STATE OF CALIFORNIA ARNOLD SCHWARZENEGGER, *Governor*

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

March 25, 2008

Agenda ID #7502
and
Alternate Agenda ID #7503
Ratesetting

TO PARTIES OF RECORD IN APPLICATION 07-01-03 et al.

Enclosed are the proposed decision of Administrative Law Judge (ALJ) Rochester previously designated as the presiding officer in this proceeding and the alternate proposed decision of Commissioner Bohn. The proposed decision and the alternate decision will not appear on the Commission's agenda for at least 30 days after the date it is mailed.

Pub. Util. Code § 311(e) requires that the alternate item be accompanied by a digest that clearly explains the substantive revisions to the proposed decision. The digest of the alternate proposed decision is attached.

This matter was categorized as ratesetting and is subject to Pub. Util. Code § 1701.3(c). Upon the request of any Commissioner, a Ratesetting Deliberative Meeting (RDM) may be held. If that occurs, the Commission will prepare and publish an agenda for the RDM 10 days beforehand. When an RDM is held, there is a related ex parte communications prohibition period. (See Rule 8.2(c)(4).)

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

Parties to the proceeding may file comments on the proposed decision and alternate proposed decision as provided in Pub. Util. Code §§ 311(d) and 311(e) and in Article 14 of the Commission's Rules of Practice and Procedure (Rules), accessible on the Commission's website at www.cpuc.ca.gov. Pursuant to Rule 14.3, opening comments shall not exceed 15 pages.

Comments must be filed either electronically pursuant to Resolution ALJ-188 or with the Commission's Docket Office. Comments should be served on parties to this proceeding in accordance with Rules 1.9 and 1.10. Electronic and hard copies of comments should be sent to ALJ Rochester at lrr@cpuc.ca.gov and Commissioner Bohn's advisor Laura Krannawitter, at llk@cpuc.ca.gov. The current service list for this proceeding is available on the Commission's website at www.cpuc.ca.gov.

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

ANG:hl2

Attachment

ATTACHMENT

Digest Explaining Substantive Differences from Proposed Decision:

Issue: Proposed Consolidation of Larkfield and Sacramento Districts –

Proposed Decision: Does not adopt the Application's proposed consolidation plan, however, it adopts an alternate consolidation plan. The alternate plan requires Sacramento District customers to provide a $.65 per month subsidy to Larkfield. Although the subsidy decreases the Larkfield District monthly rate increase by $16.40, Larkfield District customers' monthly bills will still increase by $9.75. The Sacramento subsidy will continue for 2009 and 2010, although the Larkfield District will fully absorb the increases adopted for 2009 and 2010.

Alternate Proposed Decision: Does not adopt **any** consolidation plan for the Larkfield and Sacramento districts.

(END OF ATTACHMENT)

Decision **ALTERNATE PROPOSED DECISION OF COMMISSIONER BOHN**
(Mailed 3/25/2008)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U 210 W), to Decrease Revenues for Water Service in its Coronado District By ($73,100) or (0.46%) in 2008 and Increase Revenues by $266,200 or 1.67% in 2009 and $260,900 or 1.61% in 2010.	Application 07-01-036 (Filed January 22, 2007)
And Related Matters.	Application 07-01-037 Application 07-01-038 Application 07-01-039

(See Attachment C for a List of Appearances)

OPINION ADOPTING THE REVENUE REQUIREMENT FOR CALIFORNIA-AMERICAN WATER COMPANY'S LARKFIELD AND SACRAMENTO DISTRICTS

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Settlement Agreement – Sacramento District

ATTACHMENT B: Comparison Tables

ALTERNATE OPINION ADOPTING THE REVENUE REQUIREMENT FOR CALIFORNIA-AMERICAN WATER COMPANY'S LARKFIELD AND SACRAMENTO DISTRICTS

1. Summary

This decision resolves the revenue requirement phase of the general rate case (GRC) application of California-American Water Company (Cal Am) for its Larkfield (A.07-01-037) and Sacramento (A.07-01-038) districts. A separate decision was issued for the Coronado and Village districts. We adopt a 2008 revenue increase for Larkfield of $753,200 or 36.66%, which is effective from January 1, 2008. We adopt a 2008 revenue increase for Sacramento of $6,804,300 or 25.71%, which is effective from January 1, 2008. The rate design portion of this case will be decided in Phase II.

