, however, with the observation that the IOU portion should always be relatively small."

[59] Workshop Report, Attachment A, at 22.

[60] As set out in the Assigned Commissioner's Ruling and Scoping Memo filed on August 21, 2009, as Issue No. 5, at 5, the question was whether sharing should occur "after all recoverable costs (e.g., legal and replacement costs) have been determined."

in securing those proceeds" and related taxes and fees; the expenses of remediation, replacement and capital costs would not be deducted.[61] That conception, while it reconstitutes the issue formerly scoped, has been known to the parties and participants since it was raised in the Workshop sessions.

Under DRA's approach, there would be no pool from which shares could be allocated until and unless the contamination event had been completely remediated and all related costs accounted for. The possibility of sharing would be contingent on there being excess proceeds after remediation or replacement. Under CWA's approach, allocation of proceeds between ratepayers and shareholders could occur before, during or after contamination-related remediation, replacement or capital investment, but CWA's definition of net proceeds would set the stage for an allocation determination as soon the litigation expenses were determined.

4.5.3. Perceptions of Risk and of Where It Resides

As noted above the IOU and ratepayer advocate parties see different risks at play in connection with contamination litigation. There ended up being wide agreement, but not total consensus,[62] among the parties that any sharing, if it is to occur in any given case, can take into account the relative assumption of risks and costs by the ratepayers and shareholders. The utilities and the ratepayer advocates differ greatly, however, as to who, between the ratepayers

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[61] San Gabriel, with Cal Water's support, would include in gross proceeds future reimbursements for operation and maintenance costs. Workshop Report, Attachment A, at 22-23.

[62] TURN believes that risks identified by the IOUs are accounted for in existing rates of return and that standardized rules rather than case-by-case balancing of factors are called for in this rulemaking. (See, e.g., May 28, 2010 Reply Comments of TURN to ALJ's Ruling, at 6.)

and the shareholders, generally bears the bulk of the costs and risks surrounding a contamination occurrence.[63] Throughout the Workshop and the commentary it was apparent that DRA and TURN generally perceive ratepayers to be the primary bearers of risk and cost in contamination occurrences, and that CWA and the individual party IOUs instead generally see shareholders in that position. Competing perceptions of fact, then, as well as definitions of net proceeds, lie at the heart of the issue of sharing.

DRA initially took the position that there should be no sharing of net contamination proceeds with shareholders,[64] arguing that ratepayers normally and ultimately assume the costs and risks. But DRA's position evolved, or was clarified, to allow for an IOU that proves an assumption of risk to receive a small share of net proceeds.[65]

CWA believes that the comparative risks and costs assumed by ratepayers and shareholders relative to the contamination should guide sharing and that the allocation needs to result in an incentive for the utility to pursue cost recovery and to reward success.[66]

Reflecting those different perceptions of how risks are assumed in practice, the utility and ratepayer advocate parties offered examples of risks to shareholders and ratepayers. (See Table 1 above.)

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[63] Workshop Report, at 10-12.

[64] Id. at 18-19. DRA thought that normally the net proceeds (as it defined them) should be either returned to ratepayers (via rebate or a credit) or used to reduce rate base.

[65] See January 12, 2010 Opening Comments on Workshop Report by DRA, at 5-7, and February 2, 2010 Reply Comments of DRA, at 4.

[66] February 2, 2010 Reply Comments of CWA on Workshop Report, at 9.

Additionally, DRA suggested four other factors that could be expected to guide a determination of whether and how to allocate whatever portion of the proceeds is determined to be available for sharing:[67]

1. Time taken to recover litigation cost.
2. Availability of state revolving funds.
3. Complexity of litigation which could include factors such as number of parties to the litigation, the venue, how far the litigation progressed, whether the defendants were insured and/or their level of solvency, complexity and number of motions, [and] number and length of depositions.
4. Other risks within the litigation.

The California Water Association sees those factors largely as subsets or variants of the risks already cataloged by the parties[68] and stands by its position, characterized as follows in the Workshop Report:[69]

> From CWA's perspective the primary factors for the allocation of net proceeds are: defining net proceeds as proceeds net of the cost of obtaining them and associated taxes, and the recognition of cost and risk to company and shareholders; the initiative and the success of the utility in achieving the proceeds. CWA's position is that evaluation of these types of cases should be made on a case by case basis.

4.6. Effect, if any, of past decisions of the Commission on resolution of foregoing issues

The parties' views as to the proper role of Commission precedent vary somewhat depending on whether the issue is cost allocation or accounting

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[67] January 12, 2010 Opening Comments on Workshop Report by DRA, at 6.

[68] May 12, 2010 Opening Comments of CWA in Response to ALJ's Ruling, at 8-11.

[69] Attachment A, at 8.

treatment. As to the cost allocation of contamination proceeds, there is a consensus that Commission decisions ought not to be controlling but rather reviewable for guidance. As to the ratemaking treatment of government loans, DRA urges adherence to D.06-03-015 (state government grants treated like CIAC) as precedent for not including such proceeds in rate base. The water utility parties find no precedential value in D.06-03-015 in relation to government loans.

5. Discussion

The discussion in this section assumes the uncomplicated case where the construction of replacement plant does not begin until after the receipt and application of contamination proceeds. Under circumstances where planning and construction expenditures for replacement plant precede the receipt and application of contamination proceeds, an issue may be posed whether different and segregated accounting treatment needs to be given to the respective parts of replacement plant that precede and follow the receipt and application of those proceeds. In such a circumstance the Commission would need to address and resolve the issue on the basis of the facts before it. In these cases, the IOUs should request authorization through an advice letter filing to establish a memorandum account to record and maintain separate tracking, consistent with the Uniform System of Accounts (USOA), of all expenditures associated with the replacement plant, in addition to the regular USOA treatment of such expenditures.

5.1. Local And Federal Government Grants Used To Fund Replacement Plant Should Be Given Basically The Same Accounting Treatment As State Grants Were Given In D.06-03-015

We conclude that contamination-related local and federal grant proceeds should be treated for accounting and ratemaking purposes in a manner

substantially the same as state grant proceeds were treated in D.06-03-015.[70] In D.06-03-015 we hued to the principle of preserving the "public interest integrity" of public funds "by ensuring that investor-owned water utilities and their shareholders will not be able to profit in any way through the receipt of public funds."[71] Finding no material difference between state grants on the one hand and local and federal grants on the other hand, we conclude that all government grants used to fund replacement plant should be accounted for as CIAC, except that one slight accounting change is in order.

The rules appended to D.06-03-015 designate an account numbered 266, rather than the 265 identified in the Uniform System of Accounts[72] for water utilities for booking proceeds as CIAC. During the Workshop, a water utility representative noted that the relevant section of the California State Board of Equalization (BOE) Assessor's Handbook concerning CIAC associates the capitalization of property (utility asset) that has been funded through CIAC by Class A water companies only with Account 265. This has the normal effect of CIAC being assessed locally as having zero value for property tax purposes.[73]

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[70] Dated March 2, 2006, in proceeding R.04-09-002 (Order Instituting Rulemaking on the Commission's Own Motion to Develop Rules and Procedures to Preserve the Public Interest Integrity of Government Financed Funding, Including Loans and Grants, to Investor-Owned Water and Sewer Utilities). Appendix A to D.06-03-015 contains "Rules for the Accounting of State Funds," the first of which provides that "[n]o return shall be earned by Commission regulated water utilities…on grant-funded plant."

[71] D.06-03-015, at 3.

[72] For example, for Class A water utilities *see* Uniform System of Accounts for Water Utilities (Class A), at 35-36.

