

Decision PROPOSED DECISION OF ALJ MCVICAR (Mailed 7/21/2006)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of California Water Service Company (U60W) for an Order Authorizing it to Increase Rates Charged for Water Service in the Antelope Valley District by \$437,218 or 36.94% in fiscal 2006-2007, by \$145,000 or 8.94% in Fiscal 2007-2008, and \$145,000 or 8.21% in Fiscal 2008-2009.

Application 05-08-006
(Filed August 8, 2005)

And Related Matters.

Application 05-08-007
Application 05-08-008
Application 05-08-009
Application 05-08-010
Application 05-08-011
Application 05-08-012
Application 05-08-013
(Filed August 8, 2005)

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Jonathan J. Reiger, Attorney at Law, and Yoke W. Chan, for the Commission's Division of Ratepayer Advocates, interested party.
Stephen R. Elias, Attorney at Law, for Lucerne Community Water Organization; Joseph S. Lucido and Jack L. Chacanaca for Leona Valley Cherry Growers' Association; and Marcos Pareas, Jeffrey Young, and Jack Miller for themselves; interested parties.

OPINION GRANTING GENERAL RATE INCREASES

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OPINION GRANTING GENERAL RATE INCREASES

Summary

This decision approves general rate increases for eight California Water Service Company (CalWater) districts for fiscal test year 2006/2007. Additional rate adjustments for the second and third years will be determined when advice letters for those years are filed and evaluated in May 2007 and May 2008 using summary of earnings figures we adopt today and the most recent escalation factors available at that time. In addition, CalWater may file advice letters to offset the revenue requirements of certain plant additions as they are completed over the three year rate case cycle, costs associated with its general office expansion project, costs of up to 15 specific general office personnel, and amounts booked in the general office synergies memorandum account for the Bear Gulch, Hermosa-Redondo and Marysville districts.

We also approve an all-party settlement leading to the establishment of a high-cost area general rate assistance benefit to all customers in the Redwood Valley and Kern River Valley districts and the Fremont Valley area of Antelope Valley district, and additional rate assistance to qualifying low-income customers in those three districts. Because the parties were unable to meet their commitment to fully define and finalize it, we do not adopt a separate, uncompleted stipulation agreement between CalWater and Division of Ratepayer Advocates (DRA) that proposed to establish increasing block rate structures and accompanying revenue and variable expense balancing accounts for all eight districts. To address the goals of the Water Action Plan, we order CalWater within 60 days to file a new application that proposes an increasing block rate design for each of these districts for years 2007/2008 and 2008/2009, and an accompanying mechanism to decouple sales from revenues. This proceeding is closed.

Background

CalWater, a California corporation, is a wholly owned subsidiary of California Water Service Group, which also includes Washington Water Service Company, New Mexico Water Service Company, Hawaii Water Service Company, and CWS Utility Services. As California's largest Commission-regulated water utility, it serves approximately 430,000 customers in 24 districts throughout the state. Under the Commission's Rate Case Plan (RCP) for Class A Water Utilities, CalWater files general rate case (GRC) applications on a three-year cycle for eight districts each year. This proceeding addresses test year 2006/2007 and escalation years 2007/2008 and 2008/2009 for these eight districts: Antelope Valley, Bear Gulch, Dominguez-South Bay, Hermosa-Redondo, Kern River Valley, Marysville, Palos Verdes, and Redwood Valley.¹

CalWater filed these applications on August 8, 2005, and the Commission in Resolution ALJ 176-3157 preliminarily determined them to be ratesetting proceedings expected to go to hearing. Assigned Administrative Law Judge (ALJ) James McVicar held a prehearing conference on September 9, 2005 at which he consolidated all eight applications. Assigned Commissioner John Bohn's September 26, 2005 scoping ruling confirmed the category and need for hearing, defined the issues, established a schedule, and designated ALJ McVicar as the principal hearing officer and thus the presiding officer.

ALJ McVicar conducted public participation hearings during October and November 2005 in Lancaster, Kernville, Lake Isabella, Marysville, Menlo Park, Lucerne, Guerneville, and Redondo Beach, a second prehearing conference on

¹ Redwood Valley District consists in turn of three separate ratemaking areas: Lucerne, Redwood Unified, and Coast Springs.

November 30 at which the parties reported on their efforts to reach agreements before finalizing their positions, and six days of evidentiary hearing in San Francisco between January 24 and January 31, 2006.² The proceeding was submitted on receipt of closing briefs due March 9, 2006.

CalWater's applications request the rate increases shown in Table 1 to counter the effects of substantial increases in major expense items and plant investment since the last GRCs for these districts.³ The last two columns show our adopted changes for test year 2006/2007. Appendix D compares customer bills at current and adopted rates. The RCP requires CalWater to list for each district the five most significant factors driving the increases. Those factors having the greatest effect across all districts are increased plant investments and rate base, higher requested rate of return, increased pension and benefits and personnel costs in the general office,⁴ increased district payrolls, and increased pumping and/or purchased water expense.

² In granting the intervenors other than DRA party status, the assigned ALJ limited their participation to matters potentially affecting their own ratemaking areas. Parties Young and Pareas were limited to matters affecting Redwood Valley's Coast Springs rate area; party Miller to matters affecting Redwood Valley's Unified rate area; party Lucerne Community Water Organization (LCWO) to matters affecting Redwood Valley's Lucerne rate area; and party Leona Valley Cherry Growers' Association (LVCGA) to matters affecting Antelope Valley District.

³ Requested and adopted increases are shown for 2006/2007. For 2007/2008 and 2008/2009, the increases shown as requested are only estimates based on April 2005 escalation factors. The application-requested columns include the rate effects of major plant addition projects to be filed later by advice letter. Those rate effects are not reflected in the adopted figures. In addition, CalWater seeks Commission approval to amortize balances in various balancing and memorandum accounts. The rate effects of those additional requests are also not included in the Table 1 figures.

⁴ This proceeding does not adjudicate CalWater's general office costs overall, although it does examine general office synergy savings resulting from CalWater's merger with

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**Table 1
Requested and Adopted Increases**

		Requested Increase						Adopted Increase	
		2006/2007		2007/2008		2008/2009		2006/2007	
Application	District	\$	%	\$	%	\$	%	\$	%
A.05-08-006	Antelope Valley	437,218	36.94	145,000	8.94	145,000	8.21	385,700	32.6
A.05-08-007	Bear Gulch	2,107,653	11.16	1,099,700	5.24	1,099,700	4.97	405,500	2.1
A.05-08-008	Dominguez- South Bay	321,289	1.01	874,600	2.71	874,600	2.64	1,022,400	3.2
A.05-08-009	Hermosa-Redondo	1,313,889	7.43	566,600	2.98	566,600	2.89	255,800	1.4
A.05-08-010 (as amended)	Kern River Valley	1,958,687	75.58	255,700	5.61	255,700	5.31	805,300	31.0
A.05-08-011	Marysville	592,959	31.19	423,200	16.96	423,200	14.50	101,100	5.0
A.05-08-012	Palos Verdes	2,111,565	8.38	1,890,300	6.91	1,890,300	6.47	855,600	3.4
A.05-08-013 (as amended)	Redwood Valley Coast Springs	255,290	322.7	7,900	2.36	7,900	2.31	124,400	150.6
	Redwood Valley Lucerne	1,351,700	246	305,800	16.1	305,800	13.8	667,100	121.0
	Redwood Valley Unified	454,200	149.3	18,800	2.5	18,800	2.4	257,700	80.8

CalWater prepared its request using a 12.23% return on common equity, which it estimated would produce rates of return on rate base of 9.58% in 2006/2007, 9.63% in 2007/2008, and 9.68% in 2008/2009.

Discussion

RBEA and the Rate Support Fund Settlement

In its applications, CalWater sought approval to establish a company-wide subsidy program to benefit three districts (Antelope Valley, Redwood Valley, and Kern River Valley) that have much higher than average rate bases per customer.⁵ Rather than following the Commission's standard practice of using a rate base calculated from the plant investment, depreciation reserve and other factors specific to each district, CalWater's so-called RBEA (Rate Base Equalization Account) proposed to set the rates for these three districts using the company-wide (24-district) average rate base per customer. Imputing a lower rate base would reduce each high-cost district's revenue requirement and thus its rates. The revenues foregone by charging these lower rates would accumulate in a balancing or memorandum account with interest at the company's authorized rate of return, and would eventually be charged to all customers company-wide as part of the general office allocations.

Also, at the first prehearing conference and in the Assigned Commissioner's Scoping Ruling, the parties were urged to develop proposals to moderate the potential rate impacts these applications could have on CalWater's low-income customers.

⁵ Notice of the RBEA proposal and the effect it could have was provided to all CalWater customers statewide early in the proceeding.

On March 2, 2006, the parties submitted an all-party settlement proposing to establish a new Rate Support Fund (RSF) to address both issues.⁶ The new RSF settlement would supersede the RBEA proposal and lower rates in these three high-cost districts by spreading some of their costs across all 24 districts. It would also provide support for a new low-income ratepayer assistance program. The details of the parties' agreement are spelled out in their RSF settlement attached to this decision as Appendix G.

The new RSF would be funded by a volumetric surcharge on every unit of water CalWater sells in all 24 districts, and a per customer charge for unmetered customers on a flat rate. The duration of the RSF would be this three-year GRC cycle, and the RSF credits and surcharges would be booked into a single balancing account.⁷

Two aspects of the RSF settlement require our interpretation before they could be implemented: how to define in tariffs the general rate assistance subsidy the three districts would receive, and how to define in tariffs the RSF surcharge applicable to all CalWater districts. We interpret the RSF settlement to call for general rate assistance subsidies as set forth in settlement Section 4, *i.e.*,

⁶ *Joint Motion of California Water Service Company and The Division of Ratepayer Advocates to Approve Stipulation Concerning Rate Base Equalization Account Settlement*, with attached *Rate Base Equalization Account Settlement* ("RSF settlement") filed March 2, 2006.

⁷ The RSF settlement, Section 8, sets forth certain specific procedures to be applicable to the RSF balancing account, including how subsidies and surcharges are to be booked, when and how the surcharge should be adjusted, and a provision for balances to accrue interest at the 90-day commercial paper rate. In the absence of settlement provisions to the contrary, in all other respects the RSF balancing account would be governed by the Commission's procedures for balancing accounts generally. (See RSF settlement, Section 18).

precisely \$20 per customer per month in Kern River Valley district⁸, \$17 per customer per month in the Lucerne rate area, \$8.50 per customer per month in the Fremont Valley service area, \$6.05 per Ccf (one-hundred cubic feet) in the Coast Springs rate area, and \$1.76 per Ccf in the Redwood Valley Unified rate area.⁹ These subsidy amounts are based on various underlying assumptions made by the parties; absent any future Commission order to the contrary, we consider these subsidies fixed for the duration of this GRC cycle, not to be adjusted should any party later believe the underlying assumptions to have been incorrect. With respect to the RSF surcharge to be applied in all 24 CalWater districts, we interpret the RSF settlement to call for an initial \$0.009 per Ccf surcharge on all metered water usage (except usage by low-income customers), or, for unmetered, flat rate customers, surcharges between \$0.24 and \$0.36 per customer depending on the district, both as referenced in settlement Section 5 and further detailed in settlement Attachment B, page 2. RSF surcharges are to be adjusted later if necessary to correct excessive imbalances in the account, following the provisions of settlement Section 8 and the Commission's standard balancing account procedures. The tariffs we adopt will reflect these outcomes.

Additionally, the tariffs will provide that in no instance should the total amount of the combined (general rate assistance plus low-income) subsidy

⁸ RSF support (both high-cost district and low-income) for Kern River Valley district will be implemented at the same time the rate increase associated with infrastructure improvements (see Appendix F) to comply with the new arsenic standard becomes effective. (RSF Settlement, Section 6).

⁹ These are the subsidy levels set forth in RSF settlement Section 4.a. Wording in the first sentence of Section 3 could lead one to interpret the general rate assistance subsidy for each district to be implemented differently.

received by a customer in any month exceed that customer's water bill for service received in that month.