Today's decision adopts the settlement between Cal Am and the Division of Ratepayer Advocates (DRA). We find the settlement is reasonable in light of the whole record, consistent with law and in the public interest.

We adopt a return on equity (ROE) of 10.15% for Cal Am's Larkfield and Sacramento districts for the three-year GRC period, or until the next GRC or Cost of Capital decision for a particular district is issued.[1]

We do not grant Cal Am's request for an Infrastructure System Replacement Surcharge (ISRS). Cal Am must first develop a comprehensive asset management plan, as described in the Water Action Plan, identifying the specific areas requiring capital investment to replace or improve aging infrastructure before we will implement a surcharge.

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[1] Cal Am is schedule to file the next GRC for Larkfield and Sacramento in 2008, according to the new Rate Case Plan adopted in Decision (D.) 07-05-062.

We do not implement the pilot Distribution System Improvement Charge (DSIC)[2] program developed in D.07-08-030 for the Cal Am Los Angeles District GRC. If successful, we envision the Los Angeles pilot program serving as a model for other Cal Am districts and Class A water utilities. We encourage Cal Am to take the necessary steps outlined here to implement an asset management plan and apply for a DSIC in its next GRC.

We do not adopt the Cal Am consolidation proposal. While the Water Action Plan opened the door for a renewed consideration of subsidies, it did so along with a multitude of other policy objectives to be balanced. We have not been presented with a record in this proceeding that would weigh the need to mitigate rates for a low density community heavier than the need to charge cost-based rates.

Finally, this decision approves Cal Am's requested regulatory expenses and employee pensions and benefits expenses.

2. Background

Cal Am is a Class A water company with seven districts.[3] Class A water companies are regulated by the Commission pursuant to Article XII of the California Constitution and the Public Utilities Code. Specifically, Pub. Util.

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[2] The ISRS and DSIC are different names for similar infrastructure improvement funding mechanisms.

[3] Class A water companies are privately held water companies with over 10,000 service connections. Cal Am's seven districts are Coronado, Felton, Larkfield, Los Angeles, Monterey, Sacramento, and Village.

Code § 455.2, as implemented in the Rate Case Plan (RCP), provides for a GRC proceeding every three years.[4]

The Larkfield Water Company was constructed and granted a certificate of public convenience and necessity in 1959. It was merged into Citizen's Utilities in 1995, and then acquired by American Water[5] in 2002.[6]

The Larkfield District provides water service to an unincorporated portion of Sonoma County about four miles north of the City of Santa Rosa, CA. The service area includes the Larkfield and Wikiup subdivisions which lie along the eastern boundary of U.S. Highway 101 and the community of Fulton which is located west of U.S. Highway 101. An interconnected distribution system serves the three areas of the district which provides water to approximately 2,400 customers. The mix of water provided to Larkfield District customers consists of well water and water purchased from the Sonoma County Water Agency.

In 1928, the North Sacramento Light and Water Company was purchased by the Public Utilities California Corporation. The name was changed to Citizen's Utilities Company of California (Citizens) in 1949. Over the years, through a series of mergers and acquisitions Citizens grew to encompass the ten distinct water systems that now comprise the Sacramento District. In January 2002, American Water acquired Citizens Utilities Company. The Sacramento District provides water service to areas north, east, and south of the City of Sacramento. It also includes an area west of the City of Roseville in

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[4] The original RCP was adopted in D.04-06-018. On May 24, 2007, the Commission issued D.07-05-062, revising the original RCP.