[73] See general discussion of CIAC in BOE Assessors' Handbook, Section 542 (Assessment of Water Companies and Water Rights), at 14-15. The Handbook states, at 14, that "the value of CIAC is generally zero because a prospective purchaser would

Footnote continued on next page

While both CWA[74] and TURN[75] state that it is uncertain whether property taxes are charged when costs are recovered through surcharges, we conclude below that where replacement plant is paid by ratepayer funds and the Commission does not allow any return on that investment, the Board of Equalization would have no value placed on that investment, resulting in the replacement plant not being subject to property tax. Because it is unclear, however, how individual local property tax assessors over time might treat CIAC booked in an account bearing a different number (e.g., 266), however functionally equivalent that account might be to Account 265, we are providing that a sub-account number 265.1, entitled "Government Grant Contamination Proceeds," be used for booking contamination related local and federal government grant proceeds. If D.06-03-015 is modified in the future to reconcile its provisions and rules with the decision here, then state grant proceeds may come within the new subaccount number 265.1 as well. The rules set out in Appendix A to this decision reflect minor deviations from the rules adopted to D.06-03-015.

When local and federal contamination related grant proceeds are initially received from the funding source, they should be placed in a dedicated 265.1 sub-account. For implementing rules concerning local and federal government grant proceeds, see Appendix A.

The IOU's believe that some form of compensation should be forthcoming for both the risk an IOU assumes in connection with grant terms

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not pay for property on which he or she is unable to earn a return on or recover the investment."

[74] Opening Comments of CWA on Proposed Decision (September 9, 2010), at 21.

[75] Reply Comments of TURN to the ALJ's Ruling (May 28, 2010), at 4.

and the responsibilities that come with the IOU's ownership, operation and maintenance of a replacement plant that is not in its rate base. We address that issue below in section 5.5.

5.2. Government Loans Used To Fund Replacement Plant Should Be Recorded As Contributions In Aid of Construction

After considering the Workshop discussion and separate commentary, including the variant hypothetical examples developed by the parties,[76] we conclude that government loans used to fund replacement plant should be treated as CIAC with corresponding ratepayer surcharges for loan repayment.

In general, the CIAC (recovery via surcharge) approach can avoid several costs that ratepayers incur if government loan proceeds are rate based. Those costs include depreciation expenses, income taxes, rate of return over the life of the asset, and, normally, property taxes.[77] Both CWA[78] and TURN[79] state that it is uncertain whether property taxes are charged when costs are recovered through surcharges. The only source of uncertainty would appear to lie in the circumstance where a local assessor departs from the clear guidance of the BOE handbook and deviates from normal practice. We conclude that where replacement plant is paid by ratepayer funds through surcharges and the Commission does not allow any return on that investment, no value is normally

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[76] The examples developed, enhanced and critiqued by the parties were of considerable assistance to the Commission in this proceeding.

[77] Workshop Report, Attachment A, at 4.

[78] Opening Comments of CWA on Proposed Decision (September 9, 2010), at 21.

[79] Reply Comments of TURN to the ALJ's Ruling (May 28, 2010), at 4.

placed on that investment and as a result the replacement plant is not normally subjected to property tax.

Of the examples and their variants offered by the parties to compare the cost to ratepayers of the rate basing and CIAC approaches, we found the analysis presented by TURN (based on the work of its consultant) to be the most helpful in demonstrating the cost differences.[80] Defending the DRA variant, with certain modifications,[81] TURN showed the results of introducing a $1 million zero-interest loan-funded property into a $10 million system. TURN then compared the net present value cost to ratepayers of a loan, payable over a 20 year period and recovered through a surcharge, to the net present value cost of rate basing of the asset and depreciating it over 35 years.[82] Under that example the rate base approach costs ratepayers $104,000 (net present value) more than the cost for the surcharge approach. Of this amount, a net present value cost saving of $26,000 to the ratepayer (representing 2.6% of the $1 million initial investment and 5.4% of the cost of the surcharge) is attributable to the temporal difference between the shorter loan term and the longer depreciation

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[80] See Reply Comments of TURN to the ALJ's Ruling Inviting Comments, May 28, 2010, at 2-5.

[81] CWA had found what it considered errors in DRA's presentation of depreciation and deferred taxes. TURN regarded those to be "minor" and corrected for them. (*Id*. at 2.)

[82] TURN, in its May 28, 2010 Reply Comments, at 3, used the same 8.28% discount rate (assumed weighted cost of capital) as that used in the hypothetical presented by CWA in its June 1, 2009 Opening Comments, at 7.

schedule.[83] Approximately three quarters of the $104,000 net present value cost differential is attributable to property tax savings.

We have reviewed, and find applicable, the four policy objectives[84] set out in the Commission's Quincy Water Company decision (D.88973) discussed above and in the Workshop Report. The Quincy decision provided a present value analysis that compared the revenue requirement resulting from the CIAC and rate base approaches.[85] On April 20, 2010, the ALJ sought additional information from the parties on the comparative costs to ratepayers of treating government loans as CIAC and placing loan-funded replacement plant in rate base, using the hypothetical example offered by CWA in its June 1, 2009 opening

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[83] According to TURN:

> These costs are largely caused by the fact that the plant is depreciated over 35 years but its low-cost financing runs out after 20 years. The surcharge, on the other hand, ties the life of the financing to the amortization of the asset, so there isn't a tail of return to be paid for another 15 years. Rate basing is actually $55,000 cheaper than amortizing over the first 20 years (net present value), but the tail end rate base adds $81,000 (NPV) to the cost even though it does not start until year 21 and lasts for 15 years – less than the initial term of the financing. Essentially by putting the plant in rate base, the utility can make the project cheaper on a present value basis over the first 20 years but at the expense of a very large payment in the last 15 years.
>
> In sum, DRA was correct in asserting that surcharging rather than adding to rate base is a better deal for ratepayers. Property taxes will not be avoided if the plant is in rate base but might be avoided if it is not. But even without any savings due to different treatment for property tax purposes, the surcharge is $26,000 cheaper over the 35-year life.

Reply Comments of TURN to the ALJ's Ruling, May 28, 2010, at 4-5.

[84] Workshop Report, at 7-8. The representations of the objectives in quotation marks in the remainder of this section find their source in those pages of the Workshop Report.

[85] D.88973, at 4.

comments. The hypothetical case examples of comparative costs to ratepayers offered by parties in this proceeding have provided a broader basis upon which to assess the objectives announced in Quincy.

We conclude that use of the CIAC approach "[a]llows for the benefits associated with government loans or publicly furnished capital to flow to customers in the most direct fashion possible," the first policy objective. As indicated in the Workshop Report, government loans tend to carry low interest rates and are generally intended to improve water quality in specific areas and communities (such as low income or underprivileged communities) by funding infrastructure at a lower cost for those customers. As indicated by the TURN comparative cost analysis in its reply comments, the net present value cost premium of placing government loan-funded plant in rate base is approximately 10% of the initial principal and 22% of the net present value cost of the surcharge option.[86] In TURN's example and analysis the rate base treatment of a $1 million government loan-funded asset has a net present value cost of $585,000 at an 8.28% discount rate (assuming a zero interest loan), compared to the net present cost value of $481,000 for a surcharge of $50,000 per year for 20 years.[87] In this example the rate base treatment would cost ratepayers $104,000 (net present value) more than under the CIAC and surcharge approach, reducing or eliminating any cost savings associated with the zero-interest loan.

The CIAC path further "[p]rovides checks and balances to ensure that there are no unintended windfalls to the utilities," the second policy objective and a subject of great concern to the Commission in undertaking this

[86] Reply Comments of TURN to ALJ's Ruling Inviting Comments, at 2.

OIR. The surcharge paid by ratepayers under the CIAC approach is intended to go directly to pay the loan with no additional premiums or benefits to the IOUs such as a rate of return on the asset that was funded through the loan.

