

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

August 21, 2003

Agenda ID #2620  
Ratesetting

TO: PARTIES OF RECORD IN APPLICATION 02-07-025

This is the proposed decision of Administrative Law Judge (ALJ) Econome, previously designated as the principal hearing officer in this proceeding. It will not appear on the Commission's agenda for at least 30 days after the date it is mailed. This matter was categorized as ratesetting and is subject to Pub. Util. Code § 1701.3(c). Pursuant to Resolution ALJ-180 a Ratesetting Deliberative Meeting to consider this matter may be held upon the request of any Commissioner. If that occurs, the Commission will prepare and mail an agenda for the Ratesetting Deliberative Meeting 10 days before hand, and will advise the parties of this fact, and of the related ex parte communications prohibition period.

The Commission may act at the regular meeting, or it may postpone action until later. If action is postponed, the Commission will announce whether and when there will be a further prohibition on communications.

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

Parties to the proceeding may file comments on the proposed decision as provided in Article 19 of the Commission's "Rules of Practice and Procedure." These rules are accessible on the Commission's website at <http://www.cpuc.ca.gov>. Pursuant to Rule 77.3 opening comments shall not exceed 15 pages. Finally, comments must be served separately on the ALJ and the assigned Commissioner, and for that purpose I suggest hand delivery, overnight mail, or other expeditious method of service.

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

^ ALJ/^/^

**DRAFT**

ANG:jva

Decision **PROPOSED DECISION OF ALJ ECONOME** (Mailed 8/21/03)

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Application of BAKMAN WATER COMPANY (U 219 W) for Authority to: (1) Remove the Proceeds of Water Contamination Lawsuits from Contributions-In-Aid-of-Construction, (2) Increase Rate Base, and (3) Recover Increased Revenue Requirements in Rates.

Application 02-07-025  
(Filed July 9, 2002)

**OPINION ON BAKMAN WATER COMPANY'S  
GENERAL RATE CASE FOR TEST YEAR 2000**

(See Appendix A for Appearances)

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**OPINION ON BAKMAN WATER COMPANY'S  
GENERAL RATE CASE FOR TEST YEAR 2000**

**I. Summary**

This decision grants Bakman Water Company (Bakman) an increase in rates for its general rate case (GRC) for test year 2000, and sets rates under the operating ratio method at a 10% rate of margin.

**II. Backman's Application**

Bakman is a Class C water utility that provides water service to about 1830 customers in southeast Fresno. In Resolution W-4310, approved January 9, 2002, the Commission decided contested issues in Bakman's test year 2000 GRC. Among those issues was the ratemaking treatment of proceeds from two lawsuits regarding contamination of Bakman's wells. The Commission adopted the Water Division's recommendation to reduce Bakman's rate base to zero by recording the lawsuit proceeds as contributions in aid of construction (CIAC), which reduces utility rate base. However, the Commission authorized Bakman to file an application in support of its adjustments to CIAC and the rate base. Bakman timely filed the instant application on July 9, 2002.

The principal issue in this case is the appropriate disposition, as between ratepayers and shareholders, of the lawsuit proceeds. Bakman believes that the company is entitled to the net settlement proceeds, after paying for remediation. Therefore, Bakman requests the Commission order the company to: (1) remove from CIAC \$907,495 in proceeds from two lawsuits; (2) increase rate base by the same amount; and (3) recover in rates associated revenue requirements, determined as the higher of amounts calculated under conventional cost-of-service ratemaking or a 20% rate of margin under the operating ratio method.

The Commission's Water Division opposes this request, and believes, as a general principle, that ratepayers are entitled to the net settlement less remediation costs. In applying this principle to this case, Water Division recommends that Bakman return \$640,000 plus interest to ratepayers by paying off the outstanding Safe Drinking Water Bond Act (SDWBA) loan (about \$218,000 at the time the parties briefed this matter) and leaving the remaining funds in CIAC for ratepayer benefit. The Water Division also recommends that Bakman's rate base should not include the capital improvements for contaminated wells that were financed by the SDWBA loan or the lawsuit settlement proceeds. If the rates are set under the operating ratio method, Water Division recommends they be set on a 10% rate of margin.

This case also raises several other ratemaking issues which are addressed at the conclusion of this decision.

### **III. Contaminated Wells and Their Effect on Rates**

In 1989, the Department of Health Services determined that a number of Bakman's water wells were contaminated and required Bakman to remedy them. Bakman applied for and received a SDWBA loan of \$615,000 to cover associated repair and remediation costs. In order to pay off the SDWBA loan, the Commission authorized Bakman to collect a monthly surcharge from its customers beginning March 31, 1991. (See Decision (D.) 91-03-065.) The monthly surcharge includes both the principal and interest on the principal at 3.41% for 15 years. As of the end of December 2002, the balance remaining on the loan was \$218,435.