[5] American Water is the parent company of Cal Am.

[6] The transaction was authorized by the Commission in D.01-09-057.

Placer County and the smaller communities of Isleton and Walnut Grove located southwest of the City of Sacramento. The ten water systems are now operated as one. The systems are Antelope, Arden, Isleton, Lincoln Oaks, Parkway, Rosemont, Security, Suburban, Walnut Grove, and West Placer. The Sacramento District serves approximately 59,000 customers.

On January 22, 2007, Cal Am filed applications for rate changes for its Coronado, Larkfield, Sacramento, and Village districts. DRA filed a timely protest on February 21, 2007, and a prehearing conference (PHC) was held on March 23, 2007 in San Francisco. The Mark West Area Community Services Committee (Mark West) filed a Motion to Intervene on March 12, 2007. At the PHC, Mark West's Motion to Intervene was granted and the proceedings were consolidated without objection. Both DRA and Mark West objected to including the consolidation of the Larkfield and Sacramento districts in the scope of the proceeding.

The assigned Commissioner's and Administrative Law Judge's Scoping Memo was issued on April 11, 2007, and included the proposed consolidation of Larkfield and Sacramento. The ruling found that allowing the parties to address the issue is in the public interest and, as such, consolidation is included in the scope of this proceeding.

The Commission held four Public Participation Hearings (PPHs), one each in Thousand Oaks (Village District) and Larkfield, and two in Sacramento, on April 12, 17, and 18, 2007, respectively.[7] After the Scoping Memo was issued, DRA filed a Motion to bifurcate the proceeding into two phases and move the

[7] There were two PPHs in Sacramento, one in the afternoon and one in the evening.

Conservation Rate Design, Purchased Water Balancing Account and Water Rate Adjustment Mechanism (WRAM) requests into the second phase of the proceeding. DRA sought the bifurcation because it believed it would be unable to submit its testimony in a timely fashion due to limited staff resources. There was no opposition to the motion. DRA had previously raised the issue at the PHC, but the ALJ declined to move the issues into another phase at such an early date. On May 5, 2007, an ALJ Ruling granted DRA's motion and adopted its proposed new schedule.

On April 13, 2007, Cal Am served Supplemental Testimony of Rodney Jordan and removed the Sutter Well and Well Number 6 from the Larkfield District application. Direct testimony was served by DRA and Mark West on May 2, 2007. Cal Am served its rebuttal testimony on May 21, 2007. Evidentiary hearings were held June 4-6, 2007, with Opening and Reply Briefs filed on June 28, 2007, and July 3, 2007, respectively.

DRA and Cal Am filed a Settlement Agreement on July 6, 2007. On July 20, 2007, Mark West filed Comments on the Settlement Agreement. On August 20, 2007, both DRA and Cal Am filed Replies to Mark West's Comments on the Settlement Agreement.

On October 2, 2007, Cal Am filed a motion to reopen the record to accept late-filed exhibits which corrected errors in the comparison tables attached to the Settlement Agreement. On November 2, 2007, Cal Am filed a motion for interim rate relief. An ALJ ruling issued on November 20, 2007, granted both motions.

3. Settlement Agreement Between Cal Am and DRA

Article 12 of the Commission's Rules of Practice and Procedure govern settlement agreements. According to Rule 12.1(d), prior to approval, the Commission must find the settlement, whether contested or uncontested,

"reasonable in light of the whole record, consistent with law, and in the public interest." Cal Am and DRA state that they have entered into the settlement agreement on the basis that the Commission's adoption not be construed as an admission or concession by any party regarding any fact or matter of law in dispute in this proceeding. They also intend that the Commission's adoption of the settlement not be construed as any statement of precedent or policy of any kind against them in any current or future proceedings. Furthermore, the settlement is an integrated agreement, so that if the Commission rejects any portion of the settlement, each party has the right to withdraw.[8]

