

Decision **PROPOSED DECISION OF ALJ WALWYN (Mailed 5/7/2007)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of California-American Water Company (U 210 W) for an Order Authorizing it to Increase its Rates for Water Service in its Los Angeles District to Increase Revenues by \$2,020,466 or 10.88% in the Year 2007; \$634,659 or 3.08% in the Year 2008; and \$666,422 or 3.14% in the Year 2009.

Application 06-01-005
(Filed January 9, 2006)

**OPINION ADOPTING THE REVENUE REQUIREMENT FOR
CALIFORNIA-AMERICAN WATER COMPANY (LOS ANGELES DISTRICT)**

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**OPINION ADOPTING THE REVENUE REQUIREMENT FOR
CALIFORNIA-AMERICAN WATER COMPANY (LOS ANGELES DISTRICT)**

I. Summary

This decision resolves the revenue requirement phase (Phase 1) of the general rate case (GRC) application of California-American Water Company (Cal-Am) for its Los Angeles District test year 2007 and attrition years 2008 and 2009. For 2007, we adopt a rate decrease of -0.46% which is effective from January 1, 2007.¹ The rate design portion of this GRC will be decided in Phase 2 of this proceeding.

In arriving at today's decision, we adopt the partial settlement filed by Cal-Am and the Division of Ratepayer Advocates (DRA).² We find the settlement is reasonable in light of the whole record, consistent with law, and in the public interest; the issue raised by the City of Duarte (Duarte) in its protest to the settlement is properly considered in Phase 2 of this proceeding rather than here.

We adopt here a return on equity (ROE) for Cal-Am's Los Angeles District of 10.0% for the three-year GRC period. We also find that there would be a

¹ On December 15, 2006, pursuant to Section 455.2 of the Public Utilities Code, we granted interim rate relief effective January 1, 2007 based on the rate of inflation. (Subsequent statutory sections cited are also in the Public Utilities Code unless otherwise noted.) This interim relief is subject to refund, and will be adjusted upward or downward based on the final rates adopted by the Commission in the next phase of this proceeding. (See Decision (D.) 06-12-012.)

² On February 15, 2007, Cal-Am filed a motion requesting the Commission reopen the record to accept an amended settlement agreement that corrects errors in the August 16, 2006 settlement and also includes Cal-Am's most recent financing. On February 27, 2007, at the behest of the assigned Administrative Law Judge (ALJ), Cal-Am filed additional information supporting its motion. DRA responded on March 7, 2007.

substantial decrease in business risk for Cal-Am if the Commission adopts in Phase 2 Cal-Am's proposed Water Revenue Adjustment Mechanism (WRAM) and Modified Cost Balancing Account (MCBA), and that this reduction in business risk, consistent with our case law, should be accompanied by a reduction in Cal-Am's ROE. Therefore, we decide in this decision that if the WRAM and MCBA are adopted in Phase 2, there should be a concurrent .50% reduction in ROE.³

We also adopt on a pilot basis a Distribution System Infrastructure Charge (DSIC). The adoption of a pilot DSIC for routine infrastructure investment is a strong signal to water utilities and the communities they serve that based on our Water Action Plan the Commission is undertaking for Cal-Am's Los Angeles District a significant change in water utility regulation. We are strengthening long term capital asset planning for a water utility, with a specific emphasis on ensuring an adequate ongoing level of new investment for the routine replacement and upgrades that are necessary to maintain adequate water service. Customers will not be charged for new capital projects until after these projects are completed and the Commission approves surcharge collection. The DSIC surcharge on the bill will provide customers with direct information on what portion of the rates they are paying supports new infrastructure projects. Finally, by providing a separately identified revenue stream, the DSIC is a strong

³ We may revisit the level of the ROE adjustment in later GRCs, when we have a track record of performance under the new mechanisms and also can look at the performance of the six comparable water companies we used in the DCF analysis here, especially if those companies do not have WRAMs and MCBAs.

signal to the investment community of the Commission's commitment to supporting new infrastructure investment.

In adopting the pilot DSIC, we also adopt the necessary safeguards to ensure the Commission will continue to maintain effective regulatory oversight of capital investments. We have carefully reviewed Cal-Am's capital investment plan and the underlying supporting cost documentation, and set a cap commensurate with this review. We also require Cal-Am to follow advice letter procedures that provide notice to all interested parties, a full protest period, and adoption of surcharge amounts by formal Commission resolution. We have strengthened Cal-Am's capital asset planning requirements and will fully review its planning and the results of this pilot program in the next GRC proceeding.

In reviewing water quality, the record reflects the Baldwin Hills subsystem has exceeded the Lead Action Level since 2001. While Cal-Am appears to be taking appropriate steps to bring its subsystem into compliance with drinking water standards for lead, the Commission needs additional verification that the Baldwin Hills subsystem does not now exceed the Action Level for Lead or, if it does, that Cal-Am is in compliance with all testing requirements and treatment techniques required by California and federal law for community water systems. We direct Cal-Am to address this in a compliance filing. This filing will be reviewed in Phase 2.

Finally, we fine Cal-Am \$11,000 for failure to provide notice of its rate increase applications for 20 years to the City of Inglewood and for 10 years to the County of Los Angeles. Notice is required under Rule 3.2(b) of the Commission's Rules of Practice and Procedure. In this proceeding, the City of Inglewood has made evident its interest in participating in our proceedings and its concern about lost opportunities in the past to participate. We find that while

Cal-Am's error is a serious violation that continued for a lengthy period, the error was not intentional. We direct Cal-Am to take specific actions in the future to ensure proper notice and, pursuant to Section 2107, we adopt a fine in the lower range of the amount prescribed by statute.

II. Background

The Commission regulates water service provided by Cal-Am in its seven California districts pursuant to Article XII of the California Constitution and the Public Utilities Code. For Cal-Am and other Class A water utilities, Section 455.2, as implemented in Decision (D.) 04-06-018, provides for a GRC proceeding every three years.⁴

There are approximately 27,200 customers in the Los Angeles District. The district has three physically separated subsystems, the largest being San Marino. The other two are the neighboring Duarte subsystem and the geographically farther Baldwin Hills subsystem.⁵ The district is served by wells and irrigation water utilizing Cal-Am's groundwater rights and by purchases from municipal wholesalers. The San Marino and Duarte subsystems use primarily groundwater while the Baldwin Hills subsystem uses approximately 50% purchased water from the Metropolitan Water District and the West Basin Municipal Water District.

⁴ A Class A utility is defined as an investor-owned water utility with over 10,000 service connections.

⁵ The San Marino service area lies ten miles northeast of downtown Los Angeles in the San Gabriel Valley, and the Baldwin Hills service area is centrally located in an unincorporated area of Los Angeles County southwest of downtown Los Angeles and just a few miles east of the Los Angeles International Airport.

On January 9, 2006, Cal-Am filed its initial application. A protest to the application was timely filed by DRA on January 30, and a prehearing conference (PHC) held on February 16. Petitions to intervene were filed on March 6 by the City of San Marino, March 13 by the City of Duarte, and March 28 by the Utility Workers Union of America, AFL-CIO. All petitions were granted.

The Commission held three public participation hearings (PPHs), one each in San Marino, Duarte, and Inglewood on April 5 and 6, 2006. At the PPHs, Cal-Am stated that it intended to withdraw its rate design proposal in response to San Marino and Duarte's opposition to its rate consolidation proposal. It would replace its proposal with a new conservation rate design not yet developed. In subsequent filings addressing this issue, Cal-Am requested to bifurcate the proceeding to consider rate design on a later schedule so that a final decision on the revenue requirement would not be delayed. Cal-Am also responded to Commission concerns that it had not properly noticed its application because the customer notice did not include the total revenue requirement as a dollar and percentage amount, as required under Section 454(a) and Rule 24.⁶

On April 25, 2006, the assigned Commissioner and ALJ issued a ruling finding that (1) Cal-Am's customer notice did not meet the statutory requirements of Section 454(a) and Rule 24, (2) Cal-Am must re-notice its customers before the Commission can proceed to hold any evidentiary hearings on its application, and (3) a PHC should be held on May 12 to discuss a revised procedural schedule. Further, the ruling allowed Cal-Am to file its revised rate

⁶ Rule 24 has been recodified effective September 2006 as Rule 3.2(d).

design proposal on May 3 and DRA to serve its revenue requirement testimony on May 5, 2006.

On May 9, 2006, the City of Inglewood (Inglewood) contacted the Commission's Public Advisor's Office in Los Angeles to inquire why Inglewood was not on the service list for Cal-Am's application as required under Rule 24. The ALJ contacted Cal-Am, which stated it had failed to originally serve Inglewood in January. Since the April 6 PPH, Cal-Am had been informally providing documents to employees of Inglewood. At the ALJ's request, DRA also served its testimony on Inglewood, and on May 11 the city attorney sent a facsimile stating Inglewood intended to fully participate in the proceeding and would formally intervene at the May 12 PHC.

At the May 12 PHC, all parties agreed to bifurcate the proceeding to consider revenue requirement issues on the original hearing schedule and to consider on a later schedule rate design as well as Special Requests 2, 5, and 6. Cal-Am prepared a revised customer notice and coordinated the notice with the Public Advisor and DRA before mailing to its customers. Pursuant to Rule 12.1(b), Cal-Am stated it would also notice an all-party settlement meeting on May 23, 2006.⁷

On May 22, 2006, the assigned Commissioner issued a scoping memo setting the procedural schedule. On May 31 and June 1 additional PPHs were held. Evidentiary hearings on revenue requirement issues were conducted on June 13 - 15 and June 28-29, 2006. At the later hearings, Cal-Am and DRA were

⁷ The City of Bradbury also contacted parties and participated in the settlement conference. On December 5, 2006, Bradbury filed a motion to intervene, which we grant here.

cross-examined on their June 23, 2006 proposed settlement. Duarte protested the settlement on July 6, 2006.

On July 31, 2006, opening briefs were filed by Cal-Am and DRA. On August 10, Cal-Am filed a motion to include the referenced attachments to Mr. Reiker's testimony; no party opposed this motion and the corrected exhibit is entered into evidence. Reply briefs were filed by Cal-Am, DRA, Duarte, and San Marino on August 14, 2006.

Cal-Am made two corrections to the settlement, both resulting in significant revenue increases. Cal-Am's first motion was filed on August 16, 2006. In the motion, Cal-Am stated it discovered that the calculations supporting the 2008 and 2009 settlement tables and comparison exhibits under the updated July 2006 purchased water scenarios were incorrectly calculated. Specifically, in calculating the 2008 operation and maintenance (O&M) expenses, rather than subtracting the updated 2007 purchased water costs, the original 2007 purchased water costs were subtracted. This error had a cascading effect on the calculation of the 2009 O&M Expenses. The corrections result in an increase in overall O&M expenses of \$1,096,000 for 2008 and \$1,113,900 in 2009, at proposed rates.

On February 15, 2007, Cal-Am filed a motion requesting the assigned ALJ reopen the record to accept an amended settlement agreement. Cal-Am attached amended settlement tables correcting certain errors, also described in a narrative paragraph, and included data from Cal-Am's most recent financing.

On February 22, 2007, the assigned ALJ directed Cal-Am to supplement its February 15 motion with additional information needed by the Commission in order to understand the impact of the proposed settlement changes. Cal-Am supplemented its motion on February 27.

Cal-Am shows its correction results in an increase in purchased water costs over the three-year GRC of \$1,683,741 to San Marino, a decrease of \$1,106,855 to Duarte, and a decrease of \$29,472 to Baldwin Hills. The net change overall is an increase in O&M expenses of \$547,414.

DRA filed a response on March 7. The issues raised are discussed as part of our review of the settlement, under O&M expenses.

Cal-Am's motion to reopen the record changes the submittal date of the evidentiary record in Phase 1 to March 7, 2007.

III. Water Quality for the Los Angeles District

Since its last GRC, the Los Angeles District has not received any Notices of Violations or any other compliance actions from the California Department of Health Services. However, Cal-Am provided a two-page section discussing water quality issues in each of its Los Angeles subsystems and a table showing the water sampling activity and sampling results, and this material shows that the Baldwin Hills system has exceeded the Lead Action Level since 2001.⁸ In addressing this issue, Cal-Am stated that customers have been provided public educational materials in the form of letters, bill inserts and information. In addition, Cal-Am has determined that compliance with Lead Action Levels could be achieved by installing phosphate-based corrosion inhibitors at the Garth reservoir and the Slauson Vault. These installations are underway.

⁸ Exhibit 3, Chapter 3, Section 2.

The Commission received no public comment on water quality issues, but DRA's report shows some customer complaints for the 2000-2004 period.⁹ DRA did not provide any testimony on water quality issues.

In our new rulemaking on the rate case plan for water utilities, R.06-12-016, issued December 18, 2006, we discuss the Commission's constitutional and statutory responsibilities to ensure that regulated water utilities provide water that protects public health and safety. We also propose additional minimum data requirements and the possible appointment of an independent expert witness to assist the Commission in meeting its responsibilities.

Based on the evidence here, Cal-Am appears to be taking appropriate action to bring its systems into full compliance with Lead Action Levels. However, lead exceedance is a serious issue, and the Commission needs verification that Cal-Am is now in full compliance with lead levels or a detailed showing of current Action Levels and how Cal-Am is addressing all the mitigation measures required or recommended by the Department of Health Services (DHS) and the U.S. Environmental Protection Agency.¹⁰ Therefore, we direct Cal-Am to make a supplemental filing within ten days of the effective date of this decision providing this showing. This filing will be reviewed in Phase 2 of this proceeding.