Addressing the third objective, we conclude that the CIAC approach best "[i]nforms the customer as to the costs and benefits of projects financed by these types of funds to participate intelligently in the decision making process." Ratepayers would know more clearly the portion of their bill that will go towards the projects financed by the loan due to the separate and specific surcharge on customers' water bills. By comparison, when an asset is rate based the costs of an asset financed by a loan would be included in the IOU's overall rates and ratepayers would not be able to discern the portion of the bill that is going towards paying for the asset.

Finally, CIAC treatment "[p]rovides more assurance by avoiding cash flow deficiencies." This fourth objective may be more applicable to the smaller size utilities that can face cash flow deficiencies. By having a designated surcharge, funds are more assured for payment of the loan.

Opening comments by the water utilities on the mailed (ALJ proposed) version of this decision contend that the TURN comparative cost analysis, which that version cited in reaching a determination that replacement plant provided through government loan proceeds should be treated as CIAC and not rate based, is materially flawed[88] and, as noted above, that the alleged property tax benefit associated with CIAC treatment is too uncertain to be relied

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[87] *Id.* at 4.

[88] Comments of CWA on Proposed Decision (September 9, 2010), at 20-23.

upon.[89] The first alleged flaw according to CWA is TURN's conclusion that there is benefit to surcharged ratepayers arising from the difference between the 20 year loan repayment term and the 35 year plant depreciation term. CWA argues that the difference is "fully accounted for by lower returns in earlier years," making for a wash not a benefit. DWA's staff evaluated and confirmed TURN's conclusion that there is a net benefit to the ratepayer. As TURN demonstrated in its cost comparison analysis,[90] the cost of rate basing $1 million in utility plant costs ratepayers an additional $104,000 in comparison to CIAC treatment of the utility plant in Net-Present Value (NPV) over the life of the plant. Of this NPV amount, TURN calculated that $78,333 would be to cover the costs associated with property taxes and that the remainder, $26,110, was attributable to rate basing the utility plant over the life of the plant. DWA's staff evaluated TURN's analysis and concurs with the analysis and calculations. TURN's $26,110 calculation is the difference in revenue stream between the two ratemaking approaches, rate basing and CIAC treatment, minus the property taxes in NPV, which can only be attributed to rate basing the asset.

The second and third alleged flaws of which CWA complains pertain to TURN's and DRA's use of an 8.28% discount rate for its cost comparison analysis. CWA states that TURN erroneously uses the utility's "return" of 8.28% for all years without considering the impact of the $1 million interest-free loan, and that the proper discount rate for a zero interest loan is zero. TURN persuasively replies that CWA has confused in its analysis the discount rate with the loan interest rate and the purpose of the discount rate is to

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[89] *Id.*, at 21

assess the impact of various alternative funding sources on ratepayers.[91] We concur with TURN's reply and with its cost comparison analysis.

Park and CWA, while acknowledging some benefits to ratepayers from the CIAC treatment of government loans, point to what they consider off-setting considerations, including an issue of "temporal" equity wherein earlier ratepayers during the life of the plant pay more than later ratepayers in the time frame of depreciation.[92] We recognize that CIAC treatment of contamination related government loans can pose issues of temporal equity, but we find that such considerations are outweighed by the benefits to ratepayers generally provided by CIAC treatment of government loans, including property tax savings.

The IOUs believe that some form of compensation should be forthcoming for both the risk an IOU assumes in connection with the terms and conditions of government loans as well as the responsibilities that come with the

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[90] *See* summary in Attachment D of TURN's Reply Comments (May 28, 2010).

[91] *See* Reply Comments of TURN on the Proposed Decision, at 4-5: "The purpose of a discount rate is to assess the impact of various alternative funding sources <u>on ratepayers</u>. For this analysis, a single discount rate is selected and uniformly applied to analyze the various funding options." (Emphasis in original.) TURN cites several energy proceedings in which the Commission has utilized a single discount rate reflecting a utility's weighted average cost of capital, e.g. D.82-12-120, D.05-04-051 (at Attachment 3), D.06-11-018. We see no reason why a similar approach should not be applied with respect to water utilities.

[92] January 12, 2010 Comments of Park to Workshop Report, at 6-7, cited supportively in February 2, 2010 Reply Comments of CWA, at 9. Park posed the scenario of a 20-year loan funding a plant with an average life of 40 years, under which ratepayers surcharged during the first 20 years could pay twice the amount of principle than would be the case using a loan, rather than a CIAC/surcharge, methodology and ratepayers during the second 20 years would pay no principal.

IOU's ownership, operation and maintenance of a replacement plant that is not in its rate base. We address that issue below in section 5.5.

Because we are ordering that replacement plant funding by government grants and loans be recorded as CIAC, the issue of whether new plant funded by government grants and loans should be valued at actual cost or residual book value, as well as related sub-issues, has become moot.[93]

We are providing that a sub-account number 265.2, entitled "Government Loan Contamination Proceeds," be used for booking contamination related government loan proceeds. When government loan proceeds are initially received from the funding source, they should be placed in a dedicated 265.2 sub-account. For proposed implementing rules concerning government loan proceeds, see Appendix B.

5.3. Damage Awards, Settlements, Government Ordered Funds Or Insurance Proceeds Used To Fund Replacement Plant Should Be Recorded As CIAC

In considering whether this class of contamination proceeds[94] should be treated as CIAC rather than the replacement plant being included in rate base,

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[93] The dominant view of the parties in this rulemaking, in accord with the Uniform System of Accounts for Water Utilities, was that new, replacement plant should be valued at its actual cost, not residual book value, when placed in the rate base. Under the Uniform System of Accounts the book value of the retired plant would not have to be netted against the new replacement plant because the booked cost of the retired plant is credited to the relevant utility plant account and if that plant is depreciable its booked cost is charged to the appropriate depreciation reserve. (*See* Uniform System of Accounts for Water Utilities, at 49-51.)

[94] For ease of description, the term "damage awards" is used in Section 5 of this decision as short hand for damage awards, settlements, government order or insurance, inclusive. Contamination proceeds resulting from government order are uncommon but are included in the rulemaking because one IOU cited an example of such proceeds in a workshop session.

we address the issue of which accounting protocol is advisable separate from the dual issues of whether and what incentive mechanisms should be employed to encourage IOUs to pursue contamination proceeds from third parties.

We conclude that CIAC treatment is appropriate for this class of proceeds because it results in less cost to the ratepayer.[95] New plant (replacing contaminated plant) funded through shareholder investment logically would be placed in the rate base. Where the source of the funding, as considered in this rulemaking, is otherwise, however, the proper treatment is CIAC. Treating capital infusion from sources other than investors as CIAC is standard practice under the Uniform System of Accounts.[96] We find that no persuasive basis exists for departing from CIAC treatment in connection with proceeds from damage awards.

The CWA argues that damage proceeds become the property of the water utility upon receipt and therefore lose any character of being third-party contributions before investments thereafter are made in new plant (to replace contaminated plant), or expenditures are made in remediation.[97] We reject any suggestion that the denial of rate basing treatment for damage proceeds "in

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[95] As we noted in section 5.2 above, there is an issue of temporal equity posed by CIAC treatment of contamination proceeds generally, i.e. the absence of a revenue stream to avoid a potential for "rate shock" when the replacement plant itself needs ultimately to be replaced, that warrants future consideration.

[96] Uniform System of Accounts for Water Utilities (Class A), at 35 (Account 265): "This account shall include donations or contributions in cash, services, or property from states, municipalities or other governmental agencies, individuals and others for construction purposes."

[97] See February 2, 2010 CWA Reply Comments on Workshop Report, at 2-3.

essence, would constitute a taking."[98] Contamination proceeds received by the water utility (whether derived of government grants and loans or non-governmental damage awards) may be deemed utility "property" but that designation in no way removes those proceeds from the ambit of reasonable and prudent Commission regulation.