Prior to filing the settlement, an all-party settlement conference was held on May 25, 2007, and representatives of Cal Am, DRA, and Mark West participated. Other meetings were held both in person and telephonically. Mark West declined to enter into the settlement agreement and therefore the settlement addresses disputed issues between DRA and Cal Am.[9]

3.1. Mark West Comments on the Settlement Agreement

On July 20, 2007, Mark West filed comments on the settlement agreement claiming it was systematically excluded from substantive negotiations on subjects in which it had an interest and requesting that negotiations be reopened on specific subjects. Mark West objects to three sections of the settlement

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[8] See July 6, 2007, Motion of California American Water Company and the Division of Ratepayer Advocates for Adoption of Settlement Agreement as to Certain Issues on the Revenue Requirements, p. 4.

[9] *Id.*, p. 2, fn. 2.

regarding the Larkfield District: the Faught Road Well, the water treatment plant expansion, and the inclusion of conservation plan costs in rate base.[10]

As to the Faught Road Well, Mark West claims the well is unnecessary and that inflated customer base estimates were used to justify it. Mark West similarly claims the water treatment plant expansion is based on inflated needs estimates. Mark West's position is that the existing two filters are adequate since individually they are capable of treating up to 600 gallons per minute (gpm) for a total of 1200 gpm. Mark West contends the existing treatment capacity is adequate since even with the extra 401 gpm from the addition of the Faught Road Well, only 901 gpm of capacity are required. Finally, Mark West characterizes the inclusion of conservation program costs in rates as "hiding the costs."[11] Mark West feels customers would be better served by seeing a surcharge on their bill every month as a reminder to take advantage of the conservation programs paid for in their rates. Mark West also objects to the lack of a requirement that the conservation program provide results and believes the effects of conservation should be reflected in the Water Needs Analysis.

Both DRA and Cal Am object to Mark West's claims of being excluded from the settlement negotiations. Cal Am and DRA refer to three all-party meetings in which Mark West was a participant. Cal Am goes on to explain that Mark West's participation in all the meetings was not discouraged. Rather Mark West's complaints reflect the limited issues of concern to it outside the Larkfield

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[10] The Faught Road well and the water treatment plant expansion are included in the Utility Plant in Service category and the Conservation Balancing Account is Special Request No. 6.

[11] Mark West Area Community Service Committee's Comments on the Settlement Agreement, p. 7.

District and its lack of interest in compromise positions. DRA characterizes Mark West's contention that it should have been included in all settlement discussions as unreasonable and impractical. DRA cites the Commission's policy of encouraging settlements as intended to promote efficiency in its proceedings. DRA contends that including Mark West in all the meetings would have been contrary to that policy since Mark West's interest was limited to the Larkfield District.

We agree and find that DRA and Cal Am complied with the Rule 12.1 requirement that at least one conference be held with notice and opportunity to participate provided to all parties. Mark West participated in three conferences, providing it ample opportunity to express its views and negotiate settlement terms on the items of interest to it. A non-signatory's general unhappiness with the terms is insufficient grounds to reject a settlement agreement, in part or in whole.

3.2 Terms of the Settlement

The expense amounts in dispute differed from district to district. A full comparison of the parties' original and settled positions for each section is included as Attachment 1.

The parties were able to reach agreement on the majority of issues in dispute in multiple ways. One reason for the disparate positions was the use of different inflation factors. If the difference between the two positions was nominal, Cal Am either agreed to adopt the lower DRA estimate or a compromise figure. Another reason for dissimilar original estimates was DRA's concern with high expense years being included in the calculation and Cal Am's belief that high expense year figures were legitimate and should be included. When this occurred, the parties usually adopted a mid-point compromise

amount for the settlement. Parties also reached a mid-point compromise on other issues, with the parties taking into account the actual historical expenses incurred as well as the variable nature of those expenses.