⁹ Exhibit 36, table at page 10-1.

¹⁰ See, e.g., http://www.epa.gov/safewater/lcrrm/pdfs/qrg_lcmr_2004.pdf.

IV. Partial Settlement Agreement Between Cal-Am and DRA

On June 23, 2006, Cal-Am and DRA filed a partial settlement agreement for the revenue requirement phase. The comparison exhibits attached to the settlement were corrected by an August 16, 2006 filing and on February 15, 2007, Cal-Am filed a motion to reopen the record to amend the settlement agreement to correct further errors and to include an update to the cost of capital to reflect Cal-Am's most recent debt financing.¹¹

We review this settlement under Article 12. Settlements of the Commission's Rules of Practice and Procedure. Rule 12.1(d) provides that, prior to approval, the Commission must find a settlement, whether contested or uncontested, "reasonable in light of the whole record, consistent with law, and in the public interest." Cal-Am and DRA state that they have entered into the settlement agreement on the basis that the Commission's adoption should not be construed as a precedent or policy of any kind in this or future proceedings. Further, the settlement is an integrated agreement, so that if the Commission rejects any portion of the settlement, each party has the right to withdraw.

While all parties in the proceeding received notice of the settlement conference, and Duarte, Inglewood, and San Marino participated in the May 23,

¹¹ The August 16, 2006 corrections are to O&M expenses in Attachments C, E, K, and M; these expenses were incorrectly calculated when the purchased water costs were updated to reflect July 2006 purchased water rates. The corrections result in an increase in O&M expenses of \$1,096,000 in 2008 and \$1,113,900 in 2009, at proposed rates. With these corrections, Cal-Am states the total operating expense (and total operating revenue) is still lower than that originally proposed in the application in this proceeding. The February 15, 2007 revision reflects Cal-Am's December 2006 debt filing and corrects water supply mix. The water supply mix correction is discussed in Section IV.B.3 of this decision.

2006 settlement conference, only Cal-Am and DRA are signatories to the settlement.¹² In their motion for adoption of the settlement, Cal-Am and DRA state that the settlement addresses disputed issues between DRA and Cal-Am and Cal-Am and DRA are fairly representative of affected interests.¹³

A. Duarte's Objection to the Settlement

On July 7, 2006, Duarte objected to the settlement, insofar as residents of Duarte would be charged any costs related to three projects in Section 4.8 of the settlement. Duarte stated it does not dispute the need for these projects but claims that they solely and exclusively benefit the San Marino service area. Further, Duarte stated that in light of the magnitude of these projects, and without any commitment by Cal-Am as to reciprocity in either this GRC or any future GRC, it may be time for the Commission to reevaluate the concept of district consolidation, at least as to capital improvements. On August 8, 2006, Bradbury joined in this objection.

Duarte notes Cal-Am initially proposed that purchased water costs be consolidated between the subsystems and then withdrew this request. Duarte concludes that Cal-Am's own actions in first proposing full rate consolidation and then withdrawing its proposal demonstrate the need to constantly reevaluate prior rate consolidation decisions because unforeseen circumstances may operate to the detriment of certain ratepayers and the public interest. Further, Duarte states it is waiting for information from Cal-Am regarding the

¹² See June 23, 2006 Motion of Cal-Am and DRA for Adoption of Settlement Agreement as to Certain Issues on the Revenue Requirements, page 1, footnote 2.

¹³ *Id.*, page 1.

allocation of capital improvements among the service areas since district consolidation.

On July 24, 2006, in reply to Duarte, Cal-Am stated that Duarte's objection as to how costs are allocated between subsystems is a rate design issue, and therefore not before the Commission until Phase 2. Further, Cal-Am states that Duarte's request to reconsider rate consolidation between the subsystems is short-sighted and contrary to the long-range planning objectives the Commission has adopted in our Water Action Plan. To place the issue in an historical context, and show that Duarte has received capital investment benefits from consolidation, Cal-Am provides a table showing the total plant additions for each service area since the Commission's 1994 decision consolidating rate bases and revenue requirements, minus the purchased power and purchased water costs, of the Baldwin Hills, Duarte, and San Marino service areas.¹⁴ In its August 14 reply brief, San Marino supports Cal-Am's position.

We find Duarte's objection goes to cost allocation issues that are before us in the rate design phase, not this phase. Duarte will have the opportunity to receive and analyze the information it has requested from Cal-Am, and to conduct discovery on the table provided in Cal-Am's reply. Duarte has not been an active party in Phase 2 hearings that have occurred to date, but it will have an opportunity to file comments on the proposed Phase 2 settlement reached by Cal-Am and DRA, which is scheduled to be filed with final and comprehensive rate design tables, within 30 days of this decision. We find Duarte's objections are premature, and not applicable to the Phase 1 settlement.

¹⁴ See D.94-11-004, 57 CPUC2d 127.

B. Terms of the Settlement**1. Cost of Capital**

In the settlement, Cal-Am and DRA agree on the capital structure and cost of debt. Specifically, the settlement uses Cal-Am's projected 2007 capital structure for all three years, as recommended by DRA, and the parties compromised on the cost of debt. The cost of equity remains a contested issue, and therefore the overall rate of return is also not a part of the settlement.

For the capital structure, the parties propose to impute 58.97% debt and 41.03% equity for 2007, 2008, and 2009. Cal-Am imputes a separate capital structure for the Los Angeles District based on its methodology of calculating synergy savings and amortizing the acquisition premium it paid to acquire the former Citizens' districts in 2002.

Cal-Am's application does not provide Cal-Am's actual consolidated capital structure. Rather, it states that the capital structure proposed here is calculated as the residual of calculating a ratemaking capital structure for the former Citizens districts of 63% debt and 37% equity.¹⁵

We would prefer to use Cal-Am's consolidated capital structure. There is evidence to support using the actual year end December 31, 2006 consolidated capital structure of 62.6% debt/37.4% equity, or the target 60%/40% consolidated capital structure contained in Cal-Am's testimony,¹⁶ and the use of a

¹⁵ Cal-Am cites as authority for this calculation the settlement adopted in A.04-04-040. As discussed in D.06-11-050, the settlement does not specifically provide for this proposition. That settlement, as well as all settlements we adopt, is not precedential.

¹⁶ Exhibit 7, Reiker, page 6.

consolidated capital structure would be beneficial to the customers of the Los Angeles District.

In D.06-11-050, which resolved Cal-Am's Monterey/Felton GRCs, we found that there is good cause to return to the use of a consolidated capital structure and directed Cal-Am to present a comprehensive showing in support of a consolidated capital structure in its next district GRC filing.¹⁷ The Los Angeles District evidentiary record had closed prior to the issuance of D.06-11-050; Cal-Am's next scheduled GRC filings occurred in January 2007 for the Sacramento, Larkfield, Coronado, and Village districts.

The evidentiary record here does explore the use of a 62.6% debt/37.4% equity capital structure that Cal-Am represents as its actual December 31, 2006 consolidated capital structure in its financing application, A.06-05-005. However, Cal-Am testified it was not willing to modify the settlement on this issue. DRA indicated more flexibility, but supported Cal-Am's testimony that \$20,000,000 in projected, not actual, Coastal Water Project (CWP) funding should be removed first, and that a separate imputed capital structure for the historic districts should still be made. We do not agree with these adjustments.¹⁸

While we prefer the use of the actual year end 2006 62.6% debt/37.4% equity capital structure, we will adopt the settlement's proposed 58.97%

¹⁷ See Finding of Fact 6 and Ordering Paragraph 7. The discussion of this issue is found in Section IV.A.1., mimeo. at pages 9-13, and the related issue of amortization of the acquisition premium is discussed in Section VI.C., mimeo. at pages 94-96 and Finding of Fact 48.

¹⁸ We are concerned with the appropriateness of the CWP adjustment and especially with the level proposed. In D.06-12-040, only \$3,000,000 in CWP costs was authorized for recovery by surcharge.

debt/41.03% equity. We have weighed the benefits of the overall settlement in making this decision.

We recognize that the capital structure we adopt here will have an impact on other pending Cal-Am district GRCs. Monterey and Los Angeles are the two largest historical Cal-Am districts and, as such, have been providing a capital structure subsidy to the former Citizens' districts. Sacramento is the largest former Citizens' district and has a pending GRC filing. We should carefully watch the test year period overlap of our GRC decisions to ensure Cal-Am's shareholders do not receive a windfall as we shift to a consolidated capital structure for all districts.

For the cost of debt, the settlement uses 6.89% for all three years, based on the projected cost of debt in the test year 2007. In arriving at the 2007 projection, parties agreed that the estimated cost of new debt issuances for 2006 and 2007 should be 6.42% for 2006 and 6.26% for 2007, based on the latest Data Resources, Inc. (DRI) forecast for the period in which the issuances will be made. These estimates represent an increase in DRA's original estimates, and are due to the Federal Reserve Board raising interest rates .6% between March 2006 and the settlement agreement date. The cost of debt represents a compromise between Cal-Am's original position of 6.9% for 2007, 6.91% for 2008, and 6.94% for 2009 and DRA's original position of 6.41% for all three years.

At the January 9, 2007 evidentiary hearing in Phase 2, Cal-Am asked to update the cost of debt for the Los Angeles District based on its actual December 21, 2006 debt issuance. On February 15, 2007, it filed an amended settlement which describes this issue and results in a weighted average cost of debt for 2006 of 5.77%, less than the 6.26% agreed to in the settlement. The

amended settlement tables incorporate this revised cost of debt of 6.36% for 2007, 2008, and 2009; this is a reduction of .63% each year.¹⁹

2. Customer Sales and Revenues

In Section 4.3 of the settlement, Cal-Am and DRA set forth customer counts and average water use per customer, including an allowance for unaccounted-for water. There were no initial differences between the two parties on these issues, and therefore we find this section reasonable.

3. Operations and Maintenance Expenses

In Section 4.4, the parties agree that the lower inflation rates initially used by Cal-Am will be adopted. This change can be seen in the table at Exhibit 36, page 3-2. It appears that errors made by DRA in its workpapers are corrected, as referenced in Cal-Am's rebuttal, Exhibit 11, pages 2-3.

Parties agree that purchased water and chemical costs should be based on the latest rates from the suppliers. Cal-Am's application uses January 2006 unit prices for purchased water. As discussed at hearing, Cal-Am has authority to update its water balancing account by advice letter to reflect actual unit costs for water, chemicals, and power, but not supply mix. Cal-Am and DRA provide rate tables to the settlement that contain updated July 2006 water costs. We find beneficial the use of updated water costs.

¹⁹ At the January 9, 2007 hearing, the ALJ asked Cal-Am to consider whether it should update its cost of new debt for 2007. In its motion to amend, Cal-Am states it examined the issue and believes that it is not appropriate to update the forecasted cost of new debt for 2007 included in the settlement. It states it does not believe that there is any reason to vary from our established methodology for forecasting future issuances.

On February 15, 2007, Cal-Am filed a motion to reopen the record to correct errors it made in the supply mix. In its supplemental February 27 filing, Cal-Am shows its correction results in an increase in purchased water costs over the three-year GRC of \$1,683,741 to San Marino, a decrease of \$1,106,855 to Duarte, and a decrease of \$29,472 to Baldwin Hills. The net change overall is an increase in operating and maintenance expenses of \$547,414. The rate comparison included in Cal-Am's filing shows 2007 rates for San Marino residential customers rising 7%-10% from this correction.²⁰

In its filing, Cal-Am also addresses how its correction of supply mix would be handled after a final decision is issued under existing ratemaking and under its proposed Phase 2 proposal. It emphasizes that it has changed its Phase 2 proposal from a Full Cost Balancing Account (FCBA) mechanism to an MCBA.

DRA responded to Cal-Am's supplemental filing on March 7. DRA disagrees with Cal-Am's statement that the utility could correct its supply mix error after a final decision under present ratemaking. DRA does agree with Cal-Am's statement that the utility no longer proposes an FCBA in Phase 2.

Based on its review, DRA states Cal-Am's amended tables have an error in plant-in-service and are missing two pages; it recommends that these omissions be promptly corrected. DRA also disagrees with Cal-Am's rate impact analysis as the utility appears to allocate all of the additional cost resulting from the change in water supply mix to only the metered customers, rather than all customer classes. DRA recommends Cal-Am file amended tables to correct these errors. In response to an ALJ ruling, Cal-Am submitted the amended tables.

²⁰ 2007 detailed bill comparison under standard rate design, revised settlement, if Infrastructure System Replacement Surcharge (ISRS) proposal not adopted.

Based on the filings of Cal-Am and DRA, we find that correcting the supply mix is reasonable.

The parties agree that customer accounting should reflect the settlement for General Office filed in A.05-02-012, and that cost for postage and bill forms should be reflected at the district level. This is consistent with D.06-11-050.

We find this section of the settlement reasonable. It is also consistent with the requirements of D.01-09-057 that Cal-Am carry the burden of proof for any new or increased GRC expenses, excluding those due to inflation and customer growth.

4. Administration and General Expenses

Administration and General (A&G) expenses are addressed in Section 4.5 of the settlement. The largest dollar category here is payroll expense. There were fairly large percentage differences between Cal-Am and DRA originally. Cal-Am explained that an error existed in its presentation of 2003 and 2004 numbers in that capitalized labor was removed twice from O&M expense. With this correction, DRA's trend analysis produced results close to Cal-Am's original request, and DRA agreed to accept this number.