Two statements in the settlement merit comment:

Parties acknowledge that CWS has an application pending (A.05-10-035) for a company-wide low income rate assistance (LIRA) program that would apply to all CWS districts. Parties agree that low income customers in Antelope Valley, Kern River Valley and Redwood Valley should receive the higher of any low income assistance authorized in that proceeding or the low income assistance adopted in the instant proceeding, but not both. Parties expect that in A.05-10-035 the low income assistance and corresponding surcharges authorized in this proceeding will be combined into the company-wide low income rate assistance fund and surcharge mechanism that is adopted in A.05-10-035. (RSF settlement, Section 4.b.)

And,

Consistent with Rule 51.8 of the Commission's Rules of Practice and Procedure, this Agreement is not precedential in any other proceeding before this Commission, except as expressly provided in this Agreement. (RSF settlement, Section 14).

These statements must be interpreted in a manner consistent with Rule 51.8 which states that Commission adoption of a settlement or stipulation is binding on the parties, but may not be considered precedential in future proceedings unless the Commission provides otherwise.¹⁰ What "parties expect" notwithstanding, our determinations in CalWater's pending A.05-10-035 will be

¹⁰ Rule 51.8: "Commission adoption of a stipulation or settlement is binding on all parties to the proceeding in which the stipulation or settlement is proposed. Unless the Commission expressly provides otherwise, such adoption does not constitute approval of, or precedent regarding, any principle or issue in the proceeding or in any future proceeding."

based on the record developed in that proceeding, including, if appropriate, any notice taken there of the parties' settlement and our order here.

All of the parties to this proceeding have agreed to the outcome proposed in the RSF settlement. To evaluate such agreements, the Commission applies the standards set forth in Rule 51.1(e), *i.e.*, "The Commission will not approve stipulations or settlements, whether contested or uncontested, unless the stipulation or settlement is reasonable in light of the whole record, consistent with law, and in the public interest. We are satisfied that the record supports the requisite findings under Rule 51.1(e).

Applicant CalWater prepared the original RBEA proposal and supported it with witness direct and rebuttal testimony at the evidentiary hearings. DRA, whose charge is to promote the ratepayers' interests, objected to CalWater's original RBEA proposal and prepared, presented and defended a report detailing its concerns. Both CalWater and DRA were represented by technical staff and legal counsel in the proceeding. CalWater customers at the public participation hearings, and the intervening parties representing them at all stages, were knowledgeable of CalWater's proposal and active in presenting and defending their views.

The parties have explained how in their negotiations they considered the affordability of rates in the districts (*i.e.*, income levels, usage levels, rate base per customer, availability of public loan funds, and average bills), public comments at the public participation hearings, letters to the Commission and DRA, and the impact of extraordinary water quality problems.¹¹ The RSF settlement addresses

¹¹ See, *e.g.*, Exhibits Lucerne-1 and Lucerne-2, sponsored by Lucerne Community Water Organization witnesses Stephen Elias and Catherine Elias-Jermany respectively. Those

Footnote continued on next page

both components of affordability: the burden of high rate levels in districts that need critical water infrastructure improvements, and the ability of low-income customers to pay for those improvements in these largely rural areas. The fact that the RSF would subsidize all customers in these districts, even those who could afford to pay the true cost of water, concerns us. However, we see the RSF settlement as preferable in that regard to postponing or disallowing necessary improvements, or, in the alternative, approving them and imposing a ratemaking treatment that fails to provide sufficient revenue to cover their costs.

The Commission must come to terms with how to deal with areas such as these where providing water service is costly. The RSF proposal before us is by no means the only possible solution, but it is a marked improvement over the original RBEA proposal, a complicated ratemaking treatment that resulted in hidden cross-subsidies. Cross-subsidies are generally to be avoided, but where they are truly needed, we prefer they be explicit, as they are in the RSF proposal, rather than hidden as they would have been under the RBEA.

The record shows that agreement was reached only after significant give-and-take between the parties. Attachment A to the proposed RSF settlement sets forth CalWater's and DRA's initial positions on each point, and how each was resolved in the settlement. All parties participated in the settlement negotiations, and all support the outcome. We conclude that the sponsoring parties are fairly representative of the affected interests, and the resulting settlement is reasonable in light of the whole record.

exhibits present demographic evidence to show the difficulty Lucerne rate area customers would have paying their water bills at CalWater's application-proposed rates, absent an RSF mechanism or its equivalent.

The parties state that they are not aware of any statutory provision or prior Commission decision that might conflict with any provision of the settlement, nor are we. The Commission's recent Water Action Plan provides that the Commission "will develop options to increase affordability of water service for [low-income] customers...." Indeed, the parties' proposed settlement makes rates more affordable for all CalWater customers in its highest-cost areas, provides additional support for low-income customers, and does both at minimal cost to its other ratepayers. The RSF settlement is consistent with law and the Commission's goals.

We have previously explained that a critical factor in our decision to adopt a settlement is confidence that it commands broad support among participants fairly reflective of affected interests.¹² In this proceeding, all of the parties have agreed on the RSF, and those parties fairly reflect the affected interests. CalWater provides water service to the customers in the districts affected, DRA is statutorily mandated with representing ratepayers in all 24 of CalWater's water districts, and the intervenors are both ratepayers and consumer advocates from the CalWater districts most strongly affected by the RSF. The principal public interest affected by this proceeding is the delivery of safe, reliable water service at reasonable rates. Today's settlement advances that interest. And, as the Commission has acknowledged in the past, there is a strong public policy favoring the settlement of disputes to avoid costly and protracted litigation. Today's settlement promotes that policy as well.

¹² San Diego Gas & Electric, D.92-12-019, 46 CPUC 2d 538, 554 (1992).

Our action today should not be interpreted as the final word on the broad topic of water affordability in high cost areas. We see this settlement not as the only answer, but as a reasonable and pragmatic way to proceed in the case before us. We intend in future proceedings to continue to examine the issue.

We conclude that the RSF settlement is in the public interest and should be approved.

WRAM Stipulation

On March 9, 2006, CalWater and DRA filed a motion to approve two additional, separate stipulation agreements between them.¹³ The first proposed implementing increasing-block rate structures in all eight districts during this rate case cycle and a revenue adjustment mechanism to offset any variations in revenues and variable expenses such a rate structure might produce. The second, discussed in the next section, covered the remaining issues between CalWater and DRA, with the notable exception of their plant in service issues in the Coast Springs area of Redwood Valley district and the return on equity determination for all eight districts. The other parties did not join in these two proposed stipulations.

In its eight GRC applications, CalWater proposed to establish what it termed a Water Revenue Adjustment Mechanism (WRAM), essentially a total

¹³ *Joint Motion of California Water Service Company and the Division of Ratepayer Advocates to Approve a Stipulation concerning the Water Revenue Adjustment Mechanism and a Stipulation regarding Remaining Issues*, filed March 9, 2006, attaching a WRAM stipulation and a stipulation on remaining issues. CalWater and DRA sought and were granted an extension of the Rules of Practice and Procedure, Rule 51.2 requirement that any settlements and stipulations be filed not later than 30 days after the last date of evidentiary hearing. (ALJ's Ruling Extending Time to File Settlement, March 2, 2006).

revenue balancing account that would virtually guarantee that the utility would always receive the GRC-estimated sales revenues for the districts to which the WRAM would apply. CalWater's stated purpose was to remove a disincentive to conservation. Under its current policy established in 1986, the Commission favors a water rate design consisting of service charges that recover up to 50% of the water utility's fixed costs and quantity rates that recover the remainder of the fixed costs and all variable costs.¹⁴ By placing nearly one-half of the water utility's fixed cost recovery in service charges that are less subject to variation, the Commission was able to reduce the utility's revenue volatility (and thus risk) at little or no additional cost to its ratepayers. This approach leaves at least one-half of the utility's fixed costs (and all of the variable costs) to be recovered in the quantity charges, so the more water it sells above the GRC estimate, the greater its opportunity to recover or over-recover its fixed costs.

In its applications, in prepared testimony, and until part-way through the evidentiary hearing, CalWater sought to have the Commission authorize a WRAM it characterized as being essentially identical to the WRAM the Commission has granted to California-American Water Company in each GRC for its Monterey division since 1997. When that characterization was challenged in the evidentiary hearing, however, CalWater did additional research and returned to acknowledge that it had misunderstood and unknowingly

¹⁴ Decision (D.) 86-05-065 (May 28, 1986) in Order Instituting Investigation 84-11-041, Order Instituting Investigation (Rulemaking) into Water Rate Design Policy. Under the Commission's Water Action Plan (December 15, 2005), the Commission will encourage alternative rate designs, including increasing block rate designs, where feasible to promote conservation and after considering their effects on low-income customers.

misdescribed the Monterey division WRAM mechanism it was citing as precedent.¹⁵

CalWater's applications did not propose an ascending block rate structure to accompany its WRAM proposal. Nor, according to DRA, did CalWater propose a correction for sales-related costs that decline with declining sales, or a rate of return adjustment to reflect the greatly reduced financial risk it would face if its sales revenues were subject to balancing account treatment. DRA charges that decoupling sales from revenues is not necessary to remove a perceived incentive to increase sales and a perceived disincentive to conservation. Thus, from DRA's point of view, CalWater's application request for a permanent WRAM was not about facilitating conservation, but rather about moving toward a guaranteed recovery of revenues, and hence guaranteed earnings.¹⁶

Settlement discussions on WRAM and other GRC topics began in mid-November 2005 and, according to the joint CalWater and DRA motion, continued through the evidentiary hearings in late-January and the March 9, 2006 date the WRAM settlement was filed. One statement in the motion to adopt

¹⁵ The WRAM balancing account for California-American Water Company's Monterey Division is not intended to true up the utility's steeply ascending, multiple-block revenues to the GRC estimate, but rather to what the revenues would have been had each customer been billed on the Commission-standard rate design described earlier. Thus, it does not relieve California-American Water Company of its normal revenue risk due to sales variation, but rather returns it to that normal risk level from the extreme revenue risk it would otherwise face under the steeply ascending, multiple-block rate structure the Commission has established to meet water production constraints placed on the utility by the California Water Resources Control Board.

¹⁶ Exhibit DRA-10, pages 1 through 4.

the settlement goes to the heart of our first reason for rejecting it: “As a result of those discussions, an agreement has been reached to resolve the WRAM issue raised in the Company’s applications....” While this could be read to mean, “An agreement has been reached that resolves the WRAM issue...,” it would more correct to read it literally as written: “[A]n agreement has been reached to resolve the WRAM issue....” That is, the parties have agreed to agree, but have not yet done so.

One of our oft-cited criteria for approving all-party settlements is that they must provide the Commission with sufficient information to discharge its regulatory obligations.¹⁷ While this is not an all-party settlement, the need here is no less important. As we discuss next, this settlement fails that “sufficient information” criterion and must be rejected.

The first page of the CalWater and DRA Revenue Adjustment Mechanism Agreement filed on March 9, 2006 states,

The Parties agree that increasing block rates should be implemented in the first test year for all districts and all customer classes not covered by a Ratepayer Support Fund. Accordingly, within 30 days of the filing of this agreement the Parties intend to provide detailed rate design criteria for implementing increasing block rates by district for single-family residential customers. For other customer classes, the Parties intend to provide detailed rate design criteria for implementing increasing block rates by district within 60 days of the filing of this agreement. Additionally, the Parties have agreed to propose that the rate design criteria be adopted by the Commission in deciding the ratemaking issues and establishing a revenue requirement in this proceeding. And, that within 60 days of

¹⁷ San Diego Gas & Electric, D.92-12-019, 46 CPUC 2d 538, 552-553 (1992).

adopting rate design criteria the Parties be directed to file rates with the Water Division that comport with the adopted rate design.

CalWater and DRA had not finalized their rate design criteria, and thus had not reached a complete agreement that could be adopted by the Commission, when they filed the WRAM stipulation. Instead, this statement committed them to doing so within 30 days (*i.e.*, by April 8) for single-family residential customers, and within 60 days (by May 8) for other customer classes. Rate design criteria are not an afterthought; they are an essential element to completing a water general rate case and implementing the new rates. Here, however, CalWater and DRA proposed to tender their criteria long after the record was submitted for decision, and to file the rates later with Water Division, presumably to be subjected thereafter to an as-yet-undefined approval process.