Soon after obtaining the SDWBA loan, Bakman filed two lawsuits against the polluters who caused the water contamination. First, Bakman filed a lawsuit against E & J Gallo (Gallo) in September 1992. In February 1993, the case settled

and Bakman received a gross settlement award of \$300,000 and incurred \$68,212 in legal fees. The Commission addressed the ratemaking treatment of that settlement award in Resolution W-3785 (June 23, 1993), where the Commission allowed Bakman a \$75,000 credit for legal fees and credited the remaining Gallo lawsuit proceeds of \$225,000 to CIAC, thereby reducing the ratebase by that amount.

On May 12, 1993, after the Gallo lawsuit settled, Bakman filed a lawsuit against Shell Oil Company (Shell Oil) and others, resulting in a net settlement of \$757,750.<sup>1</sup> This case was filed by Bakman's attorneys on a contingent fee basis, with Bakman paying no up-front legal expenses, but paying a set percentage of any recovery.

On June 20, 2000, Bakman initiated a test year 2000 GRC by advice letter. In accordance with Water Advisory Branch practices, Bakman did not submit an advice letter until it filed compliance tariffs after the Commission approved a rate increase. On April 19, 2001, the Commission issued Resolution W-4262, which authorized an interim rate increase covering uncontested rate case revenue requirements. On January 9, 2002, the Commission issued Resolution W-4310, which authorized a final rate increase. The resolution reduced Bakman's rate base to zero to reflect a \$ 907,779 credit to CIAC. The

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<sup>1</sup> On April 25, 1995, Bakman received \$74,939 from AMVAC. On June 7, 1995, Bakman received \$313 from Velsicol. On June 8, 1995, Bakman received \$682,498 from Shell Oil. These amounts are net of contingency fees.

CIAC amount is about equal to \$907,498, which is the sum of \$225,000 of Gallo net revenues and \$ 682,498 of Shell Oil net revenues.<sup>2</sup>

#### **IV. Procedural Background**

Water Division is the only party to protest Bakman's application. In its protest, Water Division requested evidentiary hearings to determine whether or not Bakman's request for removal of the lawsuit proceeds from CIAC is justified and to determine any other matter that arose during the proceeding. Before serving its testimony, Water Division conducted an audit of Bakman's regulatory books and records. We discuss some of the audit findings below.

On February 13 and 14, 2003, the Commission held evidentiary hearings. The case was submitted with the filing of supplemental briefs on May 23, 2003.

#### **V. Discussion**

##### **A. What is the Appropriate Ratemaking Treatment of the Lawsuit Proceeds?**

###### **1. Gallo Lawsuit Proceeds**

In 1993, the Commission reached a final determination as to the treatment of the \$225,000 net proceeds from the Gallo lawsuit, namely, that they be credited to the rate base (i.e., treated as CIAC). This final treatment was the result of a compromise between the company and the Water Division. (See Resolution W-3785 (June 23, 1993) at 2.) The Commission specifically noted the Gallo lawsuit proceeds in the discussion section of the resolution as follows:

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<sup>2</sup> Water Branch computed the rate base as negative \$10,950, but allowed zero for return rather than a negative return based on a negative rate base.

“One major difference was in the rate base calculations. BWC [Bakman] recently received a court settlement of \$300,000 from Gallo wineries for contamination of the water table and subsequent damage to some of BWC’s wells. BWC was allowed a credit of \$75,000 for legal expenses incurred in the lawsuit and the remaining \$ 225,000 was credited to rate base, thereby reducing rate base to \$296,552.” (Resolution W-3785, Reference Exhibit B at 2.)

Bakman argues that Resolution W-4310, which permitted Bakman to file this application, did not limit further review of CIAC adjustments to the Shell Oil lawsuit proceeds. Ordering Paragraph 2 of that resolution allowed Bakman to file an application “to develop a record to support adjustment of the Contributions-In-Aid-of-Construction and the rate base categories adopted in Appendix A...” Because the CIAC ratemaking in Appendix A includes both the Gallo and Shell Oil lawsuit proceeds, Bakman believes that both of these settlement proceeds are at issue here.