The next largest A&G expense item is employee pension and benefits. DRA agrees with Cal-Am that pursuant to D.88-03-072, pension cost must be based on Employee Retirement Income Security Act minimum funding requirements. The settlement notes that Cal-Am's funding requirement has increased significantly since its pension fund is no longer in an over-funded position as it had been for a number of years.

The parties compromise on rent expense for the San Marino office space and regulatory commission expense. DRA agrees that maintenance of general plant should include the net salvage portion of depreciation expense. As a result

of the adjustments to A&G and correction by Cal-Am of a formula error in the calculation of payroll taxes, the company and DRA agree on “taxes other than income.”

For the category of income taxes, a difference of \$224,000 remains due to the contested issues of estimated rate base and ROE.

Based on the foregoing, we find this section of the settlement reasonable.

5. Utility Plant in Service

Following extensive exchanges of information and negotiations on the rationale for each requested plant item, Cal-Am and DRA agree as follows:

TABLE 1: ADJUSTMENTS TO UTILITY PLANT

<u>Project</u>	<u>Cal-Am</u>	<u>DRA</u>	<u>Settlement</u>
2005 Lamanda Park	\$ 1,200.0	\$ 871.5	\$ 1,200.0
Beginning Plant Balance for 2007	72,573.3	72,317.3	72,689.8
2006-2008 Small Main Replacement	149.0	72.7	110.8*
2006-2008 Pump Replacements	155.0	138.6	146.8*
BH Fire Flow Imp.	839.0	688.5	713.6
Circle Drive Main	292.0	244.0	252.0*
Garth Reservoir	763.0	596.7	648.9*
Shenandoah Main	360.0	297.8	308.2*
Lamanda Park Main	431.0	390.2	397.0
Lemon Reservoir	604.0	501.6	518.7*
Baldwin Ave. Main	179.0	160.0	163.2*
Danford Reservoir Main Project			
2007 CWIP	100.0	0.0	0.0
2008 Plant in Service	1,220.0	496.6	0.0
2009 Plant in Service	0.0	496.5	0.0
2008 Advice Letter	0.0	0.0	1,027.6*
Patton Well and Treatment Project			
CWIP BOY 2007	597.0	0.0	0.0
CWIP EOY 2007	3,097.0	0.0	0.0
Plant Adds in 2008	4,124.0	0.0	
Memo Accounts	0.0	4,124.0	1,989.0
2008 Advice Letter	0.0	0.0	1,027.6

All figures (\$000)

* Projects are proposed Infrastructure Surcharge projects

Based on the explanations provided for each project, we find this section of the settlement reasonable.

6. Depreciation Expense and Reserves

The adjustments in this section are minor and generally reflect the settlement of plant additions. We find this section of the settlement reasonable.

7. Rate Base

In this section, Cal-Am agrees to accept DRA's calculation of cash working capital and operational working cash based on the latest information on lead/lag days. The net effect is a substantial increase in working capital from Cal-Am's original request.

We find that it would be helpful to have more information in the record on this section of the settlement, particularly the lead/lag studies relied on by the parties. However, our concern is not sufficient to modify or reject the settlement. We will examine this issue further in the next GRC.

8. Customer Service and Conservation

Cal-Am and DRA do not dispute these issues.

9. Rate Design

This issue is removed to Phase 2 of the proceeding.

10. Special Requests**a. Special Request 1**

This is a request for implementation of an ISRS. There is no settlement on this issue.

b. Special Requests 2 and 3

Special Request 2 is for a conservation rate design, an issue before us in Phase 2. Special Request 3 is for consistent rates across the Los Angeles District, a request withdrawn by Cal-Am following the PPHs.

c. Special Request 4

This request is for adoption of a temporary low income program for qualifying residential customers in the Los Angeles District. Cal-Am's proposed program would provide a fixed sur-credit of \$6.50/month for participating

customers, which equates to an approximately 15% discount at average usage under present rates. In its application, Cal-Am links its request to approval of Special Requests 2 and 3. Cal-Am would track the sur-credit revenue losses along with program implementation costs in a WRAM account. The Los Angeles District low-income program would end either when the Commission adopts a generic state-wide low-income program or at the end of this GRC cycle, whichever occurs first.

DRA recommends that the low-income program continue until the next GRC when it will be reviewed. The program would also be adjusted to meet the criteria when, and if, the Commission adopts a state-wide program. DRA agrees with the general program features but recommends some modifications:

(a) consistency with energy program low-income eligibility guidelines; and (b) a concerted effort by Cal-Am to target low-income customers for conservation programs in order to assist these customers to conserve water, thereby further lowering their monthly water bills.

In the settlement, Cal-Am accepts DRA's recommendation to remove the temporary feature of its low-income proposal.

d. Special Requests 5 and 6

Special Request 5 is for a MCBA for purchased water and purchased power and Special Request 6 is for a conservation memorandum account. Both requests are before us in Phase 2.

e. Special Request 7

This request is to establish a memorandum account to track the actual tax effects of the American Job Creation Act. This request is not disputed.

11. Step Rate Increases

The parties agree in this section that the language previously adopted for historical Cal-Am properties, including the Los Angeles District, and the language adopted for the former Citizens properties should be used in this decision to distinguish the capital structures of the different properties.

As we discuss with reference to Section 2.1 of the settlement, the Commission is concerned with Cal-Am's imputed separate capital structures and has directed that the company present a consolidated capital structure for our review in its more recent GRC filings. For this proceeding, we find this section acceptable.

C. Action on the Proposed Settlement

Based on our review of the proposed settlement, we are concerned with the imputed capital structure and the rate base sections. We will examine these issues further in the next GRC. We are also concerned with Cal-Am's submission of two substantial corrections to the settlement, on August 16, 2006 and February 15, 2007. In future proceedings, Cal-Am should address the additional procedures it has adopted to better review the accuracy of its filings.

Weighing the settlement as an integrated agreement, we find it is reasonable in light of the whole record, consistent with the law, and in the public interest. Therefore, we adopt the settlement.

V. Issues Not Included in the Settlement Agreement**A. Return on Equity**

Cal-Am testifies that its cost of equity for the Los Angeles District for 2007-2009 is in the range of 8.9 - 12.1%, before adding a proposed leverage adjustment

of 2.7%. Its recommendation is based on two financial models, the Discounted Cash Flow (DCF) model and the Capital Asset Pricing Model (CAPM).²¹ The DCF method is the most widely used model in utility rate cases, and Cal-Am uses two different approaches, estimating 9.8% for its Constant Growth DCF model and 8.9% for its Multi-Stage DCF model.²² Cal-Am's CAPM analysis yields an ROE of 10.89% and 12.1%.

DRA uses two financial models, the DCF and the Risk Premium (RP), and applies them to the six comparable water utilities that have been used in past proceedings. DRA's DCF analysis yields an ROE of 8.98% and its RP analysis an ROE of 10.4%. As it has done previously, DRA averages these results to arrive at a recommended 9.69% ROE. DRA recommends a substantial decrease to this ROE in Phase 2 of this proceeding if the Commission adopts new ratemaking mechanisms; we address this issue in the next section.

Our legal standards for selecting a fair and reasonable ROE are based on three U.S. Supreme Court cases: *Bluefield*, *Hope*, and *Duquesne*.²³ Together, these cases hold that a public utility is entitled to a reasonable opportunity to earn a return on the value of its property employed in serving the public. This return

²¹ Cal-Am uses the low end of its cost of equity range, 8.9%, and adds its leverage adjustment to arrive at its recommended 11.6% ROE.

²² In the multi-stage DCF model, Cal-Am assumes that after four years the dividend growth rate will be the same as the historical growth in gross domestic product, stating this is appropriate because it assumes that the water utility industry will neither grow faster, nor slower, than the overall economy. (Exhibit 7, Reiker testimony at page 25.)

²³ *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia (Bluefield)* 262 U.S. 679, 692-93 (1923), *Federal Power Commission v. Hope Natural Gas Company (Hope)* 320 U.S. 591, 603 (1944), and *Duquesne Light Co. v. Barasch (Duquesne)* 488 U.S. 299, 310 (1989).

should be commensurate with returns on investments in comparable companies, and should be sufficient to (1) assure confidence in the financial integrity of the company, (2) maintain its credit, and (3) attract necessary capital.

Determining a fair and reasonable ROE that meets constitutional standards is a matter of informed judgment. We do not rely solely on the analytical modeling results of any one party or a specific model application, but we do consider the range of results that two of these models, the DCF and the RP provide. We also look to interest rate trends and interest forecasts. In addition, we look at Cal-Am's earning history, the performance of comparable companies, the creditworthiness of Cal-Am's parent, RWE, and the commitment of RWE to pass through all cost of capital savings to ratepayers.

We turn first to the financial models. DRA uses the same methodologies for these two models that we reviewed in Cal-Am's last GRC proceeding, and uses the same six comparable publicly-traded water utilities in developing its estimates.²⁴ The DCF model estimates investors' expected ROE by looking at the current market price of a share of common stock and the present value of all future dividends that the investor expects to receive. The model assumes dividends grow at a constant rate. DRA examines three growth rates in arriving at its estimate: (1) historical dividend and earnings growth rates; (2) sustainable growth rates; and (3) forecasted growth rates. The RP model uses forecasted long-term bond rates and calculates an equity "risk premium" that investors require as compensation for the riskier nature of common stock. DRA uses the

²⁴ See D.06-11-050, mimeo. at 16-17.

same six comparable companies and uses their earned ROEs over an extended period as an estimate of investors' expected RP.

Cal-Am adds a seventh company, Southwest Water Company, to the group of comparable water utilities. DRA objects to the inclusion of Southwest because less than 70% of its revenues is from its regulated water business. We agree with DRA on this issue. In addition, Cal-Am departs from traditional DCF methodology by adding an additional growth component in its calculation of sustainable growth to reflect its expectation that the sample companies will issue new shares above book value. Cal-Am does not present sufficient evidence to support changing our reliance on traditional DCF methodology.

Next, Cal-Am includes a multi-stage DCF model. This model forecasts a growth rate for the comparable companies in a manner similar to DRA for the first four years (Stage 1 Growth). For the following years, Cal-Am uses a constant growth factor representative of the overall economy, specifically the rate of growth in gross domestic product from 1929 to 2004, which is 6.5%. We find this modeling concept acceptable, with the exception that Southwest Water Company should be removed from the comparable companies. We recognize that in future cases parties may provide other measurements for the constant growth factor, and we will consider those also.

Finally, we turn to the two CAPMs presented by Cal-Am. CAPM is a financial model that calculates the rate of return the market is currently offering to investors bearing a particular degree of risk. It uses a risk-free interest rate and combines this with estimates of risk betas and the expected rate of return for the market. It assumes all investors hold efficient portfolios that are fully diversified and that all such portfolios move in perfect lockstep with the market; portfolios differ only in their sensitivity to the market, which the model measures

under the beta variable.²⁵ In its analysis of data, Cal-Am includes additional water companies not in its DCF analysis. These companies are: Artesian Resources, Pennichuck Corp., and York Water Company.²⁶ In its report, DRA states it does not include these companies since forecasted growth rates are not available for them at this time. DRA also excludes Southwest Water because its water operations do not account for at least 70% of the utility's revenues and its stock is not publicly traded.²⁷

Cal-Am sponsors two CAPM analyses, one using a historical market risk premium and the other using an estimate of the current market risk premium. Its historical CAPM analysis yields 12.1% and its current market premium model yields 10.8%. Just as there are differences in the results of these two CAPM models, parties would also obtain different results if they used different proxy groups, risk-free rates, market risk premium rates, and time periods for measuring stock returns. We recognize all our financial models provide a range of ROE estimates.

In its testimony, DRA compares Cal-Am's average yield of 10.4% from its four models to a graph showing the average authorized ROEs for Class A water utilities since 1993. This graph shows that since 1999, average ROEs have been tightly grouped at 10% or somewhat below.²⁸ The most recently litigated ROE we adopted for a Class A water utility is 9.8% for Southern California Water

²⁵ Exhibit 7, Reiker testimony at page 26.

²⁶ See Schedule JMR-7 in Exhibit 7, updated August 10, 2006.

²⁷ Exhibit 37, pages 2-1.

²⁸ Exhibit 37, page 2-8.

Company in D.06-01-025. In Cal-Am's last GRC decision, D.06-11-050, we adopted a settlement for the Monterey District that included an ROE of 10.1% and we adopted an ROE of 9.95% for the Felton District.²⁹

Next, we turn to other factors we consider in setting an ROE. On the issue of interest rate trends, our record reflects a .30% to .67% decline in forecasted interest rates since our last Cal-Am proceeding. We traditionally use DRI forecasts of 10-year and 30-year Treasury bill rates. In A.05-02-012/ A.05-02-013, we relied on DRI's forecast of interest rates for 2006-2008 of 6.08% for 30-year Treasury and 5.5% for 10-year Treasury. In this record, DRI's forecast for 2006-2009 is 5.41% for 30-year Treasury and 5.20 for 10-year Treasury.³⁰

Cal-Am is a well-managed utility that has enjoyed strong earnings performance.³¹ In this application, Cal-Am reports its Los Angeles District had an authorized 2005 rate of return on operating revenue of 8.36% but had actual 2005 rate of return earnings of 9.39%, 1.03% stronger than the rate used for rulemaking purposes.³²

DRA's testimony includes a discussion of Standard & Poor's (S&P) assessment of Cal-Am's affiliate and parents. S&P evaluates a company's total

²⁹ In the Monterey/Felton proceeding, Cal-Am and DRA supported their ROE recommendations with cites to four other settlements. (See D.06-11-050, mimeo. at 9 and 67-60.)