DRA's and TURN's comparative analysis of rate basing of plant funded by government loans versus CIAC treatment of the loan proceeds demonstrates that CIAC treatment results in less cost to ratepayers than does rate basing. That analysis holds true irrespective of the source of the funding. Although costs may differ from one proceed type to another in the individual instance, the analysis is applicable as well to damage award funding of replacement plant because of the common property tax savings associated with CIAC.

We have determined that in most instances IOUs experience minimal or no adverse financial impact from the premature retirement of contaminated plant. Under the prevalent accounting practice where the IOU does not take a loss on the retired plant, there is no immediate change in rate base.[99]

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[98] Ibid.

[99] CWA and DRA agree that under the Uniform System of Accounts for Water Utilities a water utility's rate base is not reduced when contaminated plant is retired. (See Attachment A to Workshop Report, at 19.) As DRA characterized it, at *ibid.*:

> when a utility plant is prematurely retired, its original costs is deducted from Utility Plant in Service (Account 101) and at the same time an equal amount is taken out of Reserve for Depreciation (Account 250), resulting in no change in rate base. In subsequent years, the customers pay for the undepreciated amount and the related carrying cost through their water rates.

We reject the three ratemaking principles urged by CWA[100] in connection with the choice between rate basing and CIAC as to proceeds from damage awards. We recognize, however, that two of those principles[101] can suitably serve to inform an allocation of any net proceeds that may remain after appropriate deductions have been made, and we reflect that in the factors set out in Table 2 below.

To the extent, if any, that the Commission allocates to shareholders a share of the net proceeds remaining after appropriate deductions are made (see discussion of net proceeds at section 5.4.1 below) and the IOU elects to invest those net proceeds in new utility plant, those funds should be treated as shareholder funds for the purpose of determining whether the plant should be included in rate base. From a ratemaking perspective this is a direct utility investment because the funds used have been awarded to the shareholders, if the utility investment is determined to be in use and useful.

We are providing that account number 265.3, entitled "Damage Award Contamination Proceeds," be used for booking contamination proceeds derived from damage awards. Account number 265.4, entitled "Settlement Contamination Proceeds," is to be used for booking contamination related settlement proceeds. Account number 265.5.1, entitled "Government Order Contamination Proceeds From Private Funds," is to be used for booking contamination related proceeds deriving from a private funding source via government order and account number 265.5.2, entitled "Government Order Contamination Proceeds From Public Funds," will be for booking contamination

[100] Workshop Report, at 10-11.

related proceeds derived from a public funding source via government order. We are providing that account number 265.6, entitled "Insurance Contamination Proceeds," be used for booking contamination related insurance proceeds.

When contamination proceeds are initially received from any of the foregoing funding sources, they should be placed in an authorized memorandum account, until the need for making expenditures arises, whereupon an approval to transfer the proceeds to the appropriate dedicated 265 sub-account is to be sought, if not in a GRC, by a Tier 3 advice letter filing. For proposed implementing rules to be followed after an approved transfer from a memorandum account to a sub-account, see Appendix C. (See also, section 6 below.)

5.4. Sharing of net damage award proceeds

5.4.1. Portion Of Proceeds Subject To Sharing

The competing definitions of "net proceeds" offered by the utilities and ratepayer advocates in this proceeding have helped us frame the issue of sharing excess damage award proceeds. We adopt the following definition of "net proceeds" (a modified form of the DRA definition):

> Gross proceeds received minus all (1) reasonable legal expenses related to litigation, (2) costs of remedying plants, facilities, and resources to bring the water supply to a safe and reliable condition in accordance with General Order 103-A standards, and (3) all other reasonable costs and expenses that are the direct result and would not have to be incurred in the absence of such contamination, including all relevant costs already recovered from ratepayers (for which they have been, or will be, repaid or credited).

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[101] See principles nos. 2 and 3, ibid., quoted in section 4.3.1 above.

Any sharing before the completion of remediation or replacement would run the risk of future shortfalls that the IOU would seek to cover through rates. To allow allocations to be made before remediation and replacement is complete would shift the risk of incomplete, unfunded or unnecessarily deferred remediation and replacement to the ratepayer. Further, the potential for associated impacts on service if such contingencies were to occur would not be in the public interest generally.

With this adopted "net proceeds" definition as a starting point for considering sharing, it is possible that no proceeds will be left after deductions are made; in short, in any given instance there might be nothing—no excess—to allocate. As a corollary, of course, the objectives of remediation and replacement may have been well served by not allowing a premature allocation to ratepayers and/or shareholders. While we recognize there could be incentive value to utilities in defining "net proceeds" in the manner urged by CWA, we find it to be outweighed by the risks to the ratepayer and the public. We conclude that only "net proceeds" as defined above should compose the pool subject to allocation between ratepayers and shareholders.

5.4.2. Analytical Framework For Allocating Shares Of The Net Proceeds

Where net proceeds do result, the Commission should examine, within the context of the particular circumstances of the case before it, the interests, merits, burdens, benefits and equities reflected in the respective positions of the ratepayers and shareholders before determining the allocation of those proceeds. The general inquiry in each case should be: What comparative risk, benefit or burden have ratepayers and shareholders experienced, or can be expected to experience, under the particular circumstances of this case?

While it is not feasible, due to the wide-ranging factual variations between individual cases, to adopt a fixed formula for making allocation decisions, on the basis of the record in this proceeding we can cite an array of non-exclusive factors of risk, benefit and burden that should have selective value as a checklist for such decision making in individual cases. Those factors are aligned but not ranked in Table 2 below (and repeated in Appendix D) and are not to be considered the only factors that the Commission may consider when making an allocation decision pertaining to net proceeds derived from contamination-related damage awards. Any allocation decision, regardless of factors considered, should meet the dual objectives of assuring a fair and reasonable allocation of proceeds between ratepayers and shareholders, and assuring that ratepayers only pay a return on used and useful plant in service funded by shareholders.

Table 2
Factors to Inform the Allocation of Net Proceeds

I. Contamination Occurrence, Impact and Response

A. Health threat, anxiety and toxic exposure.
B. Well closures; interruption of supply.
C. Obtaining replacement supply.
E. Property and water right diminution.
F. Diversion and straining of resources for response.
G. Cash flow and capital demands of response.
H. Management generally of response.
I. Uncertainty as to scope, severity and duration of event.
J. Threat to and diminution of reputation.
K. Cash flow and rate adjustment impacts.
L. Circumstances or mechanisms that offset or mitigate risk or Impacts.

II. Cost and Damage Recovery Efforts, Claims and Events

A. Risk or reality of not receiving full recovery.
B. Risk or reality of higher water rates.
C. Requirement and conditions accompanying grants or Loans.
D. Risk or reality of being sued; exposure to costs and damages.
E. Undertaking litigation as a utility or ratepayer.
1. Risk of counter suits or cross claims.

2. Uncertainty of outcome; risk of no or low damage award.
3. Cost of experts.
4. Attorneys' fees (if not contingency contract).
5. Relative complexity; number and nature of parties, competing experts and models, duration and depth of discovery, length of pre-trial and trial proceedings or settlement negotiations, and duration overall.
6. Extent to which management resources diverted and strained.
7. Extent to which water service is affected.
8. Outcome concerning settlement or compensatory, general and punitive damage award; relative success or failure; amount of recovery relative to damage and cost of replacement and remediation.

F. Mitigating or off-setting circumstances, incentives and mechanisms; balancing and memorandum accounts; cost of capital premiums.

The Commission will have the discretion to consider and weigh the above factors, and any others appropriate to the case before it, in a selective fashion relative to the particular circumstances of the individual case before it.