We disagree. The Gallo lawsuit proceeds appear in Appendix A because they were embedded in the total CIAC amount. The discussion in Resolution W-4310 states that the Commission’s prior treatment of the Gallo proceeds was a final decision and neither the discussion nor the ordering paragraphs indicate a specific intent to revisit this determination. [“...Res. No. W-3785, dated June 23, 1993, a final decision as a matter of law, orders BWC to treat \$225,000 of the \$300,000 judgment from Gallo as contributed plant...”].)<sup>3</sup>

Bakman also argues that the Commission should readdress disposition of the Gallo proceeds because the Commission can change any rate upon a showing before the Commission and a finding by the Commission that the new rate is justified. The outcome in 1993 was the result of a compromise between the parties, which involved give-and-take in all matters in the resolution. Because we approved the compromise as a whole in 1993, we do not revisit that outcome now. We, therefore, hold that the entire \$225,000 net proceeds from the Gallo

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<sup>3</sup> See Reference Exhibit E at 2.

lawsuit should continue to be credited to CIAC as required by Resolution W-3785.

## 2. Shell Oil Lawsuit Proceeds

### a) Commission Precedent

The appropriate ratemaking treatment for water contamination lawsuit proceeds is not an issue of first impression for the Commission. We have addressed this issue before in the context of a settlement. (See *Re Great Oaks Water Company (Great Oaks)*, Decision (D.) 93-04-061, 49 CPUC2d 116 and D. 93-09-077, 51 CPUC2d 366.) Because the *Great Oaks* case involved the approval of a settlement, it is not precedential here.

Nonetheless, a brief discussion of *Great Oaks* is instructive because it is the only Commission decision which addresses in any detail the appropriate allocation of water contamination lawsuit proceeds, and it contains some similarities to the instant case.<sup>4</sup> *Great Oaks* involved a Class A water utility whose wells were contaminated. The utility sued the polluters and eventually received settlement proceeds from them.

The utility argued that giving the money to ratepayers would be a seizure of investor funds and could constitute retroactive ratemaking. Commission staff argued that customers had borne the contamination risks, and the lawsuit proceeds should be flowed through to ratepayers.

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<sup>4</sup> There are also some marked differences, such as the fact that the plaintiffs in the *Great Oaks* lawsuits included not only the company, but also an individual who was a director of *Great Oaks*, as well as a family trust. The plaintiffs received a lump sum settlement and divided it among themselves. The Commission found the allocation to the water company, \$2.5 million, to be reasonable. (See 49 CPUC2d at 122-123.)

In the main GRC decision, the Commission found the record on this issue sparse and ordered a separate phase on the ratemaking for the lawsuit proceeds. (*See* 49 CPUC2d at 121-124.) The Commission discussed that equitable arguments favored crediting ratepayers for lawsuit revenues exceeding remedial costs. On the other hand, the Commission recognized that the money offset harm to the corporation, which should be free to use the funds as it likes.

The utility and staff settled, and the Commission adopted the settlement as reasonable because it was fair to both shareholders and ratepayers, and eliminated the need for the time and costs of further litigation. (*See* 51 CPUC2d 366.) The settlement was to book half of the \$2.5 million remaining settlement proceeds (the amounts remaining after remediation) to CIAC for future utility plant, and to give the other half of the proceeds to shareholders. The parties also agreed that 50% of any future utility investment would come from rate base.

#### **b) CIAC**

The concept behind CIAC is that rate base should be reduced by contributed capital. CIAC is defined as money or other consideration received by a utility to provide for the installation, improvement, replacement, or expansion of utility facilities. Bakman argues that neither the Gallo nor the Shell Oil lawsuit proceeds are CIAC, at least not to the extent that they exceed Bakman's costs of remediating the damages that were the subject of the lawsuits, because the net funds received by Bakman do not offset the costs of constructing utility plant. Because in this case the lawsuit proceeds exceed the remediation costs, we determine the appropriate ratemaking treatment of the proceeds based on the specific facts of this case, including an assessment of the risks and rewards of shareholders and ratepayers.

### **c) Bakman's Risks**

Both Bakman's shareholders and ratepayers faced several risks because of water contamination. Bakman asserts the following risks which we discuss below. Although we agree that some, but not all, of these items were risks for Bakman, we find that the company has been made whole through receipt of the SDWBA loan and settlement proceeds.

#### **(1) Loss of Value of the Wells**

When the contamination was discovered, shareholders faced risks of losing some of their investment and incurring out-of-pocket expenses to fix or repair the contaminated wells. However, through the lawsuit proceeds and SDWBA loan, shareholders have recovered all of their losses and have been made whole.

#### **(2) Remediation and Repair Costs Were Uncertain**

Bakman had a reasonable expectation that it would be granted a SDWBA loan and that the Commission would allow recovery of some remediation and repair costs. However, Bakman was at risk to the extent that rate recovery is subject to some delay. However, this was not a large risk, and Bakman has been made whole.