Even if we were to consider this a completed agreement between CalWater and DRA, it would present us with at least three concerns. First, the other, non-settling parties would be denied an opportunity to review, and if they disapprove, to object to, the stipulation once its full extent is revealed. A post-GRC advice letter review process could not match the opportunity conveyed to them under Rule 51 to review, object to, and be heard on this stipulation in which they have not joined.

Second, CalWater and DRA strongly disagree on the effect their revenue adjustment mechanism and still-to-be-defined rate design should have on CalWater's authorized return on equity. CalWater argues they should have no effect, while DRA argues for an arbitrary 300 basis point reduction. A balancing account that relieves the company of a risk of variability in its revenues and/or expenses does so by shifting that risk to ratepayers. That is, without a balancing account, the utility is at risk for variations while customers can look forward to

paying known amounts for the water service they receive. Once a balancing account is introduced, customers assume some of that risk from the company. The effect on rate of return clearly should be examined, as we have noted in the past,¹⁸ but no party has attempted to do so in this record.

Third, notwithstanding their April 8, 2006 commitment in the WRAM stipulation statement quoted above, it was not until May 2 that the residential rate design criteria were submitted by letter to the ALJ. That letter, written on behalf of both DRA and CalWater, warned to expect a further delay in receiving the remaining criteria: “Unfortunately, due [sic] the complexities involved in transitioning from single block to multiple increasing block quantity rates the rate design criteria for the remaining customer classes will not be provided until

¹⁸ With respect to the effect of rate design on risk and return on equity, see, *e.g.*, D.86-05-064, our final order in I.84-11-041, Order Instituting Investigation (Rulemaking) into Water Rate Design Policy: “We recognize that a change in rate design affects risk, which in turn impacts a utility’s rate of return.... Because rate design affects the risk of a utility, we concur that [the impact of rate design on rate of return] should be addressed in future general rate proceedings on a case-by-case basis. This would enable us to assess the risk associated with a change in rate design with other utility risks so that we can arrive at a reasonable rate of return.”

With respect to the effect establishing a new balancing account would have on risk and return on equity, see, *e.g.*, our order in CalWater’s last GRC proceeding: “...CWS is protected through separate balancing accounts for purchased water, purchased power and pump taxes, and memorandum accounts for catastrophic events and waste contamination. The result of these protections is to reduce the risk that CWS faces with regard to its opportunity to earn its return on equity. Consequently, we expect that in future proceedings all of these existing and adopted protections against erosion of future earnings will be given their proper weight in the determination of risk and consequently return on equity.” (D.05-07-022, Section VII.G.).

July 31, 2006.”¹⁹ We cannot accept the still-negotiating parties’ suggestion that this proceeding remain open for an indefinite period while they debate between themselves criteria to finalize their stipulation and complete this round of GRCs.

The proposed WRAM stipulation should be rejected because it does not provide the Commission with sufficient information to discharge its regulatory obligations, and because it cannot be incorporated into this proceeding without unduly delaying the proceeding or denying the other parties due process.

We remain open to considering any water conservation proposals CalWater and other stakeholders may present in future proceedings, including those that provide customer incentives through increasing block rate structures. At the same time, however, we will expect the parties who present those proposals to think them through well in advance, ensure they fairly balance the interests of both ratepayers and stockholders, describe them accurately and completely, and develop a complete record to allow the Commission to make an informed decision and properly implement them should they be approved. For this proceeding, we will pattern rates after the Commission’s standard rate design while at the same time ordering CalWater to file within 60 days a new application that addresses the goals of the Water Action Plan by proposing an increasing block rate design for each of the districts in this general rate case for

¹⁹ The letter continues, “Because of the additional time necessary to develop the rate design criteria Cal Water and DRA will be filing a joint motion shortly with a recommended procedure for filing rates that implement the proposed rate design criteria.” When the ALJ completed his draft decision and circulated it for review, nothing further had been received. The May 2, 2006 letter from Danilo Sanchez of DRA to ALJ McVicar was served on the parties and entered into the proceeding record by the ALJ’s June 14, 2006 ruling.

years 2007/2008 and 2008/2009, and an accompanying mechanism to decouple sales from revenues.

Stipulation on Remaining Issues

A second, separate stipulation agreement between CalWater and DRA filed with their March 9, 2006 motion covers all of the remaining issues between them with the exception of their plant in service differences in the Coast Springs area of Redwood Valley district and the return on equity determination for all eight districts.²⁰ A copy of that stipulation is included in this decision as Appendix H. The other parties who did not explicitly join in this stipulation have had an opportunity to review it and have waived their right to object by passing up the opportunity to comment.²¹

As we did with the RSF settlement addressed earlier, we will apply the standards set forth in Rule 51.1(e) in evaluating this stipulation: “The Commission will not approve stipulations or settlements, whether contested or uncontested, unless the stipulation or settlement is reasonable in light of the whole record, consistent with law, and in the public interest.” And, as we did

²⁰ A review of the comparison exhibit prepared by CalWater and DRA confirms that Coast Springs plant and return on equity are the only differences remaining between them. Where other differences in the figures appear, they are due to these two issues.

²¹ “Whenever a party to a proceeding does not expressly join in a stipulation or settlement proposed for adoption by the Commission in that proceeding, such party shall have 30 days from the date of mailing of the stipulation or settlement within which to file comments contesting all or part of the stipulation or settlement, and shall serve such comments on all parties to the proceeding.” (Rule 51.4).

“...Any failure by a party to file comments constitutes waiver by that party of all objections to the stipulation or settlement, including the right to hearing to the extent that such hearing is not otherwise required by law.” (Rule 51.5).

with the earlier settlement, we conclude that this stipulation meets those standards. Most of our evaluation here parallels our earlier discussion, albeit with two rather than seven parties signing.

CalWater filed its applications accompanied by direct testimony and exhibits, prepared rebuttal testimony to address the other parties' presentations, presented witnesses at the evidentiary hearings, filed briefs, and has generally shown itself well capable of advocating its interests throughout this proceeding. DRA is charged with upholding the ratepayers' interests. In carrying out that charge, DRA evaluated CalWater's applications, exhibits and testimony, examined in depth the positions CalWater took on the issues, and likewise prepared, presented and defended extensive reports and testimony setting forth its own positions. Both CalWater and DRA were represented by technical staff and legal counsel in the proceeding. The stipulation represents a compromise between them arrived at through extensive negotiations, in the interest of avoiding the expense and uncertainty inherent in litigation.

For six districts, CalWater and DRA are the only parties. The five non-stipulating parties represent customers in Antelope Valley district and all three ratemaking areas of Redwood Valley district, and the RSF settlement discussed earlier addressed their top priority issue, rate affordability. Among the non-stipulating parties, Jeffrey Young and Marcos Pareas made technical showings that would directly affect CalWater's revenue requirement, advocating plant disallowances in Coast Springs rate area. Those issues are not part of this stipulation, but are instead taken up and decided in a separate decision section below.

The stipulation on remaining issues describes the agreement reached for each issue. The comparison exhibit prepared by CalWater and DRA lays out

their initial and final positions on each line item of the summary of earnings, district by district. We have evaluated DRA's and CalWater's exhibits and testimony as they relate to the stipulated items, reviewed in detail their initial positions and compared them with the stipulation and accompanying explanations. In each case, the result is supportable. We conclude that the sponsoring parties are fairly representative of the affected interests, and the resulting stipulation they have reached is reasonable in light of the whole record.

The parties state that they are not aware of any statutory provision or prior Commission decision that might conflict with any provision of the stipulation on remaining issues, nor are we.

As we noted earlier, the principal public interest affected by this proceeding is the delivery of safe, reliable water service at reasonable rates. The CalWater and DRA stipulation on remaining issues advances that interest. And, as the Commission has acknowledged in the past, there is a strong public policy in favor of settling disputes to avoid costly and protracted litigation. The stipulation promotes that policy as well. We conclude that the CalWater and DRA stipulation on remaining issues is in the public interest and should be approved.

Rate Base

CalWater and DRA were initially far apart in their estimates comprising rate base for test years 2006/2007 and 2007/2008.²² They were eventually able to resolve their differences for all districts except the Coast Springs rate area of

²² The new RCP provides for one test year and two escalation years for establishing revenue and expense components in general rate cases, and two test years plus one escalation year for rate base components.

Redwood Valley district. The agreed-upon outcomes are set forth for each district in their stipulation on remaining issues. Most importantly, after coming to agreement on the cost and timing of many of CalWater's proposed plant additions, they jointly determined that many other capital projects for which the timing and plant costs are uncertain are nonetheless needed and should be reflected in rates through an advice letter process as they are completed and placed in service.²³ Their joint rate base recommendations are described in stipulation Section 3 and reflected in each section of the comparison exhibit. We have included as Appendix F a list of the advice letters authorized to be filed as projects are completed.²⁴ We address the remaining Coast Springs differences in the following section.

We see advantages to the parties' advice letter recommendations. CalWater would benefit by the increased certainty of timely rates to support the reasonable costs of needed additions as they enter service over the coming three years. Ratepayers would benefit by reducing CalWater's incentive to increase shareholder profits by delaying or canceling needed projects the Commission has authorized and included in advance in rates. By agreeing to caps on the maximum plant cost to be recovered in each project advice letter, the parties ensure that advance authorization does not constitute a blank check at ratepayers' expense. Cost overruns, if any, will not be reflected in rates until they are presented and examined for inclusion in the first test year of CalWater's next GRC cycle for these districts (currently anticipated to be 2009/2010).

²³ In some cases, the advice letters will also reflect adjusted expense levels resulting from these projects' completion as well. See, *e.g.*, stipulation Section 2.2.4.

²⁴ The advice letter listing was provided pursuant to Stipulation Section 2.42.

Coast Springs Plant in Service

CalWater and DRA differ on the treatment to be given to two related, major plant projects in the Redwood Valley district, Coast Springs rate area. Project 14318 was initially labeled “upgrade treatment plant,” and Project 14319 was “water quality compliance.” Intervenors Young and Pareas take issue with particular components of these projects as well as CalWater’s overall performance of them. Additionally, DRA endorses without elaboration the positions intervenors Young and Pareas take with respect to two other Coast Springs projects: a glass-fused storage tank, and a solar pump to prevent storage tank nitrification.

CalWater’s witness testified that an earlier Project 8087 for a membrane treatment facility is now regarded as Phase 1 of its Coast Springs water treatment and water quality efforts. Project 14318 was further described as the Phase 2 portion of the Coast Springs membrane treatment installation, and Project 14319 is for work carried out under the water quality project.²⁵ An undefined portion of the projects was said to be in place by the time the parties were preparing for evidentiary hearings, but the accounting had not been completed and charges had yet to be cleared before the project costs could be booked. Thus, CalWater was unable to give a complete accounting of their costs, and the opposing parties were unable to test them for reasonableness. While the final figures were not clear at the time of hearing, what was clear that they had very greatly overrun CalWater’s previous estimates, and that some of the rate case figures it had presented were too tentative to be relied upon.

²⁵ RT 909.

Funding for Project 14318 is said to be spread to three sources: a State Revolving Fund (SRF) loan, excess funds collected earlier for repayment of a Safe Drinking Water Bond Act (SDWBA) loan, and amounts sought in this GRC as 2005 plant in service. Table 2 summarizes from the evidentiary record the components of the project's estimated costs and funding sources as they stood at the time of hearing.

Table 2
Costs and Funding Sources – Project 14318

Estimated Costs:		
Contractor Bid	\$616,485	
Additional CalWater Expenditures	225,000	
Total Cost	\$841,485	
Funding Sources:	Per CWS	Per DRA
SRF	\$452,000	\$494,276
SDWBA	100,000	119,410
Subtotal State Loans	552,000	613,686
2006/2007 GRC	289,485	227,799
Total Funding	\$841,485	\$841,485
GRC Estimate	\$406,350	\$227,800

CalWater sought to include \$406,350 for Project 14318 in its 2005 plant in service, and thus in rate base beginning in the first test year. DRA proposed to exclude it from rate base but would allow CalWater to file an advice letter after the final costs have been accounted for. In its opening brief, CalWater agreed to advice letter treatment. DRA would cap the project's GRC cost at its \$227,800 estimate; CalWater's closing brief is silent on Project 14318, stating only that the reasonable costs of all plant construction projects should be included in rate base. DRA's figures are the more recently prepared, better reflect both the cost and tentative sources and availability of funds, and present a more consistent, credible overall picture. As such, we accept them for our purposes today. We

will authorize CalWater to file an advice letter to recover the incremental revenue requirement associated with the project, including up to \$227,800 in company-funded plant costs (*i.e.*, exclusive of SRF and SDWBA loan funding) when Project 14318 and its companion projects discussed below are completed and placed in service.