5.5. Mechanisms For Responding To Utilities' Asserted Need For Incentives Relative To Risks And Responsibilities Undertaken In Connection With Contamination

5.5.1. Responding To Contamination Comes Within A Water Utility's Obligation To Serve

The rise in and severity of groundwater contamination in recent decades has had a significant impact on potable water purveyors, publicly owned and investor owned alike, and their ratepayers. While remedies of compensatory, general and, less likely, punitive damages can be available to affected water utilities through toxic tort litigation, that course of action is expensive, protracted, often extraordinarily complex and fraught with

uncertainty.[102] Are the demands and challenges associated with contamination occurrences--commonly including well closure; securing a replacement supply; and constructing, operating and maintaining treatment facilities — implicit in the water utility's obligation to serve its customers, or not? Can those demands and challenges reach a level that exceeds that obligation or otherwise requires discrete regulatory incentives to ensure that the utility remains viable and the customer properly served?

The Commission acknowledges that contamination occurrences, and the responses they prompt, can significantly disrupt an affected water utility's operations, straining resources and personnel. The Commission also recognizes, however, that contamination events are among the contingencies which a contemporary water utility, particularly one depending on ground water from alluvial valleys in our state, needs to be prepared to confront and manage. Being ready and able to respond to contamination, however arduous and frustrating that task, is now part and parcel of doing business as a water company. In short, it is something that now normally comes within the obligation to serve associated with utility status that also brings the opportunity to gain a reasonable rate of return as granted by the Commission. The obligation to respond to contamination events does not compel a standardized response, however, such as suing the party responsible. Selection of the type of appropriate response, whether it be litigation or another initiative, is a matter of reasonable business judgment.

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[102] A plaintiff's expense of outside counsel fees in contamination law suits, however, commonly is contingent upon there being a successful outcome in the litigation.

If a utility can show that it is assuming above normal risk related to contamination litigation, however, the Commission is willing to take that circumstance into account in connection with the cost recovery mechanisms discussed below.

5.5.2. Available Cost Recovery Mechanisms For Addressing Risk and Costs

5.5.2.1 Cost of capital proceedings

The IOUs assert that any given contamination lawsuit has the potential, because of factors of exceptional complexity, uncertainty and risk, to challenge the boundaries of a utility's obligation to serve. Cost of capital proceedings provide an appropriate forum in which to consider a Class A water utility's claim that it faces above normal risk in water contamination litigation. Class B, C and D water utilities may seek such compensation via their GRCs. The burden of a strong showing that the risk is above normal must be met, however, before the Commission will provide for the IOU to be compensated for assuming that risk.

It is true that the applicable burden was not met in the 2009 cost of capital proceedings pertaining to the Cal Water, Cal-American Water Company and the Golden State Water Company, where we stated that "utilities here in California and elsewhere in the country are obligated to provide safe drinking water" and the "risks of water quality litigation are not unique" to the applicants in that proceeding.[103] The Commission found generally that the

[103] D.09-05-019 (issued May 8, 2009), at 28-29.

applicants were "not persuasive and could not quantify their risk premium proposals."[104]

We expect IOUs to refrain from seeking such compensation except where above normal risk is apparent. The Commission has stated that California has a robust regulatory environment that is responsive to the IOUs' needs, based on the number of balancing and memorandum accounts and a regular cycle for rate cases, and that no utility is prohibited from filing an application to address new or unusual problems.

5.5.2.2. General Rate Cases

Water contamination related costs may be included in the cost projections made in the GRC, e.g., personnel, outside services, counsel, and experts would be included in Administrative and General Expenses. Such projections can be difficult or not capable of being made, leaving the option of tracking those costs in a memorandum account, discussed next. However, cost recovery of memorandum and balancing account balances existing at the time of the GRC can occur in the GRC for water utilities of all class sizes.

The IOUs assert that, if replacement plant funded by contamination proceeds is not placed in rate base, some compensation should be due the IOU for it having the responsibility of owning, operating and maintaining plant for which it is not receiving any rate of return. Since the IOU gains cost recovery for reasonable and prudent operation and maintenance expenditures in the GRC, it is not easy to visualize circumstances under which the additional compensation urged upon us would be warranted. We do not foreclose the possibility, however, that circumstances could arise in an individual

[104] *Id*. at 44 (Finding of Fact 19).

case under which a persuasive argument, with supporting evidence, for such compensation could be made. For the Commission to consider granting such additional compensation in a GRC, a memorandum account, previously established for tracking relevant expenses would be necessary.[105]

5.5.2.3. Memorandum Accounts For Litigation Expenses

In 1998 the Commission granted all regulated water utilities the authority going forward to establish water contamination memorandum accounts for litigation expenses.[106] Class A water utilities were directed to seek cost recovery of reasonable expenses recorded in this account in their subsequent GRC filings. Class B, C, and D water utilities were directed to seek cost recovery of reasonable costs in their subsequent GRC or by advice letter.

In the workshop sessions the IOUs expressed concerns over delays in cost recovery of litigation expenses tracked in memorandum

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[105] A utility may request such a memorandum account through an advice letter filing if it anticipates requesting compensation in a GRC for costs incurred prior to the GRC. Unless specified otherwise, authorization of a memorandum account does not mean that the Commission has decided that the types of costs to be recorded in the account should be recoverable in addition to rates that have been otherwise authorized. Instead, the utility shall bear the burden when it requests recovery of the recorded costs, to show that these costs are not covered by other authorized rates, separate recovery of the types of costs recorded in the account is appropriate, that the utility acted prudently when it incurred these costs and that the level of costs is reasonable. Only costs incurred after the establishment of an approved memorandum account qualify for cost recovery consideration.

[106] Resolution W-4094 (March 26, 1998), at 4. Memorandum accounts for water utilities are described generally in Standard Practice U-27-W, at para. 24-28. Recent decisions discussing the parameters of memorandum accounts include D.10-04-001and D.10-04-031, at 40-50.

accounts.[107] CWA proposed adoption of a rule under which there could be annual adjustments to rates to amortize or recover litigation cost memorandum balances, subject to reasonableness review. DRA offered variant approaches to address that issue: allow either adjustments when a monetary threshold (e.g., 2% of revenue requirement) has been reached or after a time period (e.g., 3 years) has elapsed, or when the first of those events has occurred.[108] CWA supports the combined trigger approach, 2% or 3 years "which ever occurs first."[109] Park also supports the combined trigger, but wants the time period to be one or two years rather than three years.[110]

We adopt the combined trigger approach as a default mechanism: which ever of the following occurs first, reaching the monetary threshold of 2% of revenue requirement or the elapsing of three years from the date the memorandum account was established. An IOU may seek by application a different, customized interim cost recovery mechanism. Litigation related expenses recovered from ratepayers, however, would be subject to refund upon the IOU obtaining a damage award.

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[107] A 10 year old memorandum account in San Gabriel's Los Angeles County division was cited as an example of delayed recovery. San Gabriel has requested amortization under that account but has not received it because the contamination litigation has not concluded. DRA found that particular instance of delay to be an isolated example.

[108] January 12, 2010 Opening Comments on Workshop Report by DRA, at 6. DRA subsequently characterized those approaches as examples, not standardized prescriptions, and suggested that each affected IOU should propose a suitable interim cost recovery approach in an advice letter. May 28, 2010 Reply of DRA to ALJ's Ruling Inviting Comments, at 5.

[109] May 12, 2010 Opening Comments of CWA in Response to ALJ's Ruling.

[110] May 12, 2010 Comments of Park on ALJ Ruling, at 2.

5.6. Commission's Discretion In Dealing With Smaller Water Utilities

The policies and rules adopted in this decision apply to all water IOUs. We recognize, however, that because the financial, management and operating conditions of Class B, C and D water utilities can differ significantly from those of Class A water utilities, situations may arise where modifications of or departures from those policies and rules by the Commission would be appropriate and the Commission will have the discretion to act accordingly. Any such modification or departures, however, must be compatible with the dual objectives of assuring a fair and reasonable allocation of proceeds between ratepayers and shareholders, and assuring that ratepayers only pay a return on used and useful plant in service funded by shareholders.