#### **(3) Legal Expenses Varied From the Amounts Included in Rates**

At the time Bakman initiated the Shell Oil lawsuit, it had just completed its 1993 GRC. The resolution resolving the rate case included a fixed amount of

\$86,516 for professional services, determined on a forecast basis.<sup>5</sup> Professional services expenses generally forecast legal, engineering, accounting, regulatory consulting and other such expenses. The level of expenses included in rates was fixed for test year 1993 and all subsequent years until the Commission approved Resolution W-4262 in April 2001.

While it is true under general ratemaking principles that shareholders bear some risk that the legal expenses might be higher or lower than whatever amount was forecast for such expenses, Bakman was able to proceed with the Shell Oil lawsuits on a contingent fee basis, thus incurring no legal fees unless it was victorious in the underlying lawsuit. Thus, Bakman had no actual risk for these expenses.

#### **(4) Eventual Settlement Proceeds Were Uncertain**

Bakman had hopes of settling the lawsuits when they were filed, but the amount and timing of the proceeds were uncertain. Bakman argues that to deny shareholders recovery of the proceeds would give water utilities zero incentive to pursue water contamination lawsuits.

We agree that the amount and timing of the lawsuit proceeds were a minor risk for Bakman, but strongly disagree that water utilities have no incentive to pursue water contamination lawsuits unless shareholders can obtain 100% recovery of the proceeds. As a regulated utility, Bakman is required by law to provide safe and reliable water service to its ratepayers. (See, e.g., General Order 103.) Bakman also had a strong incentive to recover damages from polluters

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<sup>5</sup> In the 1993 GRC, the forecasted professional services amount increased from \$6,680 to \$86,516.

rather than bearing the sole responsibility for repairing or replacing the contaminated wells.

**(5) Financing of Remediation and Repair Could Affect Utility Cash Flows**

Bakman's cash flows were affected by the contamination events. In 1992, before it received lawsuit proceeds, Bakman borrowed more than \$300,000 in short-term cash financing from family-owned companies. However, Bakman also received the SDWBA loan in 1991.

We agree that this item was a risk for the company; however, Bakman has been made whole.

**(6) Contamination Events Underlying the Lawsuits Could Recur or Spread After the Lawsuits Settled**

Bakman argues that by settling the Gallo and Shell Oil lawsuits, shareholders have assumed the risk that further contamination may arise from the known contamination, and Bakman will not be able to recover additional damages. In that instance, Bakman argues that investors risk losing the opportunity to earn a rate of return on their assets, as well as the market value of their property.

Although this item may pose a risk for shareholders, this matter is also a major risk for the ratepayers. If further contamination occurs, and Bakman has insufficient funds, it might come to the Commission to seek recovery of a non-recurring cost. Given Bakman's treatment of the settlement proceeds and the outcome we reach today, Bakman would have to prove compelling circumstances to justify such a request. We cannot and need not decide this potential issue at this time; we only note that both ratepayers and shareholders are at future risk if further contamination occurs.

**d) Ratepayer's Risks****(1) SDWBA Loan Surcharge**

Ratepayers assumed a large financial obligation by paying for the SDWBA loan, including principal and interest, since 1991, without receiving certainty that they would be reimbursed for any or all of this amount. The surcharge is not scheduled to end until 2007, and ratepayers are still paying this loan.

From 2002, both the Gallo and Shell Oil lawsuit proceeds were credited to CIAC. Also, as noted below, Bakman's 1993 rate case assigned the proceeds of the Gallo lawsuit to CIAC.<sup>6</sup> However, ratepayers have not been made whole for their payments on the SDWBA loan.

**(2) Legal Expenses**

Water Division also argues that ratepayers have paid about \$75,000 annually in legal expenses from June 1993 to April 2001, because in Bakman's 1993 GRC, the Commission recognized that Bakman may incur similar legal fees as to those incurred in the Gallo lawsuit to sue other polluters. For this reason, the Water Division argues that the Commission increased Bakman's rates for professional services from \$6,680 to \$86,516, thus adding approximately \$75,000 to the professional services account. Bakman argues that Resolution W-3785 does not specifically earmark this amount for legal services.

We need not decide how much of the forecast for professional services is attributable to forecast legal expenses for anticipated contamination lawsuits.

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<sup>6</sup> Bakman argues that crediting the lawsuit proceeds to CIAC is a ratepayer benefit which offsets the ratepayers' risks. However, a credit to CIAC is generally offset by an addition to gross plant for the additional expenditures made on the plant. Thus, this entry may not necessarily be a ratepayer benefit sufficient to offset their loan payments.

The fact is that Bakman received a substantial increase from prior years for its forecast professional services, which include legal services, and ratepayers were at risk that the legal expenses would be lower than those forecast in the test year. This turned out to be correct. However, this is a risk inherent in GRC forecasts, and is not directly attributable to the Shell Oil lawsuit. As stated above, neither shareholders or ratepayers bore any risk regarding Shell Oil lawsuit attorneys fees, since the lawsuit was handled on a contingent fee basis.