CWS asked to include \$242,800 in plant for Project 14319 in its late-amended application.²⁶ Because the project was said to have been completed but the accounting was not closed, CalWater was unable to provide the parties or this record with sufficient information for a proper review. DRA's initial proposal was advice letter recovery when all the costs are in, with a cap of \$239,800 in plant cost to reflect CalWater data responses that indicated \$114,250 in direct expenses and \$125,950 in unexplained CalWater labor and overhead charges. When CalWater was unable to provide a clear and consistent explanation before and during the evidentiary hearings, DRA revised its advice letter recovery cap downward, to \$114,000. In support, DRA points to the many potentially serious issues raised by intervenors Young and Pareas and outlined briefly below.

Intervenors Young and Pareas take issue with numerous aspects of Projects 14318 and 14319. Among them are the fact that these projects and others were awarded to a single contractor at prices sometimes far in excess of CalWater's own estimates, without obtaining competing bids and in apparent violation of its own competitive bidding guidelines. They also allege that CalWater inappropriately repackaged its projects to keep the amount of low cost

²⁶ DRA opening brief, page 4, citing CalWater Exhibit P-RV-CS, page 3.

SRF funding below \$500,000 in an admitted effort to avoid federal women and minority owned business contracting requirements, substituting instead higher cost capital at ratepayers' expense. Young, Pareas and DRA question whether some specific plant items included in these projects may be unnecessary, or their costs inflated or double counted from earlier Project 8087. DRA gives examples of specific suspected overruns: treatment plant inside piping increasing to \$34,000 from \$15,000; external piping to \$77,000 from \$40,000; electrical costs to \$135,850 from \$50,000; and the treatment plant building increasing to \$200,000 from \$27,000. For some items, CalWater had plausible explanations during the evidentiary hearings, but for others it did not, and it could not provide a consistent, understandable summary of these projects' costs overall.

In the end, Young and Pareas argue for strict limits on recovery from customers, through either immediate disallowances or caps on later advice letters. Both, along with DRA, advocate a disallowance equivalent to the excess cost ratepayers would bear as a result of CalWater's decision to forego SRF funds in excess of \$500,000. As Young points out in his closing brief, the Commission left the door open to just such an outcome when it addressed his similar arguments in CalWater's 2002 Coast Springs GRC:

Young argues that should SDWSRF funding for the Coast Springs and Lucerne treatment plants prove unavailable, Cal Water should bear the burden of proving that the cause of the denial was solely due to [Department of Health Services] or others. The argument is premature. Issues regarding ratemaking for these projects, if SDWSRF funding is denied, can be explored in an application CalWater may file to request such ratemaking.²⁷

²⁷ D.04-03-040, Section IV.B.

However, no party developed data in the record here to calculate an SRF-based capital disallowance, and in any case we would first need to decide the level of plant investment allowed against which to apply the SRF loan criteria.

We conclude that CalWater has failed to demonstrate the reasonableness of its plant in service estimates for Projects 14318 and 14319. DRA, Young and Pareas have shown a likelihood that, when the projects are completed and a full cost accounting is made available, some part of CalWater's costs for these projects will be found to be unnecessary and unreasonable. In the meantime, we will adopt DRA's recommendation and allow CalWater to file a single offset advice letter when all three projects (8087, 14318, and 14319) are complete and in service, and all of their associated costs properly booked. For now, DRA's estimates of these projects' costs are more reliable for that purpose than are CalWater's. The maximum company-funded plant costs (*i.e.*, exclusive of SRF and SDWBA loan funding) will be capped at \$227,800 for Project 14318 and \$114,000 for Project 14319. Young's concern that finalizing the rate base value through an advice letter filing could deprive him and other customer representatives of sufficient notice and opportunity to participate has merit. Given the amounts at stake in relation to the small number of customers in the Coast Springs system, adjudicating the issue is likely to be highly contentious and beyond the proper scope of a simple advice letter filing. Accordingly, the interim, capped rate base amounts determined in the advice letter filing will become final only after the next CalWater Coast Springs GRC, unless CalWater and/or its counterparties there present persuasive evidence supporting a different final outcome.

Young and Pareas take issue with two other Coast Springs projects: a glass-fused storage tank, and a solar-powered pump to prevent storage tank nitrification.

In CalWater's last Coast Springs GRC, it projected adding a 125,000 gallon steel storage tank in 2003 at a cost of \$104,800. That tank was never installed, and CalWater now seeks approval instead to include in rates a glass-fused 125,000 gallon tank, competitively bid, at a cost of \$216,840. CalWater's witness cited the company's experience with a previous steel tank in the area that failed after only 15 years, and another that required extensive maintenance at a cost of \$75,000 to \$80,000 after about five years. CalWater claims that its glass-fused tank will stand up better to the harsh coastal weather conditions in the area and cost less in the long run than the steel tank would have. Young, supported by Pareas, takes issue with that conclusion and advocates limiting CalWater's recovery in rates to the earlier \$104,800 estimated cost for a steel tank. Young believes glass-fused tanks are costly, untested technology for water storage in the coastal area; CalWater has no other glass-fused tanks in its California service territories and no actual experience by which to judge their expected performance, and the steel vs. glass-fused tank economic comparison study CalWater conducted was faulty. Young's cross-examination of two CalWater witnesses pointed out several shortcomings in CalWater's economic comparison, but he did not establish whether a more complete study would have tipped the balance to favor steel. CalWater claims to have been favorably influenced by a glass-fused tank on a farm in the area, but that tank was used for silage rather than water storage. The parties sparred over which use was the more damaging, and the role cathodic protection might play in prolonging tank life.

Young and Pareas fail to convince us to penalize CalWater for its selection of tank type. Absent solid proof to the contrary, choices of what equipment and materials will perform best in utility water systems are best left up to the engineers and other water company experts to whom that responsibility has been assigned.

Pareas advocates disallowing the \$10,800 cost of a solar-powered pump installed to prevent nitrification in the Ravine Tank. Pareas contends the pump is useless because solar panels are ineffective in Coast Springs' foggy coastal climate. CalWater responds that it used a solar contractor who resides in the local area and was experienced with local conditions, and the pump has proved to be an economic and effective choice. Young pointed out that the pump cost had apparently been included in two plant projects. CalWater confirmed that it had erroneously been included twice, but that error had been corrected and the pump is now only in Project 12505. We conclude that the solar-powered pump is used and useful and should be allowed in plant for ratemaking.

Finally, Pareas would have the Commission order CalWater to retain an independent firm chosen by others "to analyze the validity of the top dollar paid on CWSC's projects at Coast Springs." While we agree with Pareas that CalWater's Coast Springs plant showing left much to be desired, that does not lead us to conclude that ordering an outside audit would be justified. On the contrary, we believe all of the opposing parties involved in the Coast Springs rate area issues were very effective in making their cases, as evidenced by the caps we have placed on CalWater's major Coast Springs construction projects for this rate case cycle. DRA's plant witness, Clement Lan, is a licensed engineer and highly qualified and experienced for this undertaking. We were impressed by his thorough, competent and comprehensive plant and rate base showing for

this district and others. CalWater would undoubtedly seek to recover from Coast Springs ratepayers the additional costs of an outside auditor, and we are mindful that Coast Springs is a small district with already-high rates. Instead, we cap the plant expenditures we allow in rates for this GRC cycle, and put CalWater on notice that we will require a persuasive showing that any Coast Springs plant costs above those caps were reasonable and not reasonably avoidable before we will allow them in future rates.

Cost of Capital

In order to determine a fair rate of return for a utility, we project the proportions of debt and equity in its capital structure, estimate what the effective cost of each will be, and take a weighted average. The resulting rate of return is used to determine the revenue requirement in the summary of earnings for each test year.

Capital Structure and Cost of Debt

While capital structure and cost of debt are not mentioned in the DRA/CalWater stipulation on remaining issues, they agreed on both at the time of the evidentiary hearing. CalWater estimated it would issue \$20 million in new debt in 2005, \$15 million in 2006, \$30 million in 2007, and \$20 million in 2008. For 2005 through 2009, it projected the cost of new debt to be 6.59%, 7.13%, 7.61%, 7.85% and 8.14% respectively. It had no plans to issue or retire preferred stock during the period. DRA's cost of capital witness reviewed the embedded cost of debt and preferred stock and the projected new debt issuances set forth in the company's applications and found them reasonable. The resulting capital structure is reflected in our adopted rate of return for each year, Table 3 below.

Cost of Equity

Cost of equity is typically the most contested component of rate of return in water GRCs. It is a direct measure of the company's after-tax return on equity investment (ROE), and its determination is by necessity somewhat subjective and not susceptible to direct measurement in the same way capital structure and embedded cost of debt are.

We have many times over the years cited the well established legal standard for determining a fair ROE. In the Bluefield Water Works case,²⁸ the Supreme Court stated that a public utility is entitled to earn a return on the value of its property employed for the convenience of the public, and set forth parameters to assess a reasonable return. That return should be "...reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economic management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."

As the Supreme Court also noted in that case, a utility has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. In 1944, the Court again considered the rate of return issue in the Hope Natural Gas Company case,²⁹ stating, "[T]he return to the equity owner should be commensurate with returns on investments in other enterprises sharing corresponding risks. That return,

²⁸ Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia (1923) 262 US 679.

²⁹ Federal Power Commission v. Hope Natural Gas Company (1944) 320 US 591.

moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."

The Court went on to affirm the general principle that, in establishing a just and reasonable rate of return, consideration must be given to the interests of both consumers and investors.

CalWater and DRA each made a showing to support an ROE recommendation. With the principles above in mind, we first describe the methods each used, and then discuss our evaluation of them.

CalWater's Recommended Return on Equity

CalWater used DCF (discounted cash flow) and RP (risk premium) models to determine its recommended ROE, but ran them on different, more varied sets of data than did DRA.³⁰ CalWater also made various adjustments that DRA did not. Using data available in mid-2005, CalWater prepared a single DCF estimate (based on a sample of five water utilities and five gas utilities, all said to be

³⁰ The DCF model is a financial market value technique based on the premise that the current market price of a share of common stock equals the present value of the expected future stream of dividends and the future sale price of a share of stock, discounted at the investor's discount rate. By translating this premise into a mathematical equation, the investor's expected rate of return can be found as the expected dividend yield (the next expected dividend divided by the current market price) plus the future dividend growth rate.

The RP model is a risk-oriented financial market value technique which recognizes that there are differences in the risk and return requirements for investors holding common stock as compared to bonds. An RP analysis determines the extent to which the historical return received by equity investors in utilities comparable to the utility at issue exceeds the historical return earned by investors in stable, long-term bonds. This difference, or "risk premium," is then added as a premium to the estimated cost of long term debt to derive average expected return on equity for the test period. (D.03-02-030).

comparable to CalWater for ROE purposes), and a single RP analysis based on the same group of comparables. CalWater's witness averaged the 12.11% ROE from the DCF analysis with 11.79% from the RP analysis, and then added 28 basis points (0.28%) to recover what he calculated was the company-wide average balancing account losses due to overearnings in 2002, 2003 and 2004, to generate a final recommended ROE of 12.23%.