5.7. Prospective Effect of this Decision

Different circumstances, assumptions and approaches have resulted in varied results in the contamination proceeds decisions leading up to this rulemaking. Going forward, the accounting treatment and rules adopted in this decision shall govern. We do not intend for the decisions issued in this rulemaking to disturb decisions and settlements reached in prior proceedings that have been closed.

6. Comments on Proposed Decision

The proposed decision of the assigned Commissioner in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were filed on September 9, 2010, and reply comments were filed on September 20, 2010, by the California-American Water Company, California Water Association, California Water Service Company, Fruitridge Vista Water Company, TURN and the Division of Ratepayer

Advocates. The commenting IOUs criticized several features of the proposed decision, including:

- the requirement that proceeds be placed immediately upon receipt in a CIAC account;
- a contended obligation to sue responsible parties;
- defining net proceeds in a way that prevents any allocation to shareholders until proceeds have been applied to the extent needed for remediation;
- designation of cost-of-capital proceedings as the venue for consideration of an incentive in the form of a premium for "unique and exceptional" risk;
- contended lack of incentive for litigation;
- a contended lack of record for the accounting rules set out for government loans and damage awards (Appendices B and C, respectively);
- contended flaws in the analysis of the benefit to ratepayers from surcharging compared to ratebasing;
- contended departure from historical practice of a case-by-case approach; and
- lack of clear indication that rules are to have prospective effect only.

Upon review, some of the foregoing comments prompted changes in the version of the Proposed Decision that had been mailed on August 3, 2010.

In recognition that the immediate placement of contamination proceeds arising from damage awards, settlements, government order and insurance into CIAC sub-accounts would needlessly reduce rate base under several circumstances, such as during the lapse of time before the replacement plant goes into service or before expenditures of contamination proceeds are made for operation and maintenance or for cost increases, the decision has been changed to provide for the placement of those particular proceeds first into a

memorandum account from which transfers can be made to the appropriate CIAC sub-account when and as expenditures of those proceeds occur and are approved to be transferred. (See above, at section 5.3, and below at Ordering Paragraph 4). Since federal and local grants and government loans normally are more project specific, with less time passing between and receipt and expenditure, the decision continues to provide for direct placement of receipts in a 265 sub-account without the intermediate step of recordation in a memorandum account. (See above, at sections 5.1 and 5.2, and below, at O.P. 3)

In response to IOU concerns about the likelihood of receiving a risk premium as an incentive in cost-of-capital proceedings, the decision was revised to change the standard to be applied from "unique and exceptional risk" to "above normal risk."

While the mailed decision did not transmute the obligation to serve into an automatic obligation to sue, as feared in some of the IOU comments, express language has been added above in section 5.5.1 confirming that a water IOU's selection of a particular response to a contamination event is a matter of reasonable business judgment.

In response to the utilities' comment that the rules contained in mailed Appendices B and C had no basis in the record, the decision has been modified to provide for the proceeding to remain open for comments and, if needed, one or more workshops to be conducted for the limited purpose of considering rules appropriate for the accounting of contamination proceeds from government loans, damage awards, settlements, government order or insurance as CIAC. The decision also has been changed in section 5.7 above to make it clear that it is to have prospective effect only.

7. Assignment of Proceeding

The proceeding was assigned to Commissioner John A. Bohn and ALJ Gary Weatherford on March 16, 2009.

Findings of Fact

1. Over about eighteen years, the Commission has considered several matters in which a water IOU received one or more types of funds as a result of the contamination of its sources of water. Different accounting treatment of new plant (replacing contaminated plant) funded by contamination proceeds has resulted. Some of those plants have been placed in rate base, where they earn a return; others have been treated as CIAC where they do not.

2. New plant funded by contamination proceeds arising from state grants were determined to be treatable as CIAC in a 2006 decision, D.06-03-015.

3. Contamination events are among the contingencies which a contemporary water utility needs to be prepared to confront and manage. Being ready and able to respond to contamination, however arduous and frustrating that task, is now part and parcel of doing business as a water company and generally comes within the obligation to serve.

4. If a utility can show that it is assuming an above normal risk related to contamination litigation, the Commission may take that circumstance into account in the water utilities' cost of capital proceeding for class A water utilities and in the GRCs for the Class B, C and D water utilities.

5. Receipt of contamination proceeds by water IOUs allows those utilities and their customers to benefit by providing either cost-free or low cost funds for needed investments in water supply, treatment, and security.

6. CIAC treatment of contamination proceeds results in less cost to the ratepayer than does rate basing.

7. The valuation of CIAC under the Assessors' Handbook , Section 542 (Assessment of Water Companies and Water Rights), at 14, issued by the BOE is said to be generally zero, making it important for property tax purposes to have any CIAC treatment for new plant funded by local and federal government grants, government loans, damage awards, settlements, government ordered funds or insurance proceeds to carry an account number bearing the base number of 265 that is reserved for CIAC in the Uniform System of Accounts for Water Utilities.

Conclusions of Law

1. Pursuant to Article XII, Section 6 of the California Constitution, the Public Utilities Code statutes, and our own adopted rules and regulations, the Commission prescribes all accounting and ratemaking practices for investor owned utilities.

2. We should adopt rules that govern the accounting and ratemaking treatment of new plant (replacing contaminated plant) funded by local and federal government grants in a manner that meets the twin objectives of assuring a fair and reasonable allocation of proceeds between ratepayers and shareholders, and assuring that ratepayers only pay a return on used and useful plant in service funded by shareholders. We should propose rules to be considered for later adoption to govern government loans, damage awards, settlements, government order or insurance that meet the same objectives.

3. The adopted rules preserve the public interest integrity of local and federal government grant funds by ensuring that investor-owned water utilities and their shareholders will not be able to profit in any way through the receipt of public funds, and that the public retains the benefit of public funding.

4. New plant (replacing contaminated plant) funded by local and federal grant contamination proceeds should be given CIAC accounting treatment because it results in less cost to the ratepayer than does ratebasing.

5. New plant funded by government loans should be treated as CIAC rather than being included in rate base and earning a rate of return.

6. New plant funded by proceeds from damage awards, settlements, government order or insurance should be treated as CIAC rather than being included in rate base and earning a rate of return.

7. Where a utility can show that it is assuming above normal risks related to contamination litigation, the Commission may take those risks into account in setting the company's rate of return in the cost of capital proceeding for class A water utilities and in the GRCs for Class B, C and D water utilities.

8. The following sub-accounts within Account 265 of the Uniform System of Accounts for Water Utilities should be established for all investor-owned water utilities. A sub-account number 265.1, entitled "Government Grant Contamination Proceeds," should be used for booking contamination related local and federal government grant proceeds. A sub-account number 265.2, entitled "Government Loan Contamination Proceeds," should be used for booking contamination related government loan proceeds. A sub account number 265.3, entitled "Damage Award Contamination Proceeds," should be used for booking contamination proceeds derived from damage awards. A sub-account number 265.4, entitled "Settlement Contamination Proceeds," should be used for booking contamination related settlement proceeds. A sub-account number 265.5.1, entitled "Government Order Contamination Proceeds From Private Funds," should be used for booking contamination related proceeds deriving from a private funding source via government order.

A sub-account number 265.5.2, entitled "Government Order Contamination Proceeds From Public Funds," should be used for booking contamination related proceeds deriving from a public funding source via government order. A sub-account number 265.6, entitled "Insurance Contamination Proceeds," should be used for booking insurance contamination proceeds These various 265 sub-accounts should follow the existing format for Account 265 as it pertains to not being eligible for rate base recovery, records and depreciation.

9. When contamination proceeds arising from federal and local government grants and government loans are received they should be placed directly in the appropriate dedicated 265 sub-account.