### **(3) Return on Bakman's Investments**

Ratepayers also paid for a return on Bakman's investments from June 1995, when Bakman received the Shell Oil proceeds, until April 2001 when the rates for its 2000 GRC took effect. However, the wells were repaired with lawsuit proceeds, not from shareholder funds. According to the Water Division, the contributions should have been deducted from the plant rate base, and ratepayers were at risk that the forecast in the 1993 rate case did not include the effect of the Shell Oil lawsuit proceeds. This was a risk, and was exacerbated because Bakman failed to file a general rate case between 1993 and 2000.

#### **e) Balancing the Relative Risks to Determine the Appropriate Allocation of the Shell Oil Lawsuit Proceeds**

Determining the appropriate allocation of the Shell Oil lawsuit proceeds is fact specific. Because of this, we do not announce a general principle on allocation applicable to all water contamination lawsuit proceeds. However, we have a strong preference to consider prospectively the options for evaluating revenue. Our ratemaking for water utilities is classic public utility ratemaking, based on forecasts of future test years. The predicament presented by this application involving retrospective allocation of funds after the passage of many

years, adds substantial complexities, especially when the monies in question have already been spent.

Generally, when a water public utility receives substantial and unexpected revenues (in this case, the water contamination lawsuit proceeds), it should place the money in a memorandum account and file an advice letter seeking Commission guidance on the appropriate accounting of that revenue. In that manner, the Commission can prospectively evaluate the options for allocating the revenue.

We now address the appropriate allocation of the Shell Oil lawsuit proceeds if this allocation were to have occurred prospectively. As discussed above, ratepayers and shareholders both assumed significant risks associated with the water contamination lawsuits and events leading up to them. Because of these risks, we determine that the appropriate allocation should have been to make ratepayers and shareholders whole for the costs of remediation each assumed, and to equally divide the excess amount, if any. We caution that this holding applies to this case only; we might reach a different outcome based on different facts.<sup>7</sup>

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<sup>7</sup> Contrary to the parties' urgings, we cannot and do not assign a dollar figure to each risk each side assumed in this matter to determine what should have been the appropriate apportionment. There are endless potential scenarios and some of these risks are virtually unquantifiable.

### **3. Ratemaking Treatment Regarding Shell Oil Lawsuit Proceeds**

#### **a) Small Water Company GRCs**

Pub. Util. Code § 451 requires that all rates charged by a public utility be just and reasonable. The Commission has determined that such rates must be based on the reasonable cost of providing service to customers. Specifically, the Commission uses projections of future costs – a “future test year” – to evaluate whether the revenue to be collected from customers under proposed rates would cover the utility’s costs.

For large water utilities, the Commission has set a three-year schedule for each utility to present a general rate case to the Commission. In this way, the Commission can monitor revenue and cost levels to ensure that the utility is neither over nor under earning. (See *re Schedule for Processing Rate Case Applications by Water Utilities*, D.90-08-045; 37 CPUC2d 175.)

For small water utilities such as Bakman, the cost of presenting a formal rate case to the Commission is a significant expense. The Commission, therefore, has established a simplified procedure for rate case review, which enables small water utilities to obtain rate review and needed modifications more economically. The Commission has not imposed a specific time schedule on small water utilities to file general rate cases. Despite this flexibility, the Commission has not wavered from its commitment that small water utilities charge cost-based rates.

#### **b) Practical Realities**

In Resolution W-4310, the Commission adopted Water Division’s recommendations, giving Bakman a zero net rate of return on its ratebase. Bakman argues and the Water Division does not dispute that maintaining rates

at this level would eventually subject the company to bankruptcy. Specifically, Bakman opposes the Water Division's proposal that it pay off the SDWBA loan balance immediately, arguing that it does not have enough cash or available credit to do this.

Bakman states that at the end of 2002, Bakman had (\$16,903), a negative figure, in its operational bank account and \$8,799 in its payroll account. However, Bakman concedes that there are almost \$200,000 in accumulated profits which Bakman is holding in an irregular account called the Partners' Fund.<sup>8</sup> According to Bakman, even if it used the Partners Fund money immediately, the available cash at the end of 2002 would have been \$190,372, less than the outstanding loan balance at that time.

Because of these arguments, Water Division has modified its position and now recommends that Bakman be required to pay off the SDWBA loan balance on a monthly basis. However, Bakman still argues it will be unable to afford these payments.