In support, CalWater cites risks due to tightening of water quality standards in recent years, lowered credit ratings in November 2002 and February 2004,³¹ failure to earn its authorized return in recent years,³² potential electric

³¹ CalWater's backup documentation shows that Standard & Poor's gave CalWater an improved outlook rating in January 2005, to "stable," based in part on "its regulatory insulation from competition... and the relatively low operating risk of managing water utility systems." Standard & Poor's also credited large equity issuances in 2003 and 2004 for "bringing debt leverage comfortably within the A+ rating benchmark" (during 2003 and 2004, CalWater increased its equity ratio dramatically, to 50.2% from 41%). On the down side, Standard & Poor's cites CalWater's reliance on rate relief from the Commission. A Value Line report issued that same month cited some of the same factors for the water industry generally, and singled out CalWater thusly: "More risk-averse individuals may find added appeal in California Water, given its 2 (Above Average) rank for safety." (Exhibit L, page 8 and Enclosures 6 and 10).

³² CalWater's cost of capital witness claimed that the company earned far below its Commission authorized ROE each year from 2001 through 2004. In the same exhibit, he cites approximately \$3.5 million in lost balancing account revenues in 2002, 2003 and 2004 through the Commission's application of the earnings test. There was no explanation for this seeming contradiction, except that the witness may not understand the mechanics of the Commission's balancing account procedures. In an attempt to bolster CalWater's regulatory risk profile, his prepared direct testimony four times mischaracterizes the working of the D.03-06-072 earnings test as placing a upper limit on water utility earnings (Exhibit L, pages 15, 16, and 22; and Exhibit CWS-5, page 11). That is not the case, as we explained when we finalized those procedures: "The proposal will not deny the utility a right to earn a fair rate of return on investment.... [T]he revised procedures will permit the utility to earn at least up to its authorized rate of return, *and even more than the authorized rate of return through any means other than the*

Footnote continued on next page

power shortages in California, an unfavorable association in investors' minds between California's water utilities and the extreme financial distress of its largest energy utilities earlier in the decade, and a host of other factors.

DRA's Recommended Return on Equity

DRA also used DCF and RP models to estimate investors' expected ROE, and applied both models to a group of comparable water utilities selected based on two criteria: (1) water operations account for at least 70% of their revenues, and (2) their stocks are publicly traded. The comparable group comprised five companies: American States Water, Connecticut Water Service, Middlesex Water Service, Philadelphia (Aqua American), and San Jose Water. DRA's DCF analysis yielded an average expected ROE of 9.35%. Its RP analysis produced 10.22%. It averaged the two results to produce its 9.78% final recommended ROE for CalWater.

DRA concluded that CalWater's business risk, which DRA related primarily to regulatory risk, was low, citing the Commission's many risk-reducing mechanisms available to water utilities. Those mechanisms include balancing accounts (now redesignated as balancing-type memorandum accounts) for purchased water, purchased power, and pump taxes; memorandum accounts for catastrophic events and waste contamination and for Safe Drinking Water Act compliance; 50% fixed cost recovery in the service charge; and construction work in progress in rate base.³³ DRA also noted that

collection of these balancing-type memorandum accounts." (D.03-06-072, Section V.B.2. Emphasis added).

³³ DRA's evaluation of business risk is consistent with our own observation in CalWater's 2005 GRC: "[W]e note that many aspects of this decision provide significant

Footnote continued on next page

CalWater's average equity ratio during the test years will be higher than the comparable group's average, and its debt ratio lower, factors which tend to reduce financial risk. In the end, however, DRA's witness characterized CalWater's financial risk as "high," based on his belief that CalWater held a Standard & Poor's bond rating of B.³⁴

Return on Equity Discussion

Both CalWater and DRA recommend ROEs generated mathematically from their evaluation of the same two models, DCF and RP. We are left to sort through their underlying assumptions, data sets and biases to ferret out the root causes of their considerably different ROE results (12.23% versus 9.78%).

Several difficulties leap immediately to the fore in CalWater's calculations: The inappropriate use of gas utilities in the comparables group, biased culling of intermediate results that would otherwise work against its interests, extreme variations in some of the data sets it chose, and two arithmetic errors that cause

protections to CWS against erosion of earnings, including the use of recent expense estimates, provision for future advice letter filings regarding major plant additions and expenses, and allowance for escalation effects in escalation years 2006-2007 and 2007-2008. In addition, CWS is protected through separate balancing accounts for purchased water, purchased power and pump taxes, and memorandum accounts for catastrophic events and waste contamination. The result of these protections is to reduce the risk that CWS faces with regard to its opportunity to earn its return on equity. Consequently, we expect that in future proceedings all of these existing and adopted protections against erosion of future earnings will be given their proper weight in the determination of risk and consequently return on equity." (D.05-07-022, Section VII.G.).

³⁴ Exhibit DRA-9, pages 3-3 and 3-4. Note, however, that may not be the case. CalWater's cost of capital witness testified that its debt was rated by Standard & Poor's as A+. (Exhibit L, page 6, reiterated in Exhibit CWS-5, page 2).

large shifts in its favor in the final result. We also agree with CalWater where it points to the need to make a series of corrections to DRA's figures.

We begin by noting our disappointment that CalWater has relied so heavily in its analysis on comparisons with gas utilities, a practice the Commission has repeatedly rejected in the past because water utilities are less risky.³⁵ A simple inspection of the data in CalWater's Table 4-1 demonstrates that the gas utilities it selected to include in the comparables group have in the aggregate much higher common equity ratios than the corresponding water utilities (average 55.7% vs. 49.5%), very much higher returns on common equity (average 13.5% vs. 9.1%), and higher authorized returns on equity (average 11.7% vs. 10.6%). Each of these differences illustrates that gas and water utilities are not comparable in important ways that matter here. We would consider backing out the gas utility data to see just how much they inflate the resulting ROE, but CalWater has made that impossible by aggregating gas and water companies in one key analysis sheet, the historical growth rates in Table 4-3.

Next, we note CalWater's culling figures from its calculations where they did not promote the end it desired. The single most influential figure in the DCF model is the estimated growth rate. Both CalWater and DRA properly tabulated earnings growth, dividend growth, and sustainable growth percentages (CalWater's Table 4-3) for their comparable groups for 1995 through 2004. CalWater found two of those three measures to be markedly lower than the third, whereupon it discarded the entire data set (as opposed to averaging the figures to produce a seemingly reasonable result as DRA did), saying the low

³⁵ See, e.g., D.90-02-042, D.92-01-025, D.01-04-034, and D.04-05-023.

figures produced “implausible estimates” of the ROE.³⁶ It then proceeded to rely entirely on the simple average of four analysts’ subjective growth rate projections for its ten comparable utilities (gas and water) for an unspecified period. Even in the face of extreme variations (one analyst estimated those growth rates between minus 6% and plus 32.9% while the others’ estimates were generally confined within a reasonably narrow range), CalWater accepted subjective figures that suited its desired end (*e.g.*, the plus 32.9% growth rate estimate was included, while a minus 18% growth rate was omitted because it “would skew data to unreal averages”).

Lastly, CalWater’s cost of capital showing included two very significant arithmetic errors in calculating the average current dividend yields for its ten comparable utilities.³⁷ Correcting those two errors alone would have reduced its DCF ROE result by approximately 0.8%.

For its part, CalWater recommends a series of revisions to DRA’s DCF and RP estimates. We summarize here the four changes we agree should be made.

First, CalWater points out that in calculating its current annualized dividend yield, DRA used dividends from 2004 and stock market prices during September 2004 through August 2005. Realigning and recalculating as CalWater recommends boosts each current yield figure by approximately 0.1%.³⁸

³⁶ Exhibit L, page 13. Returning those figures to the calculation in Table 4-5 would decrease CalWater’s DCF ROE result from 12.11% to approximately 9.1%.

³⁷ Exhibit L, Table 4-2. The average 6-month and 12-month dividend yields are arithmetically incorrect. Those errors carry over to the final DCF ROE result on Table 4-5.

³⁸ Exhibit CWS-5, CalWater’s cost of capital rebuttal testimony, pages 4 and 5; and Exhibit DRA-9, DRA’s cost of capital report, Table 2-2.

Next, CalWater notes that DRA's average year forecast of interest rates uses 2005 through 2008 estimated data rather than 2006 through 2009 to most closely match this GRC cycle. We agree, but note that the 2009 data is not in the record. We will revise the calculation to include only the 2006 through 2008 data we do have available, thus raising the interest rate forecast by approximately 0.2%.³⁹

We accept CalWater's suggestion to remove historical dividend growth from the overall average growth rate calculation, for some of the reasons CalWater states on rebuttal.⁴⁰ We also note that DRA used 11 years' of data to calculate its 10-year average, so we make that correction as well. These two changes raise the overall average growth rate by approximately 0.9%.

The result of these changes is to raise DRA's DCF ROE result to 9.91% from 9.35%, the RP ROE to 10.41% from 10.22%, and the average ROE to 10.16% from 9.78%.

After evaluating the parties' ROE presentations, we find that CalWater's analysis was incorrect and less credible than DRA's, and produces results that fail a reasonability test. In addition to the infirmities we note above, investors in today's economic climate and over the forthcoming rate case cycle will not, as CalWater claims, require it to earn after-tax returns at or above 12% to purchase its debt offerings or make equity investments in it. Thus, we will adopt the 10.16% ROE that results from our revisions to DRA's analysis, as set forth above.

³⁹ Exhibit CWS-5, page 5; and Exhibit DRA-9, Table 2-6.

⁴⁰ Exhibit CWS-5, page 6; and Exhibit DRA-9, Table 2-3.

This represents a small increase over the 10.10% ROE the parties settled on and we adopted for CalWater in its last round of GRCs one year ago.⁴¹

Rate of Return on Rate Base

With the capital structure, cost of debt, and cost of equity components defined, the straightforward calculations in Table 3 derive the rates of return on rate base for each test year:

⁴¹ D.05-07-022 (July 21, 2005), as modified by D.05-11-022 (November 18, 2005).

Table 3
Adopted Cost of Capital and Rate of Return

	Adopted		
	Capital Structure	Cost	Weighted Cost
TY2006/2007			
Long-Term Debt	48.05%	6.80%	3.27%
Preferred Stock	0.53%	4.19%	0.02%
Common Equity	51.43%	10.16%	5.23%
Total	100.00%		8.52%
2007/2008			
Long-Term Debt	47.71%	6.87%	3.28%
Preferred Stock	0.49%	4.19%	0.02%
Common Equity	51.80%	10.16%	5.26%
Total	100.00%		8.56%
2008/2009			
Long-Term Debt	47.47%	6.94%	3.29%
Preferred Stock	0.45%	4.19%	0.02%
Common Equity	52.08%	10.16%	5.29%
Total	100.00%		8.60%

Other Matters

Conservation Expenses

In their stipulation on remaining issues, CalWater and DRA have agreed to conservation expense amounts for each district:

Table 4
Stipulated/Adopted Conservation Budget

District	Conservation Expense (Three-year Totals)
Antelope Valley	\$ 72,000
Bear Gulch	462,300
Dominguez-South Bay	319,300
Hermosa-Redondo	286,700
Kern River Valley	84,800
Marysville	92,500
Palos Verdes	229,600
Redwood ⁴² – Coast Springs rate area	8,100
Redwood – Lucerne rate area	43,800
Redwood – Unified rate area	17,700

The conservation expense figures in Table 4 are the three-year budget totals for each district and rate area,⁴³ to be divided equally among the three years of this GRC cycle for ratemaking. Because the parties intend these to be total amounts allocated equally for ratemaking purposes across the three-year rate case cycle, they should not be subject to the Water Rate Case Plan's escalation procedures in the second and third years.

DRA recommends that CalWater phase its actual conservation expenditures in over this three-year rate case cycle. The stipulation provides that CalWater will track its conservation expenses against this conservation budget in

⁴² Redwood Valley district breakdown to rate areas taken from comparison exhibit.

⁴³ Stipulation on remaining issues, Section 2.2.6.

a one-way balancing account and, in its next GRC filing for each district, propose to refund to customers any under-expenditure in the account.⁴⁴

Two technical details not spelled out in the stipulation are warranted here. First, the balancing account entries should be tracked by district to enable refunding by district. To do otherwise would allow, for example, customers of one district who have had excess conservation expenditures made on their behalf to be subsidized by customers of another district where the conservation budget was underspent, and yet customers in the overspent district might still receive a refund at the end of three years if the budget was underspent in the aggregate.