10. When contamination proceeds arising from damage awards, settlements, government order or insurance are initially received from the funding source, they should be placed in a memorandum account until the need for making expenditures arises, whereupon an approval to transfer the proceeds to the appropriate dedicated 265 sub-account should be sought by a Tier 3 advice letter filing.

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

> Gross proceeds received minus all (1) reasonable legal expenses related to litigation, (2) costs of remedying plants, facilities, and resources to bring the water supply to a safe and reliable condition in accordance with General Order 103-A standards, and (3) all other reasonable costs and expenses that are the direct result and would not have to be incurred in the absence of such contamination, including all relevant costs already recovered from ratepayers (for which they have been, or will be, repaid or credited).

12. Only "net proceeds" from damage awards, settlements, government ordered funds or insurance proceeds should compose the pool subject to allocation between ratepayers and shareholders, and the allocation should be

based on factors relevant to the individual case, including factors set out in Table 2 (and repeated in Appendix D) of this decision.

13. To the extent, if any, that the Commission allocates to shareholders a share of the net proceeds and the IOU elects to invest those proceeds in utility plant, those funds should be treated as shareholder funds for the purpose of determining whether the plant should be included in rate base.

14. In cases where planning and construction expenditures for replacement plant have preceded the receipt and application of contamination proceeds, the IOUs should establish and maintain separate tracking, consistent with the USOA of all expenditures associated with the replacement plant, in addition to the regular USOA treatment of such expenditures.

15. Going forward, the accounting treatment and rules adopted in this decision should govern. The decisions issued in this rulemaking should not be intended to disturb decisions and settlements reached in prior proceedings that have been closed.

16. The federal and local grant rules described in the foregoing decision and set forth in Appendix A should be adopted. The rules proposed in Appendices B and C should be considered in a comment and, if needed, workshop process preparatory to the adoption of appropriate rules governing contamination proceeds arising from government loans, damage awards, settlements, government order and insurance.

17. This proceeding R.09-03-014 should remain open pending the development and adoption of rules pertaining to contamination proceeds arising from government loans, damage awards, settlements, government order and insurance.

O R D E R

1. Each investor-owned water utility shall account for local or federal grants, government loans, damage awards, settlements, government ordered funds and insurance proceeds used to replace contaminated water supplies as Contributions in Aid of Construction as set forth in sections 5.1 through 5.3 of this decision. The rules in Appendix A are adopted. The rules proposed in Appendices B and C shall be considered in a comment and, if needed, workshop process preparatory to our adoption of rules pertaining to contamination proceeds arising from government loans, damage awards, settlements, government orders and insurance.

2. Each investor-owned water utility shall establish the following numbered sub-accounts within Account 265 of the Uniform System of Accounts for Water Utilities.

   a. Sub-account number 265.1, entitled "Government Grant Contamination Proceeds," shall be used for booking contamination related local and federal government grant proceeds.

   b. Sub-account number 265.2, entitled "Government Loan Contamination Proceeds," shall be used for booking contamination related government loan proceeds.

   c. Sub-account number 265.3, entitled "Damage Award Contamination Proceeds," shall be used for booking contamination proceeds derived from damage awards.

   d. Sub- account number 265.4, entitled "Settlement Contamination Proceeds," shall be used for booking contamination related settlement proceeds.

   e. Sub- account number 265.5.1, entitled "Government Order Contamination Proceeds From Private Funds," shall be used for booking contamination related proceeds deriving from a private funding source via government order.

f. Sub- account number 265.5.2, entitled "Government Order Contamination Proceeds From Public Funds," shall be used for booking contamination related proceeds deriving from a public funding source via government order.

g. Sub-account number 265.6, entitled "Insurance Contamination Proceeds," shall be used for booking insurance contamination proceeds.

These various 265 sub-accounts shall follow the existing format for Account 265 as it pertains to not being eligible for rate base recovery and depreciation.

3. When contamination proceeds arising from federal and local government grants and government loans are received they shall be placed directly in the appropriate dedicated 265 sub-account.

4. When contamination proceeds arising from damage awards, settlements, government order or insurance are initially received from the funding source, they shall be placed in a memorandum account until the need for making expenditures arises, whereupon an approval to transfer the proceeds to the appropriate dedicated 265 sub-account shall be sought by a Tier 3 advice letter filing.

5. If an investor-owned water utility receives proceeds from any of the funding sources identified in Ordering Paragraph 1 after the contaminated plant is replaced or remediated and all costs have been determined, the remaining amount of proceeds ("net proceeds" as defined in Ordering Paragraph 6) may be shared between ratepayers and shareholders upon Commission approval where circumstances warrant and on the basis of factors relevant to the individual case, including factors set out in Appendix D to this decision.

6. "Net Proceeds" are hereby defined as:

Gross proceeds received minus all (1) reasonable legal expenses related to litigation, (2) costs of remedying plants, facilities, and resources to bring the water supply to a safe and

reliable condition in accordance with General Order 103-A standards, and (3) all other reasonable costs and expenses that are the direct result and would not have to be incurred in the absence of such contamination, including all relevant costs already recovered from ratepayers (for which they have been, or will be, repaid or credited).

7. If the Commission allocates to the shareholders of an investor-owned water utility a share of the net proceeds and that utility elects to invest those proceeds in plant, those funds shall be treated as shareholder funds for the purpose of determining whether the plant should be included in rate base.

8. If an investor-owned water utility anticipates requesting compensation in a general rate case for costs not previously approved and associated with the responsibility of owning, operating, and maintaining replacement plant, it shall first seek authority to establish a memorandum account to track such costs.

9. Where a utility can show that it is assuming an above normal risk related to contamination litigation, the Commission shall, where appropriate, take that risk into account in setting the company's rate of return in the cost of capital proceeding for class A water utilities and in the general rate case for the Class B, C and D water utilities.

10. Rulemaking 09-03-014, adopting rules for the accounting treatment of contamination proceeds, remains open pending the development and adoption of rules pertaining to contamination proceeds arising from government loans, damage awards, settlements, government order and insurance. The assigned Commissioner or assigned Administrative Law Judge shall issue a ruling within 10 days of this date scheduling a comment and, if needed, workshop process concerning the rules proposed in Appendices B and C.

This order is effective today.

Dated _____, at San Francisco, California.

APPENDIX A

RULES FOR THE ACCOUNTING OF LOCAL AND FEDERAL CONTAMINATION GRANT FUNDS

These rules shall apply to all transactions involving local and federal Contamination grant funds (Grant Funds.)

1. No return shall be earned by Commission-regulated water utilities (Utilities) on grant-funded plant.
2. No gain shall be recovered by utilities on the disposition of local and Federal grant-funded plant.
3. When Grant Funds are received from the funding agency, the utility must place these funds in a separate account that is restricted to Grant Funds 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 Account 265.1 – Publicly Funded Grant Plant. As the grant- funded plant 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 authorized plant has been constructed, 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. Account 265.1 shall follow the following rules:

   3.1 This account shall include only publicly funded grants.

   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 each grant, and shall be segregated between depreciable and non-depreciable property.

   3.3 Depreciation accrued on the depreciable portion of properties included in this account shall be charged to this account rather than to Account 503, Depreciation, and the charges to this account to continue until such time as the balance in this account applicable to such properties has been completely amortized. (See Utility Plant Instruction 3.F.)[1] The

[1] Utility Plant Instruction 3.F. "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

Footnote continued on next page

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 by Grant Funds, 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 grant account applicable thereto.

3.4 It is intended under the provisions contained in the preceding paragraph that the credit balance in the 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 grant-funded property shall be recorded as a credit to Account 250, Reserve for Depreciation of Utility Plant.

4. Operating Expenses, Administrative and General Expenses, and Taxes associated with grant-funded plant, but not funded with Grant Funds, 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 grant-funded plant such as reductions in operating expenses resulting from infrastructure improvements must be projected as cost savings and imputed into the utilities' revenue requirement.