³⁰ See Exhibit 37, Table 2-7 and D.06-11-050, mimeo. at page 16.

³¹ In D.04-05-023, at page 54, we discussed Cal-Am's long history of overearning its authorized ROE in California.

³² Exhibit A, Chapter 1, page 1 of 2 of Exhibit 3. In a footnote, Cal-Am states its lower expense amount is caused by annualizing expenses, and updated figures should cause the return to be lower.

risk, business and financial, in order to assign a credit rating. This rating is a quantitative analysis of financial ratios and a subjective assessment of management quality and business risk; DRA cites it as a direct measure of the company's ability to attract capital. S&P's ratings for American Water Capital Corp (the affiliate Cal-Am uses to issue its debt) and RWE and Thames are, respectively, A-, A+, and A.³³ While we do not know the results of the planned Initial Public Offering (IPO) for American Water Works, the recent successful debt refinancing leads us to conclude that the offering will be well-received by the capital markets.

Based on the above discussion of the financial models, other authorized ROEs for Class A water utilities, interest trends, earnings performance, and S&P assessments, we reach an informed judgment that 10% is a fair and reasonable ROE for Cal-Am.

We next address Cal-Am's request for a 2.7% "leverage adjustment" to compensate it for the increased financial risk caused by its above-average debt ratio. Cal-Am requests this leverage adjustment because its capital structure has a greater percentage of debt, or leverage, than comparable water utilities, thereby increasing its financial risk. It testifies that investors require an additional 2.7% ROE in order to invest in Cal-Am rather than a comparable water utility with less leverage.

In Cal-Am's last GRC proceeding, we denied Cal-Am a requested 0.5% leverage adjustment, finding that (a) Cal-Am was not riskier than comparable water utilities, (b) Cal-Am's shareholders are already rewarded for a lower

³³ Ratings of AAA through BBB are considered investment grade.

equity ratio through the amortization of the Citizens acquisition premium, and (c) that Cal-Am claimed in the RWE merger proceeding that Commission approval of the merger would provide significant benefits to ratepayers from savings on cost of capital, specifically from increased leverage, and that these benefits would be passed through 100% to ratepayers.³⁴

We find here that the reasons given in D.06-11-050 for denying a leverage adjustment are still applicable. In addition, as discussed earlier in our approval of the Cost of Capital portion of the settlement, the settlement in this proceeding is based on a capital structure that is less leveraged than (1) the company's actual consolidated capital structure, (2) the company's target capital structure, and (3) the projected capital structure contained in Cal-Am's financing application, A.06-05-005.

The recent successful debt offering undertaken by Cal-Am indicates that the capital markets view it quite favorably and are not requiring a premium for financial risk. Cal-Am's chooses to carry a lower common equity ratio, and it does so without adverse affect to the company.

In summary, we find that Cal-Am's leverage ratio is within an acceptable range as reflected in S&P credit ratings of its affiliate and parent companies, has not caused investors to demand a higher ROE in comparison to comparable water utilities, provides ratepayer benefits committed to in the RWE merger proceeding, and does not warrant an upward leverage adjustment to the ROE. We deny Cal-Am's request for a leverage adjustment.

³⁴ See D.06-11-050, mimeo. at 18.

Based on our discussion, we find that an ROE of 10% is reasonable for Cal-Am under existing ratemaking mechanisms because it falls within the range of parties' financial analytical models, is consistent with other authorized ROEs, reflects Cal-Am's performance history and creditworthiness, and does not include a leverage adjustment. Further, we find that an ROE of 10.0% is fair because this return is commensurate with returns on investments in comparable companies. This return is sufficient to (1) assure confidence in the financial integrity of the company, (2) maintain its credit, and (3) attract necessary capital. Therefore, we adopt a 10.0% ROE for the Los Angeles District for the next three years under the existing ratemaking mechanisms.

B. Assessing Reduction in Business Risk Under Proposed WRAM and MCBA

The merits of adopting Cal-Am's proposed WRAM and MCBA will be considered in Phase 2 of this proceeding, where we will concurrently address Cal-Am's conservation rate design proposal. A key objective in our Water Action Plan is to strengthen water conservation programs to a level comparable to those of energy utilities. In the Water Action Plan, we recognize that because water utilities recover a portion of their fixed costs through volumetric sales, the utilities have a disincentive associated with conservation. One means of addressing this disincentive is to consider decoupling water utility sales from earnings.

In this phase, we assess the impact these mechanisms would have on Cal-Am's business risk and cost of capital, and decide whether we should make a downward adjustment to Cal-Am's ROE in Phase 2 if we adopt a WRAM and

MCBA.³⁵ As this is the first WRAM requested under our Water Action Plan, we examine our experience of adjusting ROEs each time we implemented a revenue adjustment mechanism for an energy utility in the late 1970s/early 1980s, and then consider our later history of adopting an interim revenue adjustment mechanism with an ROE adjustment for water utilities during the drought period of the early 1990s.

1. Position of the Parties

DRA states that Cal-Am's proposed WRAM would ensure recovery of all authorized fixed costs, regardless of actual sales levels, and its proposed MCBA would ensure recovery of actual water supply costs. If these ratemaking mechanisms are adopted in Phase 2, DRA recommends we concurrently lower by 1.56% to 3.28% the ROE adopted in this phase. DRA testifies that Cal-Am's business risk is low due to a multitude of current mechanisms that minimize risk, and with the addition of the WRAM and MCBA mechanisms, the Commission would remove virtually all Cal-Am's business risk, in effect turning its equity shares into risk free bonds.³⁶

³⁵ We bifurcated this proceeding at the request of Cal-Am. At the May 12, 2006 PHC, the decision to consider the ROE adjustment as part of the cost of capital testimony in Phase 1, with the other conservation issues to be heard in Phase 2, was made with all parties in agreement. (RT at 20.)

³⁶ Other regulatory mechanisms which reduce regulatory risk and protect earnings from inflation, regulatory lag, estimating errors, input price variability, loss due to catastrophic events, Safe Drinking Water Act (SDWA) compliance, and operating leverage are: balancing accounts for purchased water, purchased power, and pump taxes; memorandum accounts for catastrophic events; future test year ratemaking; memorandum accounts for SDWA compliance; 50% fixed cost recovery in service charge; and construction work in progress in ratebase. See Exhibit 37, page 3-1. The Commission further reduced business risk in D.06-04-037, which eliminated the

Footnote continued on next page

In support of its adjustment, DRA cites D.82-12-055 where the Commission states that adoption of the Energy Rate Adjustment Mechanism (ERAM) for Southern California Edison Company (Edison) provides the utility “a better opportunity to earn its authorized rate of return during the test year and the attrition year.”³⁷ DRA also cites D.86-05-064, where the Commission considered increasing the amount of fixed costs collected through the service charge and/or adopting a sales adjustment mechanism and found these mechanisms would “substantially reduce a utility’s financial risk and lead the utility towards a guaranteed recovery of revenues.”³⁸ DRA also cites the Commission’s investigation into measures to mitigate the effects of drought on regulated water utilities, where in D.91-10-042 we adopted a revenue adjustment mechanism for sales and concurrently adopted a 0.2% reduction to ROE to recognize the reduced business risk represented by the memorandum account.³⁹

Cal-Am opposes any ROE adjustment related to adoption of its proposed WRAM and MCBA mechanisms. Cal-Am’s policy consultant testifies that the Commission did not make any adjustment to the cost of capital at the time it adopted revenue decoupling mechanisms for energy utilities, and that DRA has not provided any evidence that it has been Commission policy or practice to adjust the rate of return when implementing revenue decoupling mechanisms

earnings test adopted in D.03-06-072 for balancing account recovery for Class A water companies.

³⁷ Opening Brief at page 22.

³⁸ 21 CPUC2d 158 & 161 (1986).

³⁹ 41 CPUC2d 521 & 525 (1991).

(such as the ERAM) for energy utilities.⁴⁰ Cal-Am further states that any effect revenue decoupling may have on a water utility's financial risks will be captured in ROE analysis in future GRCs.⁴¹ Finally, Cal-Am asserts that adoption of ROE adjustment for WRAM in this district will have a negative effect on other districts based on the methodology used by the Commission to compute attrition year rate increases.⁴²

2. Discussion

In reviewing case law, we find that the Commission has consistently held that the adoption of revenue adjustment mechanisms, whether for electric, gas, or water utilities, reduces business risk. Contrary to Cal-Am's testimony, in implementing these mechanisms we have explicitly reflected this risk reduction in each utility's adopted ROE.⁴³

The Commission's first revenue adjustment mechanism stemmed from a 1977 gas supply investigation, where we expressed concern with gas supply availability and the dramatic and unexpected short-term sales fluctuations from weather and the market price of alternative fuels, combined with the effects of a new inverted block gas rate design. The Commission adopted a supply adjustment mechanism (SAM) to recover the loss or gain in gas sales. The

⁴⁰ Exhibit 47 at pages 1 and 4.

⁴¹ *Id.* at page 8.

⁴² Opening Brief, page 11.

⁴³ An exception to this practice is when the Commission reinstated revenue balancing accounts during the energy crisis. We did this pursuant to the enactment by the legislature of ABX1-29, an urgency statute. See D.02-04-055, issued April 22, 2002, mimeo. at page 10.

Commission stated that “our adoption of a SAM will reduce the risk to the utility shareholder. That reduction in risk will be considered in setting a reasonable rate of return in future general rate proceedings as well as those currently pending before the Commission.”⁴⁴

In adopting the SAM, the Commission also applied an earnings test to ensure that the rate of return last found reasonable would not be exceeded.⁴⁵

Three years later, the Commission adopted the ERAM in a 1981 rate case decision for Pacific Gas and Electric Company’s (PG&E). As we summarized in a later decision, we adopted the ERAM in response to a crisis in utility finances brought on by a shortage in oil and a near doubling of oil costs and interest rates. The ERAM was intended to encourage energy conservation and help provide financial stability.⁴⁶

In adopting the ERAM for PG&E, we explicitly took into account the positive effect it had on PG&E’s business risk and reflected this in our ROE determination, where we stated:

Our adopted rate of return on rate base and return on common equity gives consideration to this increase in cash flow as well as the adoption of ERAM and attrition adjustment procedures.⁴⁷

Following the adoption of an ERAM for PG&E, the Commission next addressed San Diego Gas & Electric Company’s (SDG&E) GRC application,

⁴⁴ D.88835, 84 CPUC 5, 10, & 14. (1978).

⁴⁵ *Id.*, Finding of Fact 9 at page 14.

⁴⁶ D.94-06-033, 55 CPUC2d 158 & 178 (1994).

⁴⁷ D.93887, 7 CPUC2d 349, 391 & 392 (1981)

where we again reflected the effects of an ERAM in our adopted ROE.

Specifically, we stated:

We believe SDG&E's request for a 19.00% return on common equity to be excessive and more than necessary to demonstrate to the investment community that this Commission is concerned about the financial health of SDG&E and other California utilities.

We are well aware that all utilities have to compete in the same marketplace as industrials for the investor's dollar; however, we believe the investor is aware that utilities do not have comparable risks to industrials.

Related to the question of risk reduction for the utility, we note that this decision provides for a revenue adjustment mechanism which protects SDG&E from any reduction in electric sales below the adopted figures. Conversely, if sales are above the adopted figures, the ratepayer will receive a refund. This mechanism is described in the results of operations section. We might mention there is a similar mechanism already in place for gas sales, and this has insulated SDG&E from the effects of reduction in gas sales.

Accordingly, we will adopt a 16.25% return on common equity.⁴⁸

The following year, the Commission adopted an ERAM for Southern California Edison Company. Again, we reflected the reduction in risk of the ERAM in the adopted ROE:

As we stated in D 93892 (SDG&E), the rate of return, which will satisfy these tests depends on many circumstances. The determination of a reasonable return on equity is necessarily a matter of judgment and cannot be reduced to a fixed formula. Each case must be decided after considering many variables, such as the cost of money, the capital structure of the utility in comparison with similar utilities, and interest coverage ratios. In addition, risk factors specific to the utility must be considered. We have provided for an

⁴⁸ D.93892, 7 CPUC2d 584 & 605 (1981).

electric revenue adjustment mechanism. This mechanism reduces the risk to the company that its earnings may be eroded by a reduction in electric sales below the adopted sales levels. We have also provided an attrition allowance which will provide Edison a reasonable opportunity to earn the authorized rate of return in attrition year 1984. ... After weighing all of the above factors, we find that a return on common equity of 16% is just and reasonable.⁴⁹

Eight years later, in response to a severe water drought, the Commission authorized, on an interim basis, the water utilities to record drought and conservation related sales losses in a memorandum account. We stated that these memorandum accounts could be considered for rate recovery after the Commission had approved a Water Management Plan for the utility. We set forth our finding on the need to reduce each utility's ROE when a revenue adjustment mechanism was implemented in D.90-08-055.^{50 51}

In Phase II of the Drought OII, the Commission reviewed and approved each water utility's Water Management Plans and developed the specific risk reduction adjustment to be applied to the memorandum accounts prior to the accounts being approved for recovery. In the evidentiary record, DRA

⁴⁹ D.82-12-055, 10 CPUC2d 155, 269, & 270 (1982).