Second, if for any reason the first test year of the next GRC cycle for any or all of these districts were to be postponed so that it begins more than three years after July 1, 2006, customers would continue to pay the rate increments corresponding to these conservation allowances. In that case, we should interpret the “conservation budget” to have continued into the period after 2008/2009, and it would be reasonable to require CalWater to enter additional budgeted amounts into the balancing account during that time. CalWater could then use the additional amounts for conservation activities during the fourth year, *etc.*, until the beginning of the first test year in the next GRC cycle.⁴⁵

⁴⁴ A one-way balancing account is less disadvantageous to CalWater than it might at first seem. CalWater has control over its conservation expenditures and will be motivated not to exceed the budgeted allowances.

⁴⁵ For example: The Antelope Valley district three-year conservation budget is \$72,000. CalWater will credit the balancing account with \$24,000 annually (or a prorated lesser amount for the first year to recognize that rates will not take effect on July 1, 2006). It will reduce the account by the amount of its reasonable conservation expenses. However, if the next GRC cycle for Antelope Valley were delayed six months to calendar year 2010, CalWater would continue to collect the same level of conservation

Footnote continued on next page

Income Taxes and the American Jobs Creation Act

The parties concur on all aspects of income taxes except possibly one affecting only the federal return: CalWater has not responded to DRA's position on how to address the effects of the American Jobs Creation Act of 2004. However, because the effects of the Act are not reflected in the comparison exhibit or tax calculations for this decision, differences between their income tax estimates are due to differing estimates in other areas.

In D.05-07-044, we discussed the possible effects of the Act on San Gabriel Valley Water Company, a Class A water utility:

We conclude there is a strong likelihood San Gabriel will receive some as-yet-unquantifiable tax benefit from the Act. However, for purposes of this rate case cycle, we will not impute a specific tax benefit amount. Instead, the amount of San Gabriel's adopted revenue requirement that results from our computational assumption that the Act does not apply will be collected in rates and held subject to refund pending our order finally establishing in a future proceeding the actual tax benefit, if any, conveyed to San Gabriel under the Act. That future proceeding may be either a future San Gabriel general rate case or another, more generic proceeding involving other utilities as well. San Gabriel is to report the amount collected and the status of its tax liability under the Act in each general rate case until we have made a final determination.⁴⁶

D.05-07-044 then proceeded to order that outcome.

In CalWater's last GRC, CalWater and DRA (then ORA) memorialized their agreement that CalWater may also be affected by the Act:

expenses in rates, we would expect the balancing account to accumulate another \$12,000, and CalWater would be allowed to continue to recover additional conservation expenses from the account.

⁴⁶ D.05-07-044, page 39.

The parties agree that Cal Water may be affected by provisions of the Act, but that the extent and impact of those effects are not known. Therefore, the Parties agree that the approach taken in [D.05-07-044] on this issue should be used in this proceeding as well."⁴⁷

The adopted D.05-07-022 agreement applies only to the eight CalWater districts in that GRC proceeding; it does not apply to any of the eight CalWater districts in today's proceeding.

DRA would have us follow the D.05-07-044 (San Gabriel) outcome in our determination today.⁴⁸ CalWater is silent on the topic. Consistent with the earlier San Gabriel and CalWater GRC outcomes, neither party has reflected the Act's possibly tax and rate-reducing effects in its income tax calculations in this proceeding. We accept DRA's uncontested position, for the same reasons set forth in our San Gabriel decision.

General Office Advice Letters

In D.05-07-022, we authorized CalWater to file advice letters to recover the costs of up to 15 specific general office personnel after each has been hired, and to recover the costs associated with general office expansion project 10867 not to exceed the equivalent of the revenue requirement on \$887,000 in capital additions (or in the alternative, to rent nearby office space at equivalent or lower cost). The office expansion advice letter authority was made effective only until

⁴⁷ D.05-07-022, Appendix N, a late-filed addendum to the adopted CalWater and DRA settlement.

⁴⁸ Exhibit DRA-1, page 6-3, for Kern River Valley district; repeated in corresponding exhibits for other districts.

the beginning of the test year in the 2007 GRC cycle.⁴⁹ The CalWater and DRA stipulation on remaining issues calls for making that advice letter cost recovery applicable to the districts in this proceeding.⁵⁰ We will so order.

Dominguez Merger Synergies

In D.00-05-047, the Commission approved the merger of CalWater with Dominguez Services Corporation, at that time the holding company for what are now CalWater's Dominguez-South Bay, Redwood Valley, Kern River Valley and Antelope Valley districts. CalWater was allowed to include in rate base the purchase price of the Dominguez systems, including an amount representing the excess of fair market value over rate base (the "merger premium"), provided that the revenue requirement of the merger premium allowed in rates is at least offset by synergy savings generated by the merger. All of the first \$3 million in synergy savings flows to CalWater to offset the revenue requirement of the merger premium, and any additional synergy savings are split 90% to CalWater and 10% to ratepayers. In rate cases since D.00-05-047, CalWater and Dominguez demonstrated the base-year revenue requirements to be used to determine synergies sharing amounts.⁵¹ In accordance with D.00-05-047 and D.02-08-024, today's proceeding is to be the last scheduled evaluation of those synergies.

⁴⁹ D.05-07-022, Attachment B, Section 2.1.3.9; and Ordering Paragraph 9.

⁵⁰ Stipulation on remaining issues, Section 2.42.

⁵¹ D.00-05-047 established a timetable for determining the synergies savings amounts. D.02-08-024 authorized a delay in conducting those reviews from 2001 to 2002 and from 2004 to 2005.

In their stipulation on remaining issues, CalWater has agreed to DRA's synergies calculations, and they have provided a summary of their joint position.⁵² The components of those synergies and their joint recommendation as set forth in the stipulation are listed below.

CalWater and DRA agree that the merger premium revenue requirement is more than offset by merger-related savings. The only difference between their respective merger premium revenue requirements is due to their differing rate of return recommendations. The merger premium revenue requirement we adopt in this proceeding has been calculated to reflect our 10.16% adopted ROE and resulting rate of return. The merger premium revenue requirement expense adjustment should always exactly offset the revenue requirement of the remaining merger premium, so it will necessarily change in future rate cases as the merger premium is amortized and as the Commission's authorized rate of return changes.

CalWater and DRA agree that general office merger savings are \$5,035,000 for the 2006/2007 test year. That amount will be adopted in this proceeding for use in future general office rate filings.

CalWater and DRA agree that the Dominguez, Palos Verdes and Hermosa-Redondo operations cost savings are \$1,029,000 for the 2006/2007 test year. Allocating the total by the standard four-factor method assigns \$406,455 to Dominguez-South Bay, \$252,105 to Hermosa-Redondo, and \$298,410 to Palos

⁵² Stipulation on remaining issues, Section 2.42, referencing "Joint Cal Water/DRA Explanation of Synergies" attached to the stipulation.

Verdes.⁵³ Those amounts will be adopted in this proceeding for use in future GRCs for these districts.

CalWater and DRA agree that financing-related merger savings are \$550,000 in Dominguez-South Bay district (only) for the 2006/2007 test year. That amount will be adopted in this proceeding for use in future Dominguez-South Bay district GRCs.

In D.03-09-021, the Commission approved CalWater and DRA's joint recommendation to authorize CalWater to establish a memorandum account to track the revenue requirement associated with CalWater's proposed synergies adjustment for subsequent recovery, if found reasonable.⁵⁴ In their stipulation on remaining issues in this proceeding, they agree that CalWater should be allowed to recover amounts booked in the general office synergies memorandum account in the Bear Gulch, Hermosa-Redondo and Marysville districts from the effective date of D.04-04-041 through January 1, 2006, and that CalWater should request in its next GRC recovery of the remaining balances from that date to the effective date of rates in this proceeding.⁵⁵ Having accepted above the parties' general office merger savings calculation method, we agree and will so order.

Water Expense Memorandum Account

CalWater's applications requested authority to establish total water cost balancing accounts for Bear Gulch, Dominguez-South Bay, and Hermosa-

⁵³ The remaining \$72,030 of district operations savings is allocated to CalWater's unregulated operation in the City of Hawthorne.

⁵⁴ D.03-09-021 (September 4, 2003), Attachment B, Section 1.11.

⁵⁵ Stipulation on remaining issues, Section 2.42.

Redondo districts. In the stipulation on remaining issues, CalWater withdraws those requests for Bear Gulch and Hermosa-Redondo districts. For Dominguez-South Bay, it has now stipulated with DRA to replacing the total water cost balancing account proposal with a water expense memorandum account if it loses 5% or more of its well production capacity in that district.⁵⁶ The water production memorandum account would track changes in water production costs due to mix changes only. Production expense changes due to wholesaler prices changes would continue to be tracked in the existing water supply balancing accounts. CalWater could seek Commission approval to recover up to 90% of any balance in the new memorandum account in its next GRC for Dominguez-South Bay district. We will authorize CalWater for the duration of this three-year rate case cycle to file an advice letter initiating such a water expense memorandum account for Dominguez-South Bay under the conditions and for the reasons set forth in the stipulation.

Escalation Years

The Water RCP provides for one test year and two escalation years for establishing revenue and expense components in GRCs, and two test years plus an extrapolated third year for rate base components. We first estimate the test year 2006/2007 expenses, rate base, and needed rate of return. Our summary of operations calculation using those figures generates an adopted revenue requirement for the test year. Using adopted customer and consumption levels, we design 2006/2007 rates to match the adopted revenue requirement figure. It is these figures and rates we actually adopt in the GRC; the increase figure for

⁵⁶ Stipulation on remaining issues, Section 2.42.

the test year is simply the difference between the adopted revenue requirement and revenue at present rates.

The revenue requirement for the second year begins with the adopted 2006/2007 test year figures for customers and consumption, expenses, and rate of return, and our GRC-adopted rate base for 2007/2008. The number of customers is increased using a simple, five-year average percentage change.⁵⁷ Expenses are increased by a combination of customer growth and the then-most recent “Estimates of Non-labor and Wage Escalation Rates” and “Summary of Compensation per Hour” as published by Energy Cost of Service Branch (or, for items not covered by the ECSB rates, the most recently available, recorded, 12-month-ending change in the U.S. Cities CPI-U as published by ECSB).⁵⁸ A summary of operations calculation using those figures (with possible adjustments for significant, nonrecurring items, as defined in D.04-06-018) once again generates a revenue requirement, this time for the second year, escalation year 2007/2008. The difference between the second and first year revenue requirements, adjusted if necessary by the results of the earnings test,⁵⁹ determines the first escalation year rate changes to be made effective July 1, 2007.

Calculations for the third year parallel those for the second, except rate base is determined by extrapolating from the first two years to the third.⁶⁰ The

⁵⁷ D.04-06-018, page 11.

⁵⁸ D.04-06-018, page 12.

⁵⁹ D.04-06-018, Appendix page 16.

⁶⁰ The adopted rate bases for 2006/2007 and 2007/2008 are in Appendix B to this order.

proposed escalation year rates are to be consistent with the Commission's standard rate design policy.

We establish in this decision the 2006/2007 summary of earnings figures, rate base for 2006/2007, and the authorized rates of return for each year of this three-year rate case cycle. The revenue requirements and revised rates for the second and third years, escalation years 2007/2008 and 2008/2009, will not be fully determined until advice letters for those years based on ECSB's then-current escalation factors and the results of the earnings test are filed and evaluated in mid-2007 and mid-2008.

In their stipulation on remaining issues, Section 2.41, CalWater and DRA seek to have us adopt a specific ordering paragraph to govern CalWater's 2007/2008 and 2008/2009 escalation year filings. That paragraph would be ambiguous and erroneous in this context. First, the language CalWater and DRA seek and say was contained in D.05-07-022, CalWater's last GRC proceeding, is incorrectly quoted from Ordering Paragraph 6 of that order. Second, that language would need to be changed to reflect the correct attrition years for this proceeding. Third, the final words of the requested ordering paragraph, "for CWS districts," are erroneous in that the ordering paragraph would apparently need to be revised to recognize the parties' current agreement in stipulation Section 2.41 that seeks to except Redwood Valley district. Lastly, Ordering Paragraph 6 from D.05-07-022 that CalWater and DRA seek to carry forward here appears to have been contradicted by Ordering Paragraph 7 of that decision.⁶¹

⁶¹ Ordering Paragraph 7 of D.05-07-022 requires CalWater to follow an entirely different timeline and procedures in its advice letter filings for attrition year rates than

Footnote continued on next page

To resolve the stipulation's internal conflicts, we note that the primary point intended seems to be to apply a modified recorded earnings test based on temperature and rainfall coefficients CalWater and DRA have agreed to, rather than a full recorded earnings test without weather adjustments, for all of the districts in this proceeding except Redwood Valley, when filing advice letters for escalation year rates. For Redwood Valley, the parties agree to use a full recorded earnings test. We will so order.