### **c) Discussion**

We direct the following allocation of the Shell Oil lawsuit proceeds, weighing the equities of allocating these proceeds as stated above, while considering the ongoing needs of the utility. (See e.g. *Re California Water Service Company*, D.94-04-032, 56 CPUC2d 4, 16.) Bakman shall bear the sole responsibility for the remaining balance of the SDWBA loan, and shall assume

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<sup>8</sup> The Water Division states that the Fund's purpose is to account for and record affiliate transactions such as loan and accounts payable among the various Bakman family-owned businesses. Water Division believes that Bakman's accumulated profits are accounted for and belong in its Retained Earnings Account, and not in the Partners' Fund.

the quarterly payments as it is currently doing in accordance with the Department of Water Resource's loan repayment schedule. The money to pay off the remaining loan balance (principal and interest) shall be paid by shareholders, and not by ratepayers. The monthly surcharge imposed on ratepayers to pay for this loan shall be terminated on the date the tariffs authorized by this decision become effective. This is the best method to ensure that ratepayers are reimbursed at least some portion of their expenditures toward the remediation costs.<sup>9</sup> Because of the significant sum the Partner's Fund owes Bakman, we believe the company is able to make these quarterly payments.

We also direct that \$232,250 of the Shell Oil lawsuit proceeds be credited to CIAC. This figure represents one half of the balance of the Shell Oil lawsuit proceeds, after deducting the remaining SDWBA loan balance.<sup>10</sup> This credit (and the Gallo credit) to CIAC may be amortized over the useful life of the plant in service if the utility plant in service was constructed or acquired with the CIAC funds. The remaining balance of the settlement proceeds in CIAC should not be amortized until such time when these funds are used for new plant additions or improvements.

Because rates set on the rate base resulting from today's decision may lead to a financially unhealthy utility, we direct that rates be set under the operating ratio method at a 10% rate of margin. This rate of margin is based on the

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<sup>9</sup> We also direct a credit of a portion of the Shell Oil lawsuit proceeds to CIAC, and in theory this should benefit ratepayers; however, because we set Bakman's rates under the operating ratio method, ratepayers will not realize this benefit at least in the next rate case cycle.

<sup>10</sup> \$682,500 (the Shell Oil lawsuit proceeds rounded) less \$218,000 (the SDWBA loan balance as of December 2002) is \$464,500. One-half of this number is \$232,250.

Water Division's recommendations and testimony that other water utilities comparable to Bakman have rates of margin in the range of 5% to 15%. It is also appropriate in that ratepayers will not benefit in this rate case cycle from crediting the lawsuit proceeds to CIAC because the operating ratio method does not include a rate of return on plant. We therefore reject Bakman's proposal that we adopt at 20% margin.

### **B. Other Issues**

We adopt the following recommendations of the Water Division's audit:

- Bakman's rate base should not include \$710,872 of capital improvements for contaminated wells that were financed by SDWBA funds and lawsuit proceeds. This recommendation is appropriate because these funds were provided by third parties and not by the company.
- Bakman shall maintain better and more detailed financial records for its expenditures.<sup>11</sup>
- Bakman shall maintain detailed records of any and all transactions it enters into with other businesses, including businesses owned by Bakman family members.
- Bakman shall develop continuing property records for capital plant expenditures funded by SDWBA loan funds.

Additionally, many of these problems arose because Bakman went over seven years between GRC filings. We, therefore, require that Bakman file its next

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<sup>11</sup> For example, with respect to professional services, Bakman shall record the types of services performed, the reasons, justifications, dates, and amounts of the services.

GRC with the Commission no later than three years from the effective date of this decision.<sup>12</sup>

We also require that in the future, the company's accumulated earnings shall be held in a retained earnings account. Furthermore, Bakman shall correct its entries in its accounting books and shall submit all accounting entries to the Water Division for approval no later than 90 days after the effective date of this decision.

The parties stipulated as to revenue allocation and rate design issues. Allocation of any revenue requirement change to Bakman's four retail rate schedules will be based on equal percentage change over present rate revenues, excluding current or recently applicable rate components that amortize an undercollection of purchased power costs.<sup>13</sup> This allocation is reasonable and we adopt it.

Bakman shall implement revised rates by advice letter filed within 30 days after the effective date of this decision, which rates shall be effective five days after the date of filing. The revised rates shall be consistent with the summary of earnings and the revised schedules attached to this decision as Appendix B. Appendix C are the new tariff sheets, Appendix D contains rate comparisons, and Appendix E contains adopted quantities..

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<sup>12</sup> This requirement is reasonable given that this GRC is for test year 2000.

<sup>13</sup> The four rate schedules are: Schedule No. 1, General Metered Service; Schedule No. 2, General Flat Rate Service; Schedule No. 4, Private Fire Protection Service; and Schedule No. 5, Public Fire Protection. (See Exhibit 4 for the details of the stipulation.)