⁵⁰ 37 CPUC 2d 196 & 222 (1990).

⁵¹ On September 10, 1990, a group of eight water utilities, including Cal-Am, filed a joint petition to modify D.90-08-055. Specifically, they requested Finding of Fact 28b above be stricken and other items of relief be granted. The water utilities asserted that there was no testimony or other evidence offered in Phase I of the Drought OII on which to base the conclusion that memorandum accounts constitute protection against the normal sales risk in the water industry. In D.91-04-018, the Commission denied the petition, finding that Finding of Fact 28b was adequately supported by the record and the other items had become moot or been adequately addressed. 1991 Cal.PUC LEXIS 121.

recommended a 0.5% reduction and California Water Service Company (CWS), for the limited purpose of interim recovery, calculated a 1.23% reduction in ROE. For a permanent ROE reduction, CWS factored in all 21 of its districts and added a sales fluctuation analysis for a risk assessment of .51%. We adopted a .2% reduction, finding that since the memorandum account was only authorized for a drought period, and full recovery of a reasonable estimate of drought and conservation sales losses was already guaranteed, any residual lost sales from “normal risks” was likely to be minimal.⁵²

In later phases of the Drought OIL, the Commission declined requests by the utilities to continue the revenue adjustment memorandum accounts on a permanent basis.⁵³

In summary, it is clear from our case law on revenue adjustment mechanisms for energy and water utilities that we should make a downward adjustment to ROE to reflect reduced business risk if we adopt a WRAM and MCBA for Cal-Am in the next phase of this proceeding. Investors in utility stocks seek a stable, low risk investment. A ratemaking mechanism that minimizes the degree of uncertainty is very valuable to investors in this type of investment. There is a substantial reduction in business risk for a water utility to have regulatory mechanisms in place that ensure the utility will consistently

⁵² D.91-10-042, 41 CPUC2d 521, 532, 533, and Footnote 13 at 551. While CWS’s proposal is discussed, the decision notes that CWS effectively withdrew its proposed formula.

⁵³ In September 1992, we did, in a change to the proposed decision, agree to allow voluntary conservation memorandum accounts to track residual conservation until the next GRC for water utilities. D.92-09-084, 45 CPUC2d 630, 640-43 (1992). In 1994, we closed the 1989 drought proceeding and directed that no new memorandum accounts for voluntary conservation or other purposes were permitted unless specifically authorized by the Commission. D.94-02-043, 53 CPUC2d 271 (1994).

recover all authorized fixed costs and water supply costs, regardless of sales levels.

A WRAM ratemaking mechanism is very attractive for an equity investor in water utilities, especially since the ROE for these utilities is set considerably higher than the interest rates for the utilities' debt offerings. In this proceeding, we set an ROE before a risk adjustment at 10.0% and the proposed settlement assumes new debt financing in 2007 will cost 6.26%. In addition, under a WRAM, water utilities can still earn above their authorized ROE by lowering their actual operating and capital costs below the GRC authorized levels.

The level of downward adjustment to ROE we should adopt is a matter of informed judgment. In the Drought OIL, we stated that we would measure only reduction in "normal risk" in the ROE adjustment:

We note again that our objective is to account in a fair and reasonable manner for a utility's reduced risk of normal business loss represented by the memorandum account. We intend no reduction of lost revenue attributable to conservation and rationing, up to the level of normalized sales. The record as a whole persuades us that since the memorandum account is generally in effect during dry/warm years (when water use typically increases), the likelihood of lost sales for reasons other than conservation and rationing is minimal."⁵⁴

Therefore, finding "normal risk" to be minimal in the drought period, the Commission chose to adopt an adjustment of only .2%.⁵⁵ Of note, the record reflects that while the largest water utility, California Water Service Company

⁵⁴ *Id.*, at 533.

⁵⁵ As discussed earlier, the Commission in D.90-08-055 had already assured water utilities they would recover their reasonable estimate of lost revenue and expenses due to conservation and rationing. *Id.* at 532.

(Cal Water or CWS), formally opposed any ROE adjustment, in seeking interim relief it proposed a risk reduction formula, specifically discussed in a footnote, that resulted in approximately the same 50 basis point ROE reduction that was recommended by DRA.⁵⁶

The WRAM we consider here is broader than the 1991 drought mechanism because it addresses every weather possibility. In addition, the Drought OII record did not address the additional lowered business risk of adopting a MCBA, which is before us here in addition to the WRAM proposal. An MCBA would substantially reduce supply mix risk, a significant factor for the Los Angeles District, which relies on purchased water for its marginal supply after it has used available ground water. The only comparable ratemaking mechanism on the electric side would be the former Energy Cost Adjustment Clause, but this mechanism had rigorous economic dispatch protocols to ensure ratepayers always received the least expensive sources of energy.

⁵⁶ The full paragraph and footnote in D.91-10-041 states: “CWS opposes any ROE adjustment. In seeking interim relief, however, CWS proposed the only other risk reduction formula presented on this record. Significantly, CWS like DRA concludes that if risk reduction is to take place, it is best reflected through a reduction in return on equity. The CWS formula, discussed in the footnote below, (FN 13) results in approximately the same 50 basis point ROE reduction that is recommended by DRA. FN 13: CWS first determined the revenue impact due to lower sales based on rationing (which it estimated at 25%), then calculated the change in return on rate base. From the change in rate base, CWS then determined the change in return on equity by application of the rate return on CWS’s capital structure. (Exhibit 103.) For the limited purpose of interim recovery, CWS calculated a 123-basis point (1.23%) reduction in return on equity. For a permanent reduction, CWS factored in all 21 of its districts and added a sales fluctuation analysis for a risk assessment of 51 basis points (Exhibit 128).” Id. at 530 and 551.

We have based our ROE adjustment primarily on the WRAM. Cal-Am and DRA provide little testimony on the effects of the MCBA. As initially proposed, it would provide a true-up to actual supply mix. In Phase 2, Cal-Am has agreed in a pending settlement with DRA to instead have a “Modified Cost Balancing Account” which would have the Commission adopt an expected water supply mix at different levels of water sales.⁵⁷ Under both proposals, to differing degrees, the mechanisms will remove or significantly reduce uncertainty and risk caused by fluctuating sales levels.

We agree with DRA’s approach of establishing the ROE risk adjustment based on a comparison to Cal-Am’s cost of debt. However, we choose to establish the level lower than DRA’s proposed 1.56% to 3.28%. We find that a .50% ROE adjustment is sufficient for an initial reduction.

A .50% reduction in ROE reflects that the reduction in risk from a potential Phase 2 adoption of a WRAM and MCBA is substantial.⁵⁸ Weather has a major impact on water sales. While over a period of time the yearly swings in water consumption that are weather related may average out, each year’s level is quite uncertain, as is recovery of the fixed costs included in the commodity rates. There is also increased sales uncertainty as the Commission implements its higher levels of conservation under the Water Action Plan.⁵⁹ Both the WRAM

⁵⁷ Exhibit 74, with Cal-Am’s clarification provided in the February 27, 2007 supplemental filing.

⁵⁸ Exhibit 74 contains the specific WRAM and MCBA mechanisms in Cal-Am and DRA’s proposed Phase 2 settlement.

⁵⁹ The conservation rate design being considered in Phase 2 will shift more fixed cost recovery onto the commodity rates, thereby increasing Cal-Am's business risk under existing ratemaking mechanisms.

and MCBA offer substantial protection from weather and conservation uncertainties. The reduction in business risk that would occur in Phase 2 with the adoption of a WRAM and MCBA is much broader than the memorandum account protection we adopted in the Drought OII and our ROE reduction reflects this.

Cal-Am expresses concern that it will need to apply the Los Angeles District WRAM-adjusted ROE to other districts based on the attrition year methodology we use. To address this concern, we direct that Cal-Am use the Phase 1 ROE in the attrition calculation for any district that does not have an adopted WRAM adjustment. In specifying this proceeding's ROE to be used, we do not modify GRC decisions for other districts at this time.

In conclusion, if the Commission adopts WRAM and MCBA mechanisms in Phase 2 of this proceeding, Cal-Am shall file a compliance advice letter within five days of a final decision to adjust the revenue requirement adopted here downward to reflect a .50% reduction in ROE.⁶⁰

⁶⁰ On December 22, 2006, Cal-Am and DRA served a proposed settlement of Phase 2 issues that contained a WRAM and MCBA mechanism, entered into evidence as Exhibit 74. Hearing testimony on the specifics of these mechanisms is found at RT 945-949. In Phase 2, if the Commission does not adopt the specific WRAM and MCBA mechanisms proposed in Exhibit 74, we will reexamine the level of ROE reduction. For instance, if the parties change the WRAM mechanism to provide for guaranteed recovery of only the authorized fixed cost shortfall that is directly attributable to the conservation rate design and other conservation measures implemented by Cal-Am, then an ROE adjustment may not be warranted. In addition, after a final decision is issued in Phase 1B of Investigation (I.) 07-01-022 on the issue of a WRAM ROE adjustment for five of the other Class A water utilities, the Commission may revisit the level of ROE adjustment we adopt here for Cal-Am's Los Angeles District.

C. Request for Infrastructure System Replacement Surcharge

In Special Request 1, Cal-Am requests a distribution system improvement charge that it labels an ISRS. Cal-Am's ISRS proposal would provide the utility a greater funding level and regulatory discretion in making capital investments to replace existing facilities, and provide a revenue stream, in the form of a separate surcharge on customers' bills, for rate recovery.

1. Position of the Parties

Under its proposal, Cal-Am would file quarterly expedited advice letters, effective on 15 days notice, detailing the infrastructure investments it had completed and placed into service in the prior quarter. DRA and the Commission's Water Division would review the quarterly filings and authorize or disallow recovery of the costs incurred. The ISRS surcharge would have a price cap of 10% of the total revenues over the three-year GRC period, based on service charges and volume prices authorized by the Commission. In the next GRC proceeding, the ISRS-funded projects would be placed into ratebase and the surcharge reset to zero.⁶¹

Cal-Am indicates its ISRS proposal was developed in anticipation of the Commission's approval of the Water Action Plan. In a data response Cal-Am also states it was not aware of any financial analysis of ISRS it had prepared prior to submitting the proposal.⁶² Cal-Am testifies:

⁶¹ Opening brief at pages 222 -23. Cal-Am does not propose acceleration of recovery of depreciation or ad valorem taxes. These items, together with a pre-tax return, would be included in the surcharge at the same rate approved for base rate calculations. The capital investments would be for revenue neutral (non-revenue producing, non-expense reducing) capital expenditures to replace existing facilities.

⁶² See Exhibit 36, Chapter 12.

The proposed ISRS program is a sort of trial balloon. We have to start somewhere, and where better than with a system that will provide some consistency to the replacement needs, but which needs to be slowly accelerated so that replacements don't lag any further. DRA appropriately notes that much of the Duarte system is constructed with used unlined steel pipe, and much of the San Marino system is over 50 years old. Now is the time to start making headway into infrastructure replacement – even for systems that are as free of customer complaints as these.⁶³

Both DRA and Duarte oppose Cal-Am's request. DRA states that while it supports the goal of adopting regulatory mechanisms that ensure the ongoing viability of Cal-Am's water systems, the proposed ISRS is merely one possible ratemaking tool, the need for which Cal-Am has failed to demonstrate at this time. DRA instead proposes refinements to Cal-Am's capital asset management planning process, specifically the identification of the age and condition of all existing infrastructure and the development of a long-range infrastructure replacement strategy.

DRA believes the effectiveness of the ISRS is questionable, especially without a clear long-term plan in place, and its potential dangers are many. In other parts of the country that have adopted infrastructure surcharge mechanisms, the water systems are dramatically older, and there is an established urgency and financial need to look outside existing ratemaking mechanisms. DRA also documents that in all other states with an infrastructure surcharge, the cap is always set at 5% or less of the revenue requirement. There is no precedent for the 10% cap Cal-Am is requesting. (Exhibit 36, Chapter 12.)

⁶³ Exhibit 13, page 26.

DRA testifies that Cal-Am has been regularly investing in the Los Angeles system, and customers have been enjoying safe reliable service. Further, Cal-Am has the financial resources to make necessary capital investments, and any additional infrastructure replacement needs identified in a comprehensive asset management study could be accomplished with the existing capital funding mechanisms and at a relatively affordable rate.

Under existing ratemaking, DRA is able to carefully review proposals, make data requests, and analyze proposed infrastructure projects and their budgets in a comprehensive GRC proceeding. DRA asserts that an infrastructure surcharge does not ensure that utilities are adequately performing capital planning, and to prematurely approve an ISRS could subvert the Commission's oversight role.

In conclusion, DRA recommends that the Commission reject the ISRS and instead direct Cal-Am to focus its efforts on refining its current capital asset management planning process to provide the Commission a more detailed CPS in 2008, one that will provide a long-term and comprehensive strategy for infrastructure replacement.⁶⁴

Duarte testifies that it opposes the ISRS proposal because Cal-Am has made no compelling showing of need; moreover, the ISRS is a deregulatory device that eliminates, or at least significantly postpones, DRA review of Cal-Am

⁶⁴ In its briefs, DRA states that should the Commission reject DRA's recommendation to deny the ISRS proposal, then in adopting an ISRS the Commission should at least reduce the surcharge cap to 7%, require all advice letter filings to be made under standard General Order 96-A (now GO 96-B) procedures and affirmatively approved by the Commission, and adopt all DRA recommendations for additions to Cal-Am's planning process and 2008 CPS.

expenditures and forces ratepayers to bear the burden of those expenditures until such time as a meaningful review has taken place and reconciliation, if necessary, has been accomplished.⁶⁵

2. Discussion

Cal-Am is the first California water utility to request a separate surcharge mechanism for its routine infrastructure investments.⁶⁶ Therefore, in considering this proposal, we first discuss the history of infrastructure surcharges in other regulatory jurisdictions and the policy direction we have given on this mechanism in our Water Action Plan, and then turn to an evaluation of Cal-Am's specific proposal.