Amortizing Balancing Accounts

CalWater asks for authorization to recover any amounts booked in its balancing accounts that are below the advice letter recovery threshold of 2% of revenue requirement. Aside from its two-sentence request in each of the eight applications, it gave no explanation, offered no support, and made no further mention of this topic during the proceeding. CalWater should continue to follow the Commission's standard practices for balancing accounts.

Water Quality

Under the RCP, in each GRC the Commission examines the utility's district-by-district compliance with water quality standards. CalWater addressed the topic; DRA did so only peripherally.

Our requirement for utility compliance with water quality standards is expressed in General Order (GO) 103:

does Ordering Paragraph 6. Ordering Paragraph 7 is more technically correct in that, *e.g.*, it would permit Water Division to review the advice letter, and would not allow CalWater to make its attrition rates effective *before* July 1 of each year as Ordering Paragraph 6 and the parties' suggested ordering paragraph here would.

Any utility supplying water for human consumption ... shall comply with the laws and regulations of the state or local Department of Health Services.... A compliance by a utility with the regulations of the State Department of Health Services on a particular subject matter shall constitute a compliance with such of these rules as relate to the same subject matter except as otherwise ordered by the Commission. (GO 103, Section II.1.a.)

The Commission exercises concurrent jurisdiction with DHS (Department of Health Services) over the quality of drinking water provided by the regulated water utilities, and has used DHS standards in its regulatory proceedings as an integral part of its program of regulating water utilities for many years.

CalWater's application included extensive, prepared direct exhibits by its Director of Water Quality and Environmental Affairs summarizing the company's compliance in each district. All of those exhibits were admitted into evidence without cross-examination or objection. The company's presentation was based on mid-2005 and earlier data and provided descriptions of water sources, treatment methods, problem areas and future corrective measures where applicable, for all eight districts and the individual water systems within each. CalWater also included the 2004 issues of EPA-required Annual Water Quality Reports mailed to its customers.

DRA did not address the water quality issue directly, instead including this statement in its exhibit for each district:

CWS requests that the Commission make a finding that the district water quality meets all applicable state and federal drinking water standards and the provisions of General Order 103. CWS should be in compliance with applicable drinking water standards and water

quality regulations which need to be verified preferably by DHS. ORA cannot make the finding as requested by CWS.⁶²

DRA did, however, make many observations relating to water quality in the course of addressing various expense, plant, and affordability issues. Those observations typically involved the challenges CalWater faces in its smaller systems, and were broadly consistent with CalWater's water quality testimony.

For each district, CalWater asked and answered the following three questions. Has this district exceeded any MCL (maximum contaminant level) or deviated from accepted water quality procedures in the time since the last GRC? Has this district been cited by DHS since the last GRC? Does this district meet all federal and state drinking water standards? For Hermosa-Redondo, Marysville, and Palos Verdes districts, the answers were favorable without qualification. For various systems within the other districts, the answers were generally favorable, but with qualifications. Several systems have had problems that CalWater has since addressed or says it is planning to address in the near future.

Bear Gulch district had a single incidence of aluminum levels exceeding the secondary MCL, but still below the MCL.⁶³ CalWater is monitoring aluminum levels at DHS' request.

Dominguez-South Bay district had one well containing color in excess of the secondary MCL, but otherwise received a favorable report. That well was on

⁶² Exhibits DRA-1 through DRA-8, Executive Summary sections.

⁶³ According to DHS, "Section 64449(b)(3), Chapter 15, Title 22, California Code of Regulations, requires all existing community water systems to comply with all secondary MCLs." (Exhibit E-BG, attached August 20, 2004 letter from DHS to CalWater). Secondary MCLs address the taste, odor, and appearance of drinking water.

standby status and CalWater was in the process of identifying an appropriate treatment.

The Lake Hughes system in Antelope Valley district had one well with manganese levels in excess of the secondary MCL. The company reported plans to add iron and manganese removal treatment during 2005. Aside from this, CalWater reports that Antelope Valley district met all applicable drinking water standards.

The remaining two districts, Kern River Valley and Redwood Valley, consist of many small, previously independently owned systems acquired by Dominguez Services Corporation, CalWater's predecessor in these areas.⁶⁴ Kern River Valley district is comprised of twelve separate systems, some with wells producing levels above the secondary MCLs for (in various combinations) iron, manganese, arsenic, copper and uranium.⁶⁵ In response, CalWater has grouped these small Kern River Valley systems into three geographic regions based on the ability to physically combine them within each region. With the new arsenic rule taking effect in early-2006, arsenic levels have become the district's most critical problem. In its capital projects justification report, CalWater has provided a description of its \$4.9 million arsenic mitigation effort, laying out for each region

⁶⁴ Dominguez acquired most of its then-troubled Kern River Valley systems in the 1980's and 1990's, and all of the Redwood Valley district systems in 1997 and 1998. CalWater acquired Dominguez by way of a merger in 2000.

⁶⁵ Despite these longstanding problems, CalWater reports that DHS has issued no citations in the district since June 2002 when it was cited for a procedural violation relating to nitrate sampling at two wells during 2001. CalWater's reports give no indication that nitrates have been a concern in any of its Kern River Valley systems. (Exhibit F, page 7).

a time schedule, project summaries, and descriptions of the options considered. In one region,⁶⁶ it will increase the size of the surface water treatment plant to take additional water from the Kern River and eliminate its dependence on wells. In the other two regions, it plans to combine several systems, eliminate some wells, and construct a treatment plant that will provide a reliable supply of good water. It has taken other, interim measures to address the problems in the meantime.

Redwood Valley is the other district that, like Kern River Valley, was assembled from separate, small, previously independent systems acquired by Dominguez Services Corporation and later merged into CalWater. Despite many challenges, CalWater reports that it does meet all federal and state drinking water standards in Redwood Valley district.⁶⁷ CalWater reports no current or recent problems in the Armstrong Valley system, but water from its two wells may need future treatment to meet the surface water treatment rule if they are confirmed to be groundwater under the influence of surface water. Both wells in the Hawkins system produce water exceeding the secondary MCLs for iron and manganese. Although DHS has not cited CalWater for the problem, it is requiring it to submit a corrective plan and proposed schedule. The last round of monitoring in Noel Heights system detected lead and copper levels exceeding EPA's notification levels. CalWater is also looking into alternative treatment methods in Noel Heights to address seasonal turbidity problems that can overwhelm its filtration system and lead to shutdowns during rainstorms. The

⁶⁶ Exhibit E-KRV, page 30.

⁶⁷ Exhibit F-RV, page 11.

Rancho del Paradiso system has also suffered seasonal turbidity in the past. CalWater installed a microfiltration membrane and took other measures in 2004, but the permanent solution will come from replacing its single well with an intertie to nearby Sweetwater Springs Water district for which construction was to begin in 2005.

Lucerne is CalWater's largest Redwood Valley district system. Periodic algal blooms in its Clear Lake water source have in the past driven turbidity to levels in violation of California's surface treatment rule. With EPA's new, more strict enhanced surface water treatment rule set to go into effect in 2005, CalWater acknowledges that periodic non-compliance is likely to continue until it addresses the system's treatment problems. As a result, CalWater is proposing to build a new, multi-million dollar water treatment plant for Lucerne that it hopes to finance through a state revolving fund low-interest loan.⁶⁸

CalWater was cited by DHS in January 2005 for exceeding the MCL for trihalomethanes in Coast Springs system during 2004. Trihalomethanes are a disinfection byproduct, a contaminant produced when a disinfectant reacts with naturally-occurring organic and inorganic matter present in water. DHS required CalWater to notify its Coast Springs customers and continue a quarterly monitoring program. CalWater attributes the problem to high amounts of organic and inorganic organic matter in the local water, coupled with chlorine used for disinfection and a high detention time. In response, CalWater switched

⁶⁸ The anticipated cost of this treatment plant is the major factor in CalWater's GRC request to more than triple rates in the Lucerne rate area. The resulting high rates (along with the area's high proportion of low-income residents) were in turn a major factor in the all-party settlement's proposal to include Lucerne in the Rate Support Fund.

from free chlorine disinfection to chloramines. Since that time, disinfection byproduct levels have been reduced by nearly 75%. According to CalWater's exhibits, the Coast Springs citation was the only one it has had during the past GRC cycle, and the only exception to its statement that it has complied with all applicable water quality standards in Redwood Valley district.⁶⁹

CalWater has made a thorough water quality presentation for the eight districts in this proceeding. Where there are problems noted above, those problems result from the difficult local conditions CalWater faces and are not atypical of small systems. Most importantly, the company has made and continues to make substantial progress in improving water quality in the systems it took over with the Dominguez merger. We see no reason to question CalWater's assertion that it has complied with applicable water quality standards in these eight districts during the recent three-year period.

Other Intervenor Requests

Intervenor Lucerne Community Water Organization (LCWO) made additional requests in its opening brief that have not otherwise been addressed in our discussions above.

LCWO asks the Commission to order CalWater to impose a \$10 per square foot capacity buy-in fee for new residential construction. CalWater responds with general support for the view that existing customers in Lucerne (and any other water system) should not experience an increase in rates due to customer growth. The current rules protect ratepayers by requiring new development to pay its actual costs; under tariff Rule 15, connections by individuals or

⁶⁹ Exhibit F-RV, page 10.

developers requiring a main extension are already subject to charges for main extensions and special facilities (including water supply facilities) at actual cost. In addition, where significant growth occurs, a water utility may seek Commission authorization to impose a special per-lot facilities fee in lieu of following the actual cost procedure.

As LCWO acknowledges, this proposal was not previously raised in the proceeding, so we lack a sufficient record to order it at this time. The parties should more fully develop any proposals they wish to make and present evidence to support them in the next GRC for their district.

LCWO asks CalWater to distribute information on how to read meters, and to hold classes on meter reading. CalWater responds that meter reading pamphlets are available to customers either at the Lucerne office or by mail. Customers will also be provided a meter reading demonstration at the company's Lucerne office upon request. Further, if LCWO or other groups organize a meeting, CalWater will send a representative with meter reading instructional material and conduct a meter reading demonstration.

LCWO requests that CalWater meet quarterly with it to review capital, maintenance and other issues concerning the Lucerne water system. CalWater agrees to do so.

LCWO charges that CalWater has not adequately addressed leaks in the Lucerne system. This is a new charge, and as CalWater points out, not one addressed by evidence in the record.

No additional orders relating to these points are necessary.

Comments on Proposed Decision

The principal hearing officer's proposed decision was filed with the Commission and served on all parties in accordance with Pub. Util. Code

§ 311(d) and Rule 77.1 of the Rules of Practice and Procedure. _____ filed comments, and _____ filed replies to comments.

Assignment of Proceeding

John Bohn is the Assigned Commissioner and James McVicar is the assigned ALJ in this proceeding.

Findings of Fact

1. The parties' RSF proposal properly considers rate affordability in the districts (*i.e.*, income levels, usage levels, rate base per customer, availability of public loan funds, and average bills), public comments at the public participation hearings, letters to the Commission and DRA, and the impact of extraordinary water quality problems.

2. The parties' RSF proposal makes rates more affordable for all CalWater customers in the highest-cost districts, and provides additional support for low-income customers, both at minimal cost to other CalWater ratepayers.

3. CalWater and DRA's WRAM stipulation does not provide rate design criteria. Rate design criteria are an essential element to completing a water general rate case and implementing new rates.

4. There is insufficient evidence in the record to determine what return on equity adjustment, if any, would be appropriate for CalWater if the Commission were to approve the WRAM stipulation.