**VI. Comments on the Proposed Decision**

The proposed decision of the Administrative Law Judge (ALJ) in this matter was mailed to the parties in accordance with Section 311(d) of the Public Utilities Code and Rule 77.7 of the Rules of Practice and Procedure.

**VII. Assignment of Proceeding**

Michael R. Peevey is the Assigned Commissioner and Janet A. Econome is the assigned ALJ in this proceeding.

**Findings of Fact**

1. Bakman is a Class C water utility that provides water service to about 1830 customers in Southeast Fresno, California.
2. In 1989, the Department of Health Services determined that a number of Bakman's water wells were contaminated and required Bakman to remedy them. Bakman applied for and received a SDWBA loan of \$615,000 to cover associated repair and remediation costs.
3. In order to pay off the SDWBA loan, the Commission authorized Bakman to collect a monthly surcharge from its customers beginning March 31, 1991. The monthly surcharge includes both the principal and interest on the principal at 3.41% for 15 years. As of the end of December 2002, the balance remaining on the loan was \$218,435.
4. Soon after obtaining the SDWBA loan, Bakman filed two lawsuits against the polluters who caused the water contamination. First, Bakman filed a lawsuit against Gallo in September 1992. In February 1993, the case settled and Bakman received a gross settlement award of \$300,000 and incurred \$68,212 in legal fees. On May 12, 1993, after the Gallo lawsuit settled, Bakman filed a lawsuit against Shell Oil and others, resulting in a net settlement of \$757,750. This case was filed by Bakman's attorneys on a contingent fee basis.

5. The Commission, in Resolution W-3785 (June 23, 1993), allowed Bakman a \$75,000 credit for legal fees and credited the remaining Gallo lawsuit proceeds of \$225,000 to CIAC, thereby reducing the rate base by that amount. This outcome was a result of a compromise, which involved give-and-take in all matters in the resolution.

6. Both Bakman's shareholders and ratepayers faced several risks because of the water contamination lawsuits. Bakman has been made whole for the risks assumed through receipt of the SDWBA loan and settlement proceeds, whereas the ratepayers have not been made whole for the risks that they have faced.

7. Bakman has the incentive to pursue water contamination lawsuits even if shareholders cannot obtain 100% recovery of the proceeds from these lawsuits. As a regulated utility, Bakman is required by law to provide safe and reliable water service to its ratepayers. Bakman also had a strong incentive to recover damages from polluters rather than bearing the sole responsibility for repairing or replacing the contaminated wells.

8. We have a strong preference to consider prospectively the options for evaluating revenue. Our ratemaking is based on forecasts of future test years. Retrospective allocation of funds after the passage of many years adds substantial complexities, especially when the monies in question have already been spent.

9. We determine the appropriate allocation of the Shell Oil lawsuit proceeds by weighing the equities of allocating these proceeds while considering the ongoing needs of the utility.

### **Conclusions of Law**

1. Because we approved a compromise in Resolution W-3785 in 1993, we do not revisit that outcome today.

2. The entire \$225,000 net proceeds from the Gallo lawsuit should continue to be credited to CIAC as required by Resolution W-3785.

3. Because in this case the lawsuit proceeds exceed the remediation costs, we determine the appropriate ratemaking treatment of the proceeds based on the specific facts of this case, including an assessment of the risks and rewards of shareholders and ratepayers.

4. Generally, when a water public utility receives substantial and unexpected revenues (in this case, the water contamination lawsuit proceeds), it should place the money in a memorandum account and file an advice letter seeking Commission guidance on the appropriate accounting of that revenue.

5. The appropriate allocation of the Shell Oil lawsuit proceeds, if they were allocated prospectively, would have been to make ratepayers and shareholders whole for the costs of remediation each assumed, and to equally divide the excess amount if any.

6. At the effective date of the tariffs authorized by this decision, Bakman should bear the sole responsibility for the remaining balance of the SDWBA loan, and should assume the quarterly payments as it is currently doing in accordance with the Department of Water Resource's loan repayment schedule. The money to pay off the remaining loan balance (principal and interest) should be paid by shareholders and not by ratepayers. The monthly surcharge imposed on ratepayers to pay for this loan should be terminated on the date the tariffs authorized by this decision become effective.

7. \$232,250, representing a portion of the Shell Oil lawsuit proceeds, should be credited to CIAC.

8. The CIAC credits for the Gallo and Shell Oil lawsuit proceeds may be amortized over the useful life of the plant in service if the utility plant in service

was constructed or acquired with CIAC funds. The remaining balance of the settlement proceeds in CIAC should not be amortized until such time when these funds are used for new plant additions or improvements.