On December 15, 2005, in our Water Action Plan, we adopted four key water principles: safe, high quality water; highly reliable water supplies; efficient use of water; and reasonable rates and viable utilities. To meet these principles, we adopted six Water Action Plan objectives, one of which is to promote water infrastructure investment.

In our Water Action Plan, at pages 12-13, we discuss the need for water utilities to address their infrastructure needs by undertaking comprehensive long-term planning to provide all capital investments necessary to upgrade or replace their existing infrastructure. In preparing a comprehensive plan, a utility may find that it cannot provide for the necessary infrastructure investments under our normal ratemaking process. We indicate that in these circumstances,

⁶⁵ Exhibit 42, page 4.

⁶⁶ In D.06-12-040, we have authorized Cal-Am an infrastructure surcharge for a specific long-term project, the CWP, in the Monterey district. This surcharge is quite different, as we discuss, from Cal-Am's proposal here.

we may consider a special surcharge mechanism to collect the necessary funds. Our objective is to have a regulatory process in place that (1) ensures the utilities develop long-term comprehensive plans to address aging infrastructure issues, (2) provides a forum for the Commission to carefully review these plans, and (3) ensures that each California water utility is able to fund the necessary infrastructure investments. The Water Action Plan references a DSIC as a ratemaking mechanism that we would consider to fund a utility's comprehensive infrastructure plan.⁶⁷

In response to growing concerns about the condition of the existing water infrastructure in the U.S., and calls for increased financial assistance, Congress considered a number of infrastructure-related proposals. In August 2002, Congress's Government Accounting Office (GAO) issued a report titled "Water Infrastructure: Information on Financing, Capital Planning, and Privatization." This report found "a significant number of water and wastewater utilities have not been charging rates adequate to cover their cost of providing service. Many were also found to have deferred maintenance due to insufficient funding."⁶⁸

In response to this GAO report, James Barr, the Chief Executive Officer of Cal-Am's parent, American Water Works, issued a press release stating:

Water infrastructure can be rehabilitated without federal assistance...There is absolutely nothing new or particularly complicated about the issue of infrastructure replacement. ... I believe it stretches credibility to suggest that this basic, fundamental physical characteristic of any water or wastewater

⁶⁷ The DSIC is the more common name for an infrastructure surcharge mechanism; Cal-Am uses the term ISRS.

⁶⁸ See Exhibit 40, page 1.

system is anything other than a daily routine - albeit a routine that requires huge investments ... Since the early 70s, AWW invested more than \$7 billion or roughly \$2,000/customer in the infrastructure ... the figures disprove the contention that the cost of service cannot be supported through rates for service.⁶⁹

Also in response to the GAO Report, the American Water Works Association (AWWA) adopted a statement of policy on capital asset management in June 2003. This policy states that water utilities must adopt a proactive approach to the management of their assets, which commences with planning and design, and continues through O&M on to rehabilitation and replacement.⁷⁰

In March 2004, the GAO issued a new report finding that comprehensive asset management has potential to help water utilities better identify infrastructure needs and plan future investments. The report cites to legislation before Congress to require water utilities to implement asset management planning.⁷¹

We turn now to Cal-Am's ISRS proposal. Based on the evidentiary record, Cal-Am's identified need for infrastructure replacement is easily met within our existing ratemaking process.

Cal-Am has had a capital asset planning process, known as a CPS, in place for many years, similar to the process referenced by its former CEO James Barr.

⁶⁹ Exhibit 40 at pages 15-16 and full text at <http://waterindustry.org/Water-Facts/water-costs-9.htm>.

⁷⁰ Exhibit 40 at pages 12-13.

⁷¹ GAO-04-461, published March 2004, "Water Infrastructure: Comprehensive Asset Management Has Potential to Help Utilities Better Identify Needs and Plan Future Investments," web accessible at www.gao.gov/new.items/d04461.pdf. We take official notice of this document.

The record reflects that almost all of the projects Cal-Am proposes to be funded through the ISRS were identified in its 2000 CPS and/or its 1997 Baldwin Hills Fire Flow Improvement Study.⁷² These are infrastructure replacements and upgrades that are planned in advance and are able to be met within the existing ratemaking process. Cal-Am testifies that in 2003, 2004, and 2005 it spent slightly less than the amount authorized by the Commission for capital projects.⁷³ Cal-Am does not identify an infrastructure need for its Los Angeles District that it was unable to meet through existing ratemaking. Cal-Am also has access to state grant funds for its capital projects. It has applied for four Proposition 50 grants for the Los Angeles system and three are short-listed by the Department of Health Services in its top 50 listing of proposals.⁷⁴

Cal-Am's witness agrees that its Los Angeles District needs have been met under existing ratemaking. He sees the ISRS as providing the utility additional flexibility for levels of spending beyond those identified by Cal-Am in its application and also reducing Cal-Am's regulatory risk as projects not identified in the GRC could be undertaken with full assurance of rate recovery and not be subject to later reasonableness review.⁷⁵

Cal-Am agrees it currently has the operational flexibility to pursue newly-identified or emergency infrastructure replacement, but it is concerned

⁷² See Exhibit 22 and transcript at 343-5.

⁷³ Transcript at 329-331.

⁷⁴ Transcript at 335-6, and Exhibit 21.

⁷⁵ Transcript at 331-2.

that in doing so it must carefully evaluate and document these projects because it risks a later reasonableness review.

The record does not show Cal-Am has experienced any disallowances in its Los Angeles District. Rather, Cal-Am testifies that it has in place an existing internal review procedure for capital projects that are outside those identified in its comprehensive plan. This process appears to function well, similar to the management oversight process utilized by well-run nonregulated companies needing to routinely make large capital investments. We would not want to provide Cal-Am an incentive to discontinue its internal project review of all change orders and re-prioritizations.

We are concerned that despite a lengthy and successful history of infrastructure investment in the Los Angeles District under existing ratemaking, Cal-Am suddenly asserts that its Los Angeles customers face immediate and grave risk if its ISRS is not approved. It asserts on this record:

California American Water wants to make sure that its customers continue to enjoy their current high-quality water service by undertaking infrastructure replacement now, rather than waiting until mains break, service is interrupted, boil order notices are issued, and a succession of emergency repairs are required.⁷⁶

This alarmist statement does not persuade us to adopt an ISRS. It is hard to believe that Cal Am has suddenly discovered an immediate infrastructure crisis in its Los Angeles District. If it has, a 3% increase in infrastructure funding levels will not be sufficient to address the problem. Further, if Cal-Am has failed

⁷⁶ See Reply Brief at page 3.

to properly plan its infrastructure replacements, we should exercise more, not less, regulatory oversight.

Having found Cal-Am has no need for infrastructure investment in its Los Angeles District that cannot be met under existing ratemaking mechanisms, we next consider if there are overriding benefits to adopting the ISRS that we should consider. Cal-Am states that under its ISRS proposal, ratepayers will benefit because they will not begin to pay for capital projects until the projects are actually completed and placed in service. This is the primary benefit it cites.

The Commission already has in place ratemaking mechanisms that provide this benefit. First, if the timing of a large project is uncertain, parties often recommend that the project be given a price cap and brought into rates through a separate advice letter when the project is completed. An example of an advice letter project in the proposed settlement here are the Danford Reservoir and Patton Well projects. Reviewing projects in the GRC for later advice letter treatment has an advantage over ISRS for two reasons: (1) the review is done prior to project construction, not in an after-the-fact reasonableness review, and (2) a price cap is established.

The second existing mechanism to ensure ratepayers are timely receiving the benefits of projects included in their rates is that the Commission reviews in each GRC the levels of authorized and actual capital investment. In this proceeding, we find that while Cal-Am funded slightly less than authorized levels in the past three years, its investment levels are satisfactory and ratepayers have received the benefits in a timely manner.

Cal-Am states an additional benefit of ISRS will be its quarterly change in rates, so that ratepayers pay less in the early quarters of the three-year GRC cycle. Our existing ratemaking mechanism also spreads out rate increases for

new capital projects, with specific infrastructure investment made in each of the three years. Cal-Am's proposal to do this quarterly rather than annually does not represent a significant benefit for ratepayers.⁷⁷

While we are not persuaded by Cal-Am's ISRS proposal, we do see benefits to adoption of an infrastructure surcharge. The adoption of an infrastructure surcharge as a pilot project for the Los Angeles District would send a strong signal to water utilities and the communities they serve that based on our Water Action Plan the Commission is undertaking a significant change in water utility regulation. The message we intend to send is that we are strengthening long term capital asset planning for a water utility, with a specific emphasis on ensuring an adequate ongoing level of new investment for the routine replacement and upgrades that are necessary to maintain adequate water service for communities it serves. A separate infrastructure surcharge would also provide customers with direct information on what portion of the rates they are paying supports new capital investment projects that the utility has recently completed. Finally, by providing a separately identified revenue stream, the infrastructure surcharge would be a strong signal to the investment community of the Commission's commitment to supporting new infrastructure investment.

Having identified potential benefits, we next turn our attention to whether adequate regulatory safeguards can be adopted for an infrastructure surcharge in this proceeding. As discussed in the national studies and on this record, there are substantial risks in removing infrastructure replacement from existing ratemaking mechanisms and replacing it with a separate surcharge. The major

⁷⁷ Cal-Am's ISRS does not propose a ceiling for quarterly increases, only an overall three-year 10% cap.

risk is that the ISRS mechanism proposed by Cal-Am would remove effective regulatory oversight from these investments. Rather than continuing to review and pre-approve the capital projects in the comprehensive GRC proceedings, Cal-Am proposes to provide the Commission a 15-day window of review through an expedited advice letter process, with the provision that the Commission, in a later GRC, can review and disallow rate recovery for already built facilities. Cal-Am would also delink its level of infrastructure investment from its own asset management plan, the CPS, thereby leaving the Commission and its customers without a roadmap for infrastructure investment and effective oversight of the capital budget.

The record provides strong evidence that the existing level of regulatory oversight for Cal-Am's Los Angeles District is necessary to protect ratepayers from paying significantly higher rates for the same capital projects. In the proposed settlement between Cal-Am and DRA, the capital projects Cal-Am requests be placed under ISRS total \$2,488,098 for 2007 and \$3,020,272 for 2008. Over half of the ISRS project dollars are for individually identified projects rather than replacement of general network, hydrants, services, and meters.⁷⁸ DRA undertook an extensive review of these projects and recommended substantial reductions in the requested costs. In the proposed settlement, Cal-Am agrees to lower its originally requested costs by 15%, a savings to ratepayers of \$239,300 in 2007 and \$353,000 in 2008. Clearly, careful scrutiny of costs is needed, and is

⁷⁸ Attached at Attachment 1 is a spreadsheet of Cal-Am's capital projects, both ISRS and non-ISRS. The ISRS projects are identified as individual projects (IP) and recurring projects (RP). The data is taken from the evidentiary record, Exhibit 7, Feizollahi, pages 5-15 and 72-73, and workpapers.

most effective when done prior to construction.⁷⁹ Changing prospective review for a system of after-the-fact disallowances is inconsistent with our regulatory objectives.

For Cal-Am, an example of an infrastructure surcharge that meets our Water Action Plan objectives is found in the Monterey District. In D.06-12-040, we authorized two infrastructure surcharge mechanisms to fund the CWP or an alternative water supply project. We authorized these surcharges after finding that the CWP has the potential to produce a near doubling of current rates in Cal-Am's Monterey District. After careful review of preconstruction costs Cal-Am has already incurred, we authorized a surcharge of 4% rising to 10% for collection of these costs. A second surcharge, which will rise to 60% of customer bills, will commence after the Commission issues a Certificate of Public Convenience and Necessity (CPCN) for the CWP or an alternative long-term water supply solution for Monterey. The surcharges collected will not be placed in ratebase and Cal-Am will not earn an ROE on these funds. The revenues collected under this surcharge will be treated as a customer contribution to reduce the capital cost of the approved long-term supply project.

The infrastructure surcharges we approved for Cal-Am in D.06-12-040 are very different from the proposal before us here. We there found a long-term

⁷⁹ We note here that the non-individual projects under Cal-Am's ISRS proposal, which are approximately 40% of the total ISRS projects, are less vigorously contested by DRA. If the Commission does choose to adopt an ISRS as an alternative to this proposed decision, this is the only set of projects that the record could justify as a pilot ISRS project, with the additional safeguards addressed by DRA. This would place the surcharge under 3% of total revenues for the GRC period -- an amount within the 3-5% caps that are authorized by other states.

infrastructure need that could not be met through normal ratemaking, and we carefully fashioned safeguards and oversight features for this departure from traditional ratemaking. All costs that are collected through these surcharges will be thoroughly reviewed for reasonableness prior to recovery being authorized.