5. The WRAM stipulation does not provide the Commission with sufficient information to discharge its regulatory obligations.

6. The WRAM stipulation cannot be incorporated into this proceeding without unduly delaying the proceeding or denying the other parties due process.

7. No party filed and served comments contesting the stipulation on remaining issues as they were required to do by our Rules of Practice and Procedure, Rule 51.4, if they desired to oppose it.

8. The agreed-upon outcomes CalWater and DRA jointly recommend in their stipulation on remaining issues are reasonable for ratemaking purposes in this proceeding.

9. CalWater has not demonstrated the reasonableness of its plant in service estimates for Projects 14318 and 14319 in the Coast Springs rate area. DRA, Young and Pareas have shown a likelihood that, when the projects are completed and a full cost accounting is made available, some part of CalWater's costs for these projects will be found to be unnecessary and unreasonable. DRA's estimates of these projects' costs are more reliable for our purpose than are CalWater's.

10. Young and Pareas have not shown that CalWater's selection of a glass fused-storage tank for Coast Springs was imprudent or unreasonable.

11. The solar-powered pump installed to prevent nitrification in Coast Springs' Ravine Tank is used and useful and should be allowed in plant for ratemaking.

12. It would not be reasonable to order CalWater to retain an independent firm to audit CalWater's Coast Springs construction contracting practices.

13. DRA's ROE analysis, once revised to incorporate certain of CalWater recommendations, produces a reasonable ROE estimate. CalWater's ROE analysis was incorrect and less credible than DRA's.

14. The capital structure, cost of debt, rate of return on equity, and rate of return on rate base shown in Table 3 are reasonable for setting CalWater's rates for the 2006/2007 through 2008/2009 GRC cycle.

15. The three-year conservation budget CalWater and DRA have agreed to in their stipulation on remaining issues is reasonable and necessary for promoting water conservation in the districts and rate areas to which it applies.

16. CalWater has not justified its request to recover amounts booked in its balancing accounts that are below the advice letter recovery threshold of 2% of revenue requirement.

17. The merger premium revenue requirement for test year 2006/2007 resulting from the merger of CalWater with Dominguez Services Corporation is more than offset by merger-related savings. The synergy savings amounts discussed in the Dominguez Merger Synergies section of this decision are appropriate for use in future ratesetting proceedings.

18. If CalWater should lose 5% or more of its well production capacity in Dominguez-South Bay district during this GRC cycle, it would be reasonable to allow CalWater to file an advice letter initiating a water expense memorandum account for that district to track changes in water production costs due to mix changes only, and for CalWater to seek Commission approval in its next GRC for Dominguez-South Bay district to recover up to 90% of any balance in the new memorandum account.

19. When filing advice letters for escalation year rates, it would be appropriate to apply a modified recorded earnings test based on the temperature and rainfall coefficients CalWater and DRA have agreed to, rather than a full recorded earnings test without weather adjustments, for all of the districts in this proceeding except Redwood Valley. For Redwood Valley, it would be more appropriate to use a full recorded earnings test.

20. The adopted summary of earnings for each district presented in Appendix A, the adopted 2006/2007 and 2007/2008 rate bases in Appendix B,

and the adopted quantities and calculations included as Appendix E that underlie them, are reasonable for ratemaking purposes.

21. The test year 2006/2007 rates in Appendix C have been designed to produce revenues consistent with the summary of earnings adopted in this order.

22. CalWater has made and continues to make substantial progress in improving water quality in the systems it took over with the Dominguez merger.

Conclusions of Law

1. The RSF settlement entered into by all parties to this proceeding is an uncontested settlement as defined in Rule 51(f).

2. The stipulation on remaining issues entered into by CalWater is an uncontested stipulation as defined in Rule 51(f).

3. The RSF settlement and the stipulation on remaining issues are reasonable in light of the whole record, consistent with law, and in the public interest.

4. The RSF settlement and the stipulation on remaining issues should be approved.

5. The WRAM stipulation should not be approved.

6. For each of the eight districts in this proceeding, CalWater should be required to collect subject to refund the amount of its adopted revenue requirement that results from our computational assumption that the American Jobs Creation Act of 2004 does not apply, until our order finally establishing in a future proceeding the actual tax benefit, if any, conveyed to CalWater under the Act. CalWater should report the amount so collected and the status of its tax liability under the Act in each GRC for these districts until the Commission has made a final determination.

7. CalWater has complied with applicable federal and state water quality standards and the water quality requirements of GO103 in these eight districts during the recent three-year period.

8. The increases authorized in this decision are justified, and the revised rates set forth in Appendix C are just and reasonable.

9. CalWater should be authorized to implement the rate changes set forth in this order.

10. This decision should be made effective immediately to allow CalWater to put the revised rates into effect as near as possible to the first day of the test year.

O R D E R

IT IS ORDERED that:

1. The Joint Motion of California Water Service Company (CalWater) and Division of Ratepayer Advocates (DRA) to Approve Stipulation Concerning Rate Base Equalization Account Settlement, filed March 2, 2006, is granted. The settlement included as Attachment A to that motion and referred to in this order as the Rate Support Fund (RSF) settlement is approved.

2. The Joint Motion of California Water Service Company and Division of Ratepayer Advocates to Approve a Stipulation concerning the Water Revenue Adjustment Mechanism and a Stipulation regarding Remaining Issues, filed March 9, 2006, is granted in part and denied in part. The Revenue Adjustment Mechanism Agreement included as Attachment A to that motion and referred to as the WRAM stipulation is not adopted. The Stipulation of California Water Service Company and the Division of Ratepayer Advocates included as Attachment B to that motion and referred to in this order as the stipulation on remaining issues is adopted.

3. CalWater shall within 60 days file a new application that addresses the goals of the Water Action Plan by proposing an increasing block rate design for each of the districts in this general rate case for years 2007/2008 and 2008/2009, and an accompanying mechanism to decouple sales from revenues.

4. CalWater is authorized to file in accordance with General Order 96-A and make effective on not less than five days' notice revised tariff schedules for each district and rate area in this proceeding, reflecting the adopted rates for test year 2006/2007 included as Appendix C to this order. The revised tariff schedules shall apply to service rendered on and after the date this decision is mailed.

5. Not later than May 15, 2007 and May 15, 2008 for escalation years 2007/2008 and 2008/2009 respectively, CalWater shall file advice letters in conformance with General Order 96-A or its successor proposing new revenue requirements and corresponding revised tariff schedules for each district and rate area in this proceeding. CalWater's advice letters shall follow the escalation procedures set forth in the Commission's Rate Case Plan for Class A Water Utilities, and shall include appropriate supporting workpapers. CalWater shall reduce the escalation year revenue requirement for any district or rate area to the extent its rate of return on rate base for the twelve months ending March 31, 2007 and March 31, 2008 for that district or rate area, taking into account the rates then in effect and normal ratemaking adjustments, exceeds the rate of return found reasonable in this order. The revised tariff schedules shall take effect on July 1, 2007 and July 1, 2008, respectively, and shall apply to service rendered on and after their effective dates. The proposed, revised revenue requirements and rates shall be reviewed by the Commission's Water Division. Water Division shall inform the Commission if it finds that the revised rates do not conform to the Rate Case Plan, this order, or other Commission decisions, in which case all

revenues collected under the revised rates shall be subject to refund until the Commission has decided the matter.

6. CalWater shall use a full recorded earnings test in evaluating, and if necessary, adjusting, its 2007/2008 and 2008/2009 escalation year filings for Redwood Valley district, and a modified recorded earnings test based on weather-adjusted earnings using temperature and rainfall coefficients set forth in Appendix E, Adopted Quantities, of this order for the other seven districts subject to this order.

7. CalWater is authorized to file an advice letter to begin recovering in rates the change in revenue requirement for each group of related projects listed in Appendix F, after that group of projects has been completed and placed in service. The plant costs used for advice letter purposes shall not exceed the cap listed for each group of projects. Each advice letter shall become effective when Water Division has determined that it is in compliance with CalWater and DRA's stipulation on remaining issues and this decision. This authorization shall expire as of the effective date of the new rates set for each district in the first test year in CalWater's next general rate case (GRC) for that district, currently anticipated to be July 1, 2009. When new rates are set in the next GRCs for these districts, rate recovery going forward for each project shall be as determined by the Commission at that time.

8. CalWater is authorized to file a single advice letter to begin recovering in rates the incremental revenue requirement associated with Projects 8087, 14318, and 14319 in Coast Springs rate area when all three have been completed and placed in service and all of their associated costs properly booked. The advice letter shall become effective when Water Division has determined that it is in compliance with this decision. The company-funded plant costs (*i.e.*, exclusive of

State Revolving Fund and Safe Drinking Water Bond Act loan funding) used for advice letter purposes shall not exceed \$227,800 for Project 14318, and \$114,000 for Project 14319. The capped plant amounts determined in the advice letter filing shall be considered interim and will become final after the next CalWater Coast Springs GRC unless CalWater and/or the other parties there present persuasive evidence supporting a different final outcome.

9. The conservation expense figures in Table 4 of this decision are adopted as the three-year budget totals for each district and rate area. For purposes of setting rates in this proceeding, they shall be divided equally among the three years of this GRC cycle and are not subject to the Water Rate Case Plan's escalation procedures in the second and third years.

10. CalWater shall track its actual conservation expenses by district against the corresponding conservation expense budget allowances defined by Table 4 and adopted in this order, in a one-way balancing account. In its next GRC filing for each district, CalWater shall propose to refund to customers any under-expenditure for their district in the account. No recovery is authorized for expenditures above the adopted budgets.

11. For each of the eight districts in this proceeding, CalWater shall collect subject to refund the amount of its adopted revenue requirement that results from our computational assumption that the American Jobs Creation Act of 2004 does not apply, until our order finally establishing in a future proceeding the actual tax benefit, if any, conveyed to CalWater under the Act. CalWater shall report the amount so collected and the status of its tax liability under the Act in each GRC for these districts until the Commission has made a final determination.

12. The provisions in Decision 05-07-022, Ordering Paragraph 9 and Attachment B, Section 2.1.3.9, wherein the Commission authorized CalWater to file advice letters to recover the costs of up to 15 specific general office personnel after each has been hired and to recover the costs associated with general office expansion project 10867 not to exceed the equivalent of the revenue requirement on \$887,000 in capital additions (or in the alternative, to rent nearby office space at equivalent or lower cost), are made applicable to the districts in this proceeding as well.

13. The following amounts resulting from our evaluation of the synergies savings generated by CalWater's merger with Dominguez Services Corporation are adopted for the 2006/2007 test year and shall be used in future CalWater rate proceedings: general office merger savings are \$5,035,000; operations cost savings allocated to the districts are \$406,455 to Dominguez-South Bay district, \$252,105 to Hermosa-Redondo district, and \$298,410 to Palos Verdes district; and financing-related merger savings are \$550,000 in Dominguez-South Bay district.

14. CalWater is authorized to file an advice letter(s) to begin recovering amounts booked in the general office synergies memorandum account for the Bear Gulch, Hermosa-Redondo and Marysville districts from the effective date of Decision 04-04-041 through January 1, 2006.

15. If CalWater should lose 5% or more of its well production capacity in Dominguez-South Bay district during this three-year GRC cycle, it may file an advice letter initiating a water expense memorandum account for that district to track changes in water production costs due to mix changes only, to be effective on the date of filing. Production expense changes due to wholesaler price changes would continue to be tracked in the existing water supply balancing

accounts. Once established, CalWater may seek Commission approval in its next GRC for Dominguez-South Bay district to recover up to 90% of any balance in the new memorandum account.

16. The capital structure, cost of debt, rate of return on equity, and rate of return on rate base shown in Table 3 are adopted for the 2006/2007 through 2008/2009 GRC cycle.

17. The summaries of earnings presented in Appendix A, the adopted 2006/2007 and 2007/2008 rate bases in Appendix B, and the quantities and calculations included as Appendix E to this order that underlie them, are adopted.

18. CalWater's requests in Application 05-08-006 through Application 05-08-013 are granted as set forth above, and in all other respects are denied.

19. This proceeding is closed.

This order is effective today.

Dated _____, at San Francisco, California.