9. Rates should be set under the operating ratio method at a 10% rate of margin.

10. The following recommendation from the Water Division audit should also be adopted:

- Bakman's rate base shall not include \$710,872 of capital improvements for contaminated wells that were financed by SDWBA funds and lawsuit proceeds.
- Bakman shall maintain better and more detailed financial records for its expenditures.
- Bakman shall maintain detailed records of any and all transactions it enters into with other businesses, including businesses owned by Bakman family members.
- Bakman shall develop continuing property records for capital plant expenditures funded by SDWBA loan funds.

11. Bakman's accumulated earnings should be held in a retained earnings account.

12. Bakman should correct its entries in its accounting books and should submit all accounting entries to the Commission's Water Division for approval no later than 90 days after the effective date of this decision.

13. Bakman should file its next GRC no later than three years from the effective date of this decision.

14. Because we wish these rates to take effect as soon as possible, this decision should be effective immediately.

**O R D E R****IT IS ORDERED** that:

1. Bakman Water Company (Bakman) shall implement revised rates by advice letter filed within 30 days after the effective date of this decision, which rates shall be effective five days after the date of filing. The revised rates shall be consistent with the summary of earnings and the revised schedules attached to this decision as Appendix B, and shall concurrently cancel Bakman's presently effective date schedules: (1) General Metered Service; (2) General Flat Rate Service; (4) Private Fire Protection Service; and (5) Public Fire Protection Service. This filing shall comply with General Order 96-A.

2. At the effective date of the tariffs authorized by this decision, Bakman shall bear the sole responsibility for the remaining balance of the Safe Drinking Water Bond Act (SDWBA) loan, and shall assume the quarterly payments as it is currently doing in accordance with the Department of Water Resource's loan repayment schedule. The money to pay off the remaining loan balance (principal and interest) shall be paid by shareholders and not by ratepayers. The monthly surcharge imposed on ratepayers to pay for this loan shall be terminated on the date the tariffs authorized by this decision become effective.

3. The entire \$225,000 net proceeds from the E & J Gallo (Gallo) lawsuit shall continue to be credited to contributions in aid of construction (CIAC) as required by Resolution W-3785 (June 23, 1993).

4. \$232,250, representing a portion of the Shell Oil Company (Shell Oil) lawsuit proceeds, shall be credited to CIAC.

5. The CIAC credits for the Gallo and Shell Oil lawsuit proceeds may be amortized over the useful life of the plant in service if the utility plant in service

was constructed or acquired with CIAC funds. The remaining balance of the settlement proceeds in CIAC shall not be amortized until such time when these funds are used for new plant additions or improvements.

6. Rates shall be set under the operating ratio method at a 10% rate of margin.

7. The following recommendation from the Water Division audit are adopted:

- Bakman's rate base shall not include \$710,872 of capital improvements for contaminated wells that were financed by SDWBA funds and lawsuit proceeds.
- Bakman shall maintain better and more detailed financial records for its expenditures.
- Bakman shall maintain detailed records of any and all transactions it enters into with other businesses, including businesses owned by Bakman family members.
- Bakman shall develop continuing property records for capital plant expenditures funded by SDWBA loan funds.

8. Bakman's accumulated earnings shall be held in a retained earnings account.

9. No later than 90 days after the effective date of this decision, Bakman shall correct its entries in its accounting books and shall submit all accounting entries to the Commission's Water Division for its approval.

10. Bakman shall file its next general rate case no later than three years from the effective date of this decision

11. This proceeding is closed.

This order is effective today.

Dated \_\_\_\_\_, at San Francisco, California.

**APPENDIX A**

\*\*\*\*\* APPEARANCES \*\*\*\*\*

James Weil  
AGLET CONSUMER ALLIANCE  
PO BOX 1599  
FORESTHILL CA 95631  
(530) 367-3300  
jweil@aglet.org  
For: Bakman Water Company

Sindy J. Yun  
Legal Division  
RM. 4107  
505 VAN NESS AVE  
San Francisco CA 94102  
(415) 703-1999  
sjy@cpuc.ca.gov  
For: Water Division

Richard Tim Bakman B  
President  
BAKMAN WATER COMPANY  
PO BOX 7965  
FRESNO CA 93747  
(559) 255-0324  
tim@bakmanwater.com  
For: Bakman Water Company

Stacie M Castro  
Legal Division  
RM. 5025  
505 VAN NESS AVE  
San Francisco CA 94102  
(415) 703-4530  
smc@cpuc.ca.gov  
For: Water Division

Donald McCrea  
Water Division  
AREA 3-B  
505 VAN NESS AVE  
San Francisco CA 94102  
(415) 703-3087  
don@cpuc.ca.gov  
For: Water Division