Cal-Am's Los Angeles district does not have the extraordinary infrastructure investment needs of the Monterey district, so a different surcharge mechanism may be appropriate. However, an infrastructure surcharge for routine infrastructure investment will still need to contain all the safeguards necessary for effective regulatory oversight. We look to the record here and DRA's alternative proposal in crafting a surcharge for the Los Angeles district. We will adopt a routine infrastructure surcharge as a pilot program, with the intention that if this is successful in meeting our Water Action Plan objectives, a similar surcharge mechanism could be considered for other Cal-Am districts and other Class A water utilities. We will fully review the pilot in Cal-Am's next Los Angeles District GRC proceeding.

The primary safeguard is to ensure the Commission retains effective regulatory oversight. We can retain effective oversight by first requiring long term capital asset management planning, to include the development of an infrastructure replacement strategy, and by reviewing these plans and underlying detailed cost estimates in a GRC proceeding prior to Cal-Am commencing the construction projects. We should then set a dollar cap on the surcharge based on our planning review. In this proceeding, we have reviewed and found reasonable for the Los Angeles district a routine infrastructure investment level for the GRC period of 7% of annual revenues. Therefore, we should adopt a 7% surcharge cap for this GRC. In dollar terms, this is a \$1,323,588 cap for 2007, and will be adjusted for 2008 and 2009 based on revenue

escalation factors. Cal-Am will have flexibility within this cap to reprioritize or add projects, and to shift authorized funding between projects, provided it continues to follow its existing internal project review process and submits supporting documentation to the Commission at the time it requests new or revised projects be included under the surcharge.

Effective regulatory oversight also requires that Cal-Am submit its infrastructure surcharge requests under our advice letter procedure that requires a formal Commission resolution. This procedure is designated a Tier 3 filing in the General Order 96B procedures recently adopted in D.07-01-024 and effective in July 2007.⁸⁰ The advice letter procedure we adopt is not the expedited 15-day review proposed by Cal-Am. Rather, it is a process that provides notice to all interested parties, a full protest period, and requires a formal Commission resolution for adoption. We further direct that Cal-Am explicitly and clearly state in the advice letter filing, and provide supporting documentation, for (1) any project that was not approved in this GRC proceeding, and (2) any project that is included at an amount over the cost estimate authorized in this GRC proceeding. In evaluating projects not included in this GRC review, Water Division should apply the following criteria: Does the expenditure contribute to an adequate ongoing level of new investment for the routine replacement and upgrades that are necessary to maintain adequate water service for customers? For these projects as well as authorized projects with final costs in excess of estimates found reasonable in the GRC, Cal-Am retains the same burden of proof to justify costs that we applied in our GRC review.

⁸⁰ This is consistent with our decision to make water ratebase offset filings a Tier 3 rather than Tier 2 filing. See Section 8.5 of D.07-01-024, mimeo. at page 46.

In its comments on the proposed decision, Cal-Am requests the Commission adopt a process to implement “interim” DSIC surcharges within 15 days of filing its Tier 3 advice letters, with adjustments made following the full review. As we have discussed here, 15 days does not allow for adequate review. Instead of this proposal, we will address Cal-Am’s concern that the pilot program may create unnecessary delay by allowing each advice letter filing to be effective immediately, subject to refund if necessary when the Commission issues its resolution on the advice letter. This “interim” surcharge should have a quarterly cap of 4%, approximately half of the 7% authorized DSIC, and any refunds should include interest at the 90-day commercial rate. If we find during the pilot project that Cal-Am does not provide all supporting documentation necessary to process its advice letters in a timely manner, we may revisit this interim authority.

In its comments, DRA recommends the Commission require Cal-Am to provide notification to customers of the DSIC in the form of a bill insert and a public notice, published in local newspapers, prior to initiating the first surcharge. We adopt this proposal, and direct Cal-Am to work with our Public Advisor on notice language and procedure. DRA also recommends Cal-Am be required to file a one-time tariff describing the pilot DISC. We agree.

Cal-Am shall meet and confer with Water Division and DRA to develop DSIC tariff language that implements this decision. Within 60 days, Cal-Am shall file a tariff that includes the following:

1. A statement of purpose and applicability, and definitions of terms;
2. Descriptions and definitions of the categories of plant eligible for inclusion in a DSIC, by account number and type, and a description of supporting documentation to be provided for completed projects;

3. The formulas for calculating the fixed costs that are collected via the customer surcharge; and
4. The DSIC requirements, procedures, and customer safeguards. Cal-Am may submit its advice letter filings on a quarterly basis and should designate on its customer billing the surcharge as a DSIC. All DSIC surcharge amounts will be reviewed in the next GRC prior to inclusion in rate base.

Cal-Am may submit its advice letter filings on a quarterly basis and should designate on its customer billing the surcharge as a DSIC. All DSIC surcharge amounts will be reviewed in the next GRC prior to inclusion in rate base.

We also direct Cal-Am to explicitly address infrastructure replacement in its capital asset planning process. While Cal-Am has a capital asset planning process in place now, there are areas that can be improved. Specifically, Cal-Am testifies it does not explicitly address the aging infrastructure issue in its current plan.⁸¹ DRA recommends that Cal-Am revise its 2008 CPS to include an infrastructure replacement plan, and that such a plan include: delineating the age, condition, location, operating history and risk associated with the parts of the distribution infrastructure needing replacement or rehabilitation; justifying the extent of infrastructure replacement or rehabilitation warranted; incorporating impacts addressed by water conservation savings; identifying the amount of replacement per year, and how long the replacements will continue to provide safe reliable service to customers; discussing the financing and recovery alternatives considered; describing the long-term financial investment required; and, providing an analysis of the rate impact to customers over the course of the

⁸¹ Transcript Volume 5 at 325.

long-term project to replace or rehabilitate infrastructure.⁸² We will adopt DRA's specific planning recommendations.

In conclusion, we adopt here a pilot program for a routine infrastructure surcharge, designated as a DSIC, for Cal-Am's Los Angeles district. We do this in order to further advance our Water Action Plan objectives and to provide a model for consideration in other proceedings for Cal-Am districts and other water utilities. The specific capital projects and dollar amounts identified as ISRS in the Cal-Am/DRA settlement will be subject to the Tier 3 advice letter procedures we have discussed here. We will fully review this DSIC pilot in Cal-Am's next Los Angeles district GRC proceeding.

D. Violations of Rule 3.2(b)

Rule 3.2(b) of the Commission's Rules of Practice and Procedure requires Cal-Am to serve notice of its GRC application within ten days of its filing on each city and county within its service territory. The rule states:

(b) Applicants for authority to increase rates shall, within 10 days after filing the application with the Commission, mail a notice to the following stating in general terms the proposed increases in rates or fares: (1) the State, by mailing to the Attorney General and the Department of General Services, when the State is a customer or subscriber whose rates or fares would be affected by the proposed increase; (2) each county, by mailing to the County Counsel (or District Attorney if the county has no County Counsel) and County Clerk, and each city, by mailing to the City Attorney and City Clerk, listed in the current Roster published by the Secretary of State in which the proposed increase is to be made effective; and (3) any other persons whom applicant deems appropriate or as may be required by the Commission.

⁸² Opening Brief at page 11.

In its Baldwin Hills subsystem, Cal-Am has 80-90 customers who are residents of the City of Inglewood, with the remaining customers residing in the unincorporated area of Los Angeles County.

At the April 6, 2006 PPH in Inglewood, a city staff member inquired whether Cal-Am had provided notice of its application to that city. Cal-Am stated on the record that it had. Inglewood's city attorney later researched the matter and determined that notice had not been provided. On May 9, 2006, the city attorney contacted the assigned ALJ, who directed Cal-Am and DRA to promptly provide copies of all their filings on Inglewood. At the May 12 PHC, Inglewood participated as a full party. At the June 1 PPH, Inglewood stated it had discovered that Cal-Am had also not provided service to the city of the last GRC application. The councilwoman representing the Inglewood customers requested that the Commission take action to require Cal-Am to refund to Inglewood customers all rate increases previously authorized in cases where the city had not been served and did not have the opportunity to participate on behalf of its residents.

Further research by Cal-Am found that:

- Cal-Am's 1985, 1988, and 1991 applications for Baldwin Hills were not served on the County of Los Angeles.
- Cal-Am's 1985, 1988, and 1991 applications for Baldwin Hills were served at a former mailing address for the City of Inglewood. (Cal-Am indicates that none of these applications were returned by U.S. Mail as being undeliverable.)
- Cal-Am's 1994 application for Baldwin Hills and the 1997, 2009, 2003, and 2006 applications for the Los Angeles District were not served on the City of Inglewood at any address.

At the close of hearings in the revenue requirement phase, all parties were requested to brief how the Commission should address Cal-Am's violations of Rule 3.2(b). Cal-Am, DRA and Duarte are the parties who address this issue.

Cal-Am agrees it has 11 violations of the Commission's noticing requirements.⁸³ It states it is deeply sorry for its failure to provide notice of this and prior GRC applications on Inglewood and its failure to provide notice of past applications on the county. Cal-Am commits to make any and all efforts to ensure that no such notice deficiency occurs in the future and outlines a plan it has initiated to prevent this from reoccurring.⁸⁴ On the issue of fines under Sections 2107 and 2108, Cal-Am states its notice violations were unintentional and its behavior does not merit fines under the criteria established by the Commission in D.98-12-075. Cal-Am asserts that its notice error is greatly mitigated by the fact that notice of each application was given to each ratepayer.

DRA states that Cal-Am should be fined for its persistent failure to provide notice to Inglewood and the county because the violations of Rule 3.2(b) are severe offenses in terms of the harm to the integrity of the regulatory process. The violations impinge on parties' due process rights by effectively denying Inglewood and the county the opportunity to participate in the proceedings on behalf of their residents. Under the criteria of D.98-12-075 and the fine levels of Section 2107, DRA recommends a fine of \$10,000 per violation, for a total fine of \$110,000.

⁸³ Opening Brief at page 32.

⁸⁴ Cal-Am should modify its proposed new noticing review procedures in the manner recommended by DRA.

In its reply brief, Duarte supports DRA's recommendation. Duarte states that it believes Cal-Am's violations were serious, multiple, and sufficiently flagrant to justify the imposition of monetary sanctions. Duarte adds:

First, the fact that actual notice was provided to ratepayers should not, in any way, justify wholesale disenfranchisement of jurisdictional public entities. It is naïve to assume that a typical ratepayer will possess the expertise, financial wherewithal, or intensity of stakeholder interest to challenge, or even participate, in a GRC.

Second, as Cal-Am well knows, Cal-Am's participation in the GRC is effectively financed by ratepayers themselves since Cal-Am recovers its costs in the proceeding as part of the revenue requirement...all ratepayers, including those in Inglewood and Los Angeles County whose local government did not receive the required notice over an extended period of time, effectively paid for Cal-Am's GRC participation.⁸⁵

We review Cal-Am's violations in light of the five criteria we established in D.98-12-075. These criteria are:

- (1) the severity of the offense;
- (2) the conduct of the utility;
- (3) the financial resources of the utility;
- (4) the totality of the circumstances; and
- (5) the role of precedent.

We find the violations to be serious. Cal-Am states that its actions did not cause physical harm to people or property. However, the Commission also considers economic harm and harm to the regulatory process. We cannot accurately assess any economic harm that may have occurred from the record

⁸⁵ Reply Brief at pages 1-2.

here. For this reason, we do not consider Inglewood's request for a refund to all affected customers. We can assess harm to the regulatory process, and we find in this case that it is serious and of long duration. We agree with DRA and Duarte on this, and find Duarte's pleading particularly persuasive.

The next criterion is the conduct of the utility, and here we assess the utility's actions to prevent a violation, to detect a violation, and to disclose and rectify a violation. The record indicates that Cal-Am's actions were inadvertent and appear to have stemmed from careless practices. However, its lack of care for basic due process procedures is of serious concern. We agree with DRA that this is a long-standing failure of an experienced utility to meet one of its most basic obligations. Cal-Am is a Class A water utility with trained regulatory personnel.

In addition, Rule 3.2(b) is very explicit in providing guidance for how to comply with the noticing requirements for cities and counties. It states that the utility should consult the current Roster published by Secretary of State for the address of each city and county. Cal-Am failed to do this for the years 1985, 1988, and 1991, and then inexplicably simply dropped Inglewood from any service. When Cal-Am was first made aware that city had not been served, it did take steps to address the service but did not vigorously pursue the matter. Cal-Am's conduct is partially mitigated by the new procedures it has put in place to ensure this omission does not occur again.

The financial resources of the utility is the next criterion. No party disputes that Cal-Am is a financially strong utility, capable of paying a \$220,000 fine, the maximum level of fines authorized under Section 2107 for its 11 violations of our rules.

The fourth criterion is the totality of the circumstances. Cal-Am emphasizes here that its actions were inadvertent, it did not do them willfully for the profit of its shareholders, no physical harm occurred by its actions, and its defective notice is mitigated by the fact that ratepayers received notice. Cal-Am seemingly makes light of its behavior, stating in its reply to DRA and Duarte that it did not impinge on customers' due process rights when it inadvertently failed to serve the counsel and clerks of the city and county. DRA and Duarte however, find the violations to be serious due process violations. We agree with DRA and Duarte.

The last criterion is the role of precedent. Cal-Am cites to three cases where the Commission imposed fines and states that its actions can be distinguished. We agree with Cal-Am that it did not willfully disregard Commission directives, encumber utility property in violation of the Public Utilities Code, or cause physical harm to any person or property.