6. Unless the utility has received authorization from the funding agency, Grant Funds shall not be spent on expenses. Grant 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 Grant Funds on expenses the utility must file a Tier 3 advice letter filing that sets forth an accounting treatment to exclude

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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 Account 265.1."

such expenses from the Results of Operations and forecast of future expenses in a general rate case.

7. Depreciation on grant-funded plant must be calculated using the existing methodology detailed in the Commission's Standard Practice U-4. Grant Funds used to acquire land should not be amortized or included in this category as well as other non-depreciable property such as water rights.

8. The utilities must deduct depreciation expenses for income tax purposes and flow through to their customers any benefits derived from the tax deduction in the most direct fashion possible.

9. In the event construction or study completion time limits are not established by the funding 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 advice letter to the Commission's Division of Water and Audits Director.

10. Neither utilities nor their affiliate companies and their shareholders should be allowed to engineer or install the facilities for grant-funded projects.

11. Water utilities shall use a competitive bidding process specified by the funding agency when awarding contracts for the construction of grant-funded projects. If the funding 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 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. Utilities must seek by a Tier 3 advice letter filing a waiver for sole source contracts;
- Affiliate companies are not allowed to participate.

13. Water utilities may not use Grant Funds for work done prior to the execution of the grant funding agreement unless the funding agency has authorized this use. To the extent approval is given to use grant funds for work already performed such activity shall be accounted for pursuant to the accounting procedures set forth in this appendix for grant 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 Grant 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 grant-funded plant transactions, water utilities shall notify the Director of the Division of Water and Audits and the Director of the Division of Ratepayer Advocates 45 days prior to the disposition and encumbrance of grant-funded plant.
16. The following rule should apply to the sale or transfer 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 Grant Funds in whole or part, the utility selling or transferring the asset may not receive compensation for the portion of the asset that has been funded with Grant Funds, and the purchasing utility shall record a non-rate base asset in Account 265.1. The

non-grant portion of the asset, if any, should sell or transfer at fair market value.[2]

17. When grant-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 grant 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.

18. When grant-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 grant is not preserved. In these instances, the appropriate treatment is for the buyer to pay fair market value and for the selling utility to remit all proceeds received from the sale of the grant-funded asset to the original funding agency, or another designated agency.

19. For plant wholly funded by a grant, 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 fund and again within 45 days after completing the funding agreement execution with the responsible agency. For any portion of plant that is paid for by non-grant funds, the utility must obtain Commission approval in its general rate case or through separate application.

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[2] For example, Utility A decides to sell one of its three districts (call it District X) to Utility B. District X includes government grant-funded plant with a depreciated value of $50,000. Valuation of the district shall not include the government grant-funded plant. Therefore, not only does Utility A not receive payment for the depreciated book value of the government grant-funded plant, it receives no gain on its disposition, either. Utility B must record the government grant-funded plant at the depreciated book value of the seller ($50,000) in Account 100-1 and Account 265.1. Since the selling utility did not receive payment for the government grant-funded plant, it receives no gain or reimbursement for the book value of the grant-funded plant. Since Utility B records the rant-funded plant it has acquired in Account 265.1 at its depreciated book value, no return is earned by it.

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

21. When the "fair market value" valuation of a district or total utility is difficult or impossible to perform without the grant-funded plant, the grant-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 grant-funded plant in the valuation has most likely been inflated, the selling utility should inflate the depreciated book value of the grant-funded plant using the Handy-Whitman index.[3] This inflated value of grant-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.

(END OF APPENDIX A)

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

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 Water Division's Standard Practice U-13-W and summarized in the example below:[1]

   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 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

[1] 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.

Govt. Loan Amortization Expense	$ 10,300	
Accumulated Amortization – 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 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. The annual adjustments to the surcharge shall be done through a Tier 2 Advice Letter filing.
4. No gain shall be recovered by utilities on the disposition of government contamination loan-funded plant repaid through ratepayer surcharges.
5. Capital charges for this loan shall be offset by a quantity surcharge which last as long as the loan. The charges shall not be intermingled with other utility charges; special accounting requirements and a refund condition are necessary to ensure that there are no unintended windfalls 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 these expenses occur in.
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 the utilities' 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 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 advice letter to the Commission's Division of Water and Audits Director.
10. Neither utilities nor their affiliate companies and their shareholders should be allowed to engineer or install the facilities for government loan-funded projects.
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. Utilities must seek by a Tier 3 advice letter filing a waiver for sole source contracts;
   - Affiliate companies are not allowed to participate.
13. Water utilities may not use Loan Funds for work done prior to the execution of the loan agreement unless the funding government agency has authorized this use. 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 the Director of the Division of Water and Audits and the Director of the Division of Ratepayer Advocates 45 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.[2]

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[2] 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

Footnote continued on next page

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.
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.
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 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.
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

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loan-funded plant it has acquired in Account 265.2 at its depreciated book value, no return is earned by it.

inflated, the selling utility should inflate the depreciated book value of the loan-funded plant using the Handy-Whitman index.[3] 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.

(END OF APPENDIX B)

[3] 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.)

1. No return shall be earned by Commission-regulated water utilities (Utilities) on plant funded by Water Contamination proceeds.
2. No gain shall be recovered by utilities on the disposition of plant funded by Water Contamination proceeds.
3. When Water Contamination proceeds are received by a utility, 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. As the 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 plant has been constructed, 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 segregated 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 Water Contamination proceeds designated account applicable thereto.

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.

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 plant funded by Water Contamination proceeds such as reductions in operating expenses

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[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."

resulting from infrastructure improvements must be projected as cost savings and imputed into the utilities' revenue requirement.

6. Depreciation on 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 utilities must deduct depreciation expenses for income tax purposes and flow through to their customers any benefits derived from the tax deduction in the most direct fashion possible.

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 the Director of the Water Division and the Director of the Division of Ratepayer Advocates 45 days prior to the disposition and encumbrance of plant funded by 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]

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.

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 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.

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

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[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 Contamination 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.

Commission approval in its general rate case or through separate application.

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 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 value" 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.

(END OF APPENDIX C)

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

APPENDIX D

Table 2
Factors to Inform the Allocation of Net Proceeds

I. Contamination Occurrence, Impact and Response

A. Health threat, anxiety and toxic exposure

B. Well closures; interruption of supply

C. Obtaining replacement supply

E. Property and water right diminution

F. Diversion and straining of resources for response

G. Cash flow and capital demands of response.

H. Management generally of response.

I. Uncertainty as to scope, severity and duration of event.

J. Threat to and diminution of reputation.

K. Cash flow and rate adjustment impacts.

L. Circumstances or mechanisms that offset or mitigate risk or Impacts.

II. Cost and Damage Recovery Efforts, Claims and Events

A. Risk or reality of not receiving full recovery.

B. Risk or reality of higher water rates.

C. Requirement and conditions accompanying grants or loans.

D. Risk or reality of being sued; exposure to costs and damages.

E. Undertaking litigation as a utility or ratepayer.

1. Risk of counter suits or cross claims.
2. Uncertainty of outcome; risk of no or low damage award.
3. Cost of experts.
4. Attorneys' fees (if not contingency contract).

5. Relative complexity; number and nature of parties, competing experts and models, duration and depth of discovery, length of pre-trial and trial proceedings or settlement negotiations, and duration overall.
6. Extent to which management resources diverted and strained.
7. Extent to which water service is affected.
8. Outcome concerning settlement or compensatory, general and punitive damage award; relative success or failure; amount of recovery relative to damage and cost of replacement and remediation.

F. Mitigating or off-setting circumstances, incentives and mechanisms; balancing and memorandum accounts; cost of capital premiums.

(END OF APPENDIX D)