Lastly, Cal-Am argues that a fine will not accomplish the Commission's objective of ensuring future compliance. We disagree. We find that a fine is effective in sending a clear message to all utilities that failure to properly notice rate increases is a matter the Commission takes very seriously.

Weighing all the criteria discussed above, we find that for the eleven violations a fine of \$1,000 per violation is an appropriate penalty and will send an effective message to ensure future compliance. We fine Cal-Am \$11,000 under Section 2107, the fine to be paid to the State General Fund. Cal-Am shall place the penalty amount into Account 538, described as "Miscellaneous Income

Deductions,” of the Uniform System of Accounts. Amounts in this account are for expenditures for which the utility will not be reimbursed.⁸⁶

VI. Comments on Proposed Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and Rule 14.2(a) of the Commission’s Rules of Practice and Procedure. Comments were filed by Cal-Am and DRA on May 29 and reply comments on June 4, 2007. We have made appropriate changes to the proposed decision based on these comments.

On May 29, 2007, motions for party status were filed by Cal Water and California Water Association (CWA). Cal Water states it seeks party status to address whether the relationship between a WRAM and a utility’s ROE should be more appropriately handled in a generic proceeding such as the conservation OII, I.07-01-022, and also to respond to statements in the proposed decision that do not accurately represent Cal Water’s position in the Commission’s Drought OII. CWA also seeks party status to address whether the relationship between a WRAM and a utility’s ROE should be more appropriately handled in a generic proceeding such as the conservation OII.

Cal-Am requested a WRAM and conservation rate design in this application, filed on January 9, 2006. When the Commission issued I.07-01-022 on January 11, 2007, it made all Class A water utilities respondents but chose to only consolidate four pending company specific applications. CWA and all water utilities had an opportunity to file comments on the OII’s preliminary

⁸⁶ See Uniform System of Accounts for Water Utilities (Class A), effective January 1, 1955, at 78.

scoping memo on January 29, 2007 and to address this issue at the PHC on February 7, 2007. In its comments, CWA stated that since the Commission's adoption of the Water Action Plan, it has advocated that water conservation and rate design be addressed in individual company GRC applications. At the PHC, Cal-Am's attorney referenced this Los Angeles GRC and the utility's recently filed Sacramento/Larkfield/Village/Coronado districts' GRC, and stated that Cal-Am preferred to keep the conservation issues within the GRC proceedings.

The WRAM ROE adjustment addressed in this proceeding is specific to Cal-Am's Los Angeles district. Cal Water and CWA will have an opportunity in I.07-01-022 to be heard on the issue of this decision's applicability, if any, to other Class A water utilities prior to the Commission considering an ROE adjustment for another Class A water utility. Regarding Cal Water's request to comment on statements related to it in D.91-10-041, the decision speaks for itself and we provide the specific decision language and cites we rely on. Therefore, we deny the motions of Cal Water and CWA.

VII. Assignment of Proceeding

John A. Bohn is the assigned Commissioner and Christine M. Walwyn is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. This decision resolves the revenue requirement phase of Cal-Am's Los Angeles GRC application.
2. On June 23, 2006, Cal-Am and DRA filed a partial settlement of the revenue requirement issues. On August 16, 2006, corrected tables to the settlement were filed that result in an increase in overall O&M expenses of \$1,096,000 for 2008 and \$1,113,900 for 2009, at proposed rates.

3. On February 15, 2007, Cal-Am filed a motion requesting the assigned ALJ reopen the record to accept an amended settlement agreement that corrects certain errors and includes data from Cal-Am's most recent financing. Cal-Am was directed by ALJ ruling to supplement this motion with further information by ALJ ruling on February 23, 2007.

4. Since its last GRC, the Los Angeles District has not received any Notices of Violations or any other compliance actions from the California Department of Health Services.

5. The record reflects the Baldwin Hills subsystem has exceeded the Lead Action Level since 2001. While Cal-Am appears to be taking appropriate steps to bring its subsystem into compliance with drinking water standards for lead, the Commission needs additional verification that the Baldwin Hills subsystem does not now exceed the Action level for Lead or, if it does, that Cal-Am is in compliance with all testing requirements and treatment techniques required by California and federal law for community water systems. If Cal-Am is not employing any treatment techniques recommended by DHS and EPA, it should explain why.

6. Cal-Am's actual consolidated capital structure of 62.6% debt/37.4% equity, rather than the separate imputed capital structure contained in the partial settlement, is a more accurate description of capital structure.

7. We find it reasonable to adopt the updated July 2006 water costs.

8. The O&M section of the revised settlement contains a substantial correction to the supply mix. We find this section reasonable but direct Cal-Am in future proceedings to address the additional procedures it has adopted to better review the accuracy of its filing.

9. The A&G Expense section of the settlement is reasonable.

10. The Utility Plant in Service and depreciation sections of the settlement are reasonable.

11. It would be helpful to have more information in the record on the most recent lead/lag studies relied on by Cal-Am and DRA in reaching their settlement.

12. The low-income program proposed in the settlement is reasonable.

13. In future proceedings, Cal-Am should address in each GRC application the additional procedures it has adopted to better review the accuracy of its filings.

14. Weighing the settlement as an integrated agreement, we find it is reasonable in light of the whole record and in the public interest.

15. An ROE of 10.0% in this phase is reasonable based on the record and is fair because the return is commensurate with returns on investments in comparable companies and is sufficient to (a) assure confidence in the financial integrity of Cal-Am, (b) maintain its credit, and (c) attract necessary capital.

16. A leverage adjustment for Cal-Am's ROE is not warranted.

17. The adoption of a WRAM and/or MCBA in Phase 2 would substantially reduce Cal-Am's business risk and should be accompanied by a concurrent reduction in ROE. We find that a .50% ROE adjustment is reasonable based on the record.

18. While timely infrastructure replacement is an important component of responsible utility management and DSICs are useful in some circumstances to fund infrastructure replacement, Cal-Am has not established a need for its proposed ISRS.

19. There are substantial risks to ratepayers in adopting the proposed ISRS, and the record provides strong evidence of this for the Los Angeles District.

20. We should not adopt Cal-Am's proposed ISRS.

21. There are benefits to adoption of a DSIC and we should consider adoption of a pilot program provided we adopt effective regulatory oversight mechanisms.

22. Cal-Am should revise its 2008 CPS to specifically address an infrastructure replacement strategy, in the manner proposed by DRA.

23. This proceeding should remain open for the next phase.

Conclusions of Law

1. We grant the City of Bradbury's December 5, 2006 petition to intervene.

2. The issue raised by Duarte in its protest to the partial settlement is properly considered in the rate design phase, Phase 2, of this proceeding rather than here.

3. We should reopen the record to accept the February 15, 2007 amendment to the partial settlement.

4. The partial settlement, as amended on February 15, 2007, is reasonable in light of the whole record, consistent with law, and in the public interest.

5. We should adopt the amended partial settlement.

6. The settlement should not be construed as precedent or policy of any kind in this or future proceedings.

7. Our case law for energy and water utilities reflects that the Commission has consistently held that the implementation of a revenue adjustment mechanism does reduce business risk and this reduction in risk should be explicitly reflected in a downward adjustment to ROE.

8. We should adopt as a pilot program for this GRC period a DSIC as follows:

- a. The surcharge should be based on the infrastructure projects reviewed and approved in this proceeding, identified in the Cal-Am/DRA settlement, and have a cap of 7% of annual adopted revenues for the

test period. The dollar cap for 2007 is \$1,323,588, and will be adjusted for 2008 and 2009 based on escalation factors.

- b. Cal-Am should file by quarterly advice letter, under the Tier 3 procedures specified in D.07-01-024, for its DSIC surcharge. It should explicitly and clearly state in each advice letter filing, and provide supporting documentation, for (1) any project that was not approved in this GRC proceeding, and (2) any project that is included at an amount over the level authorized in this GRC proceeding.
- c. To allow for interim recovery, each advice letter should be effective immediately, subject to refund if necessary when the Commission issues its resolution. This “interim” surcharge should have a quarterly cap of 4% and any refunds should include interest at the 90-day commercial rate.
- d. Cal-Am should meet and confer with Water Division and DRA to develop DSIC tariff language that implements this decision. Within 60 days, Cal-Am shall file a tariff that includes the following:
 - (1) A statement of purpose and applicability, and definitions of terms;
 - (2) Descriptions and definitions of the categories of plant eligible for inclusion in a DSIC, by account number and type, and a description of supporting documentation to be provided for completed projects;
 - (3) The formulas for calculating the fixed costs that are collected via the customer surcharge; and
 - (4) The DSIC requirements, procedures, and customer safeguards.
- e. Cal-Am should provide notification to customers in the form of a bill insert and a public notice (published in local newspapers) prior to initiating the first surcharge. It should consult with the Public Advisor on notice language.
- f. In evaluating projects not included in this GRC review, Water Division should apply the following criteria: Does the expenditure contribute to an adequate ongoing level of new investment for the routine replacement and upgrades that are necessary to maintain adequate water service for customers? For these projects as well as authorized

projects with final costs in excess of estimates found reasonable in the GRC, Cal-Am retains the same burden of proof to justify costs that we applied in our GRC review.

- g. All surcharges will be reviewed in the next GRC proceeding prior to inclusion in rate base.
- h. This pilot program will be reviewed in the next GRC proceeding.

9. Cal-Am has violated Rule 3.2(b) eleven times by its repeated failure to provide notice of its rate increase applications to the City of Inglewood and the County of Los Angeles.

10. Under the criteria established in D.98-12-075, Cal-Am should be fined \$11,000 under Section 2107. This fine shall be paid to the State's General Fund.

11. We should deny the May 29, 2007 motions of California Water Service Company and California Water Association for party status.

O R D E R

IT IS ORDERED that:

1. The partial settlement between California-American Water Company (Cal-Am) and the Division of Ratepayer Advocates, for Cal-Am's Los Angeles District, attached as Attachment 2, is adopted. The utility plant amounts in Section 4.8 of the settlement that are designated in the record as subject to Cal-Am's Infrastructure System Replacement Surcharge (ISRS), Special Request Number 1, are separately addressed in this decision, consistent with Section 1.7(a) of the settlement.

2. The Los Angeles District revenue requirement tables, attached as Attachment 3, are adopted.

3. The specific capital projects and dollar amounts identified as ISRS in Attachment 2 to this decision are eligible for collection under the pilot

Distribution System Infrastructure Charge (DSIC) surcharge, based on the Tier 3 advice letter mechanism specified in this decision and subject to a \$1,323,588 cap for 2007. The cap for 2008 and 2009 will be adjusted based on revenue escalation factors.

4. We shall adopt as a pilot program for this GRC period a DSIC as follows:
 - a. The surcharge shall be based on the infrastructure projects reviewed and approved in this proceeding, identified in the Cal-Am/DRA settlement, and have a cap of 7% of annual adopted revenues for the test period. The dollar cap for 2007 is \$1,323,588, and will be adjusted for 2008 and 2009 based on escalation factors.
 - b. Cal-Am shall file by quarterly advice letter, under the Tier 3 procedures specified in D.07-01-024, for its DSIC surcharge. It should explicitly and clearly state in each advice letter filing, and provide supporting documentation, for (1) any project that was not approved in this GRC proceeding, and (2) any project that is included at an amount over the level authorized in this GRC proceeding.
 - c. To allow for interim recovery, each advice letter shall be effective immediately, subject to refund if necessary when the Commission issues its resolution. This "interim" surcharge should have a quarterly cap of 4% and any refunds should include interest at the 90-day commercial rate.
 - d. Cal-Am shall meet and confer with Water Division and DRA to develop DSIC tariff language that implements this decision. Within 60 days, Cal-Am shall file a tariff that includes the following:
 - (1) A statement of purpose and applicability, and definitions of terms;
 - (2) Descriptions and definitions of the categories of plant eligible for inclusion in a DSIC, by account number and type, and a description of supporting documentation to be provided for completed projects;
 - (3) The formulas for calculating the fixed costs that are collected via the customer surcharge; and

- (4) The DSIC requirements, procedures, and customer safeguards.

5. Cal-Am shall make a supplemental filing within ten days of the effective date of this decision that addresses the Lead Action Levels in its Baldwin Hills subsystem. Its filing shall provide verification that the Baldwin Hills subsystem does not now exceed the Action Level for lead or, if it does, that Cal-Am is in compliance with all testing requirements and treatment techniques required by California and federal law for community water systems. If Cal-Am is not employing any treatment techniques recommended by DHS and EPA, it shall explain why. This filing shall be reviewed in Phase 2 of this proceeding.

6. If the Commission adopts a Water Revenue Adjustment Mechanism and a Modified Cost Balancing Account mechanism in Phase 2 of this proceeding, Cal-Am shall within five days of a final decision make a compliance filing to adjust its revenue requirement and rates to reflect an ROE reduction of .50%.

7. Cal-Am shall revise its 2008 Comprehensive Planning Study to include the infrastructure replacement strategy discussed in this decision.

8. A fine of \$11,000 is imposed on Cal-Am under Public Utilities Code Section 2107. Within 15 days of the effective date of this decision, Cal-Am shall remit to the State's General Fund the amount of \$11,000.

9. We grant the City of Bradbury's December 5, 2006 petition to intervene and deny the May 29, 2007 motions of California Water Service Company and California Water Association for party status.

This order is effective today.

Dated _____, at San Francisco, California.