In some areas, the difference in position was due to calculation or accounting errors. Once the errors were identified and corrected, the parties agreed on the final figure or were able to adopt a settled amount. The following discussion deals with specific areas in which settlement was achieved in a manner other than those described above.

3.2.1. Cost of Capital

Cal Am and DRA agree on the districts' capital structure for the test year and both escalation years. They agree to a ratio of 58.16% debt to 41.84% equity for Test Year 2008, 58.32% debt to 41.68% equity for Escalation Year 2009, and 58.83% debt to 41.17% equity for Escalation Year 2010. The settlement uses Cal Am's projected 2007 capital structure, believing it is essentially equivalent and representative for all three years. DRA accepted Cal Am's cost of debt for 2008, 2009 and 2010, as 6.20%, 6.25% and 6.29% respectively. We find the capital structure reasonable and in compliance with D.06-11-050, which required a return to the use of a consolidated capital structure in Cal Am's next GRC. We also find the parties' agreed upon cost of debt reasonable.

3.2.2. Customer Sales and Revenue

Section 3.2 of the settlement for each district addresses Customer Sales and Revenue. The parties' initial positions essentially agreed on the customer counts, average water use, and an allowance for unaccounted-for water for each of the districts. Therefore, we find this section reasonable.

3.2.3. Operation and Maintenance Expense

The description of the settlement for Operations and Maintenance Expenses (O&M) appears in Section 3.3 of the settlement for each district. The specific items discussed below are O&M expense elements for the various districts that were not settled in the manner previously described.

3.2.3.1 Sacramento District Pumping Expense - Miscellaneous

The settlement figure for this expense item reflects clarification of vendor labeling and inclusion of certain 2002 expenses.

3.2.3.2 Sacramento District Water Treatment - Miscellaneous

The parties agreed to include Hazardous Materials charges for Oscar Larson Associates in 2003 and 2004 which had been removed, and recalculate the five-year average using DRA escalation numbers.

3.2.3.3. Sacramento District Source of Supply – Wells

The original difference between the parties' figures was due to an accounting error on Cal Am's part. Once corrected, there was no difference in the parties' figures.

Parties agreed that correcting the unaccounted for water figure altered the production numbers, which necessitated updating the purchased water and power costs for the district.

We find the manner in which compromise was achieved and the final settlement positions in this section reasonable.

3.2.4. Administrative and General Expenses

Administration and General Expenses (A&G) are addressed in Section 3.4 of the settlement for each district. By far, the largest expenses in this section and

the one in which the parties' positions are most disparate, is employee pensions and benefits and regulatory expenses. All other elements of A&G were either agreed upon initially or settled in the course of negotiations. Employee pensions and benefits, including employee awards are not a part of the settlement and are discussed in another section of this decision. Regulatory expenses are also excluded from the settlement and discussed later.

For all of the districts except Sacramento, the parties reached settlement on miscellaneous general expenses by removing charitable contributions, conservation expenses and community relations/outreach expenses. For the Sacramento District, Cal Am adopted DRA's estimate, adjusted by an inflation factor.

We find the settled items in this section reasonable.

3.2.5. Utility Plant in Service

Utility Plant in Service is discussed in Section 3.5 of the settlement for each district. Following extensive exchanges of information and negotiations on the rationale for each requested plant item, Cal Am and DRA agree as set forth in Tables 1 and 2 and in the following discussion:

TABLE 1:
LARKFIELD DISTRICT UTILITY PLANT IN SERVICE (000s)

Project	Cal Am	DRA	Settlement
Meters Replacement	$ 310.00	$195.00	$ 257.00 over 3 years
Treatment Replacement	150.00	0.00	150.00 over 2 years
Faught Road Well	1,550.00	0.00	$2,048.75 (Combined)
Larkfield Treatment Plant	600.00	0.00	
Lower Wikiup Main	$ 311.00	$286.00	$ 286.00

The Faught Road Well and the Larkfield Treatment Plant were controversial issues both for the settling parties and Mark West. Mark West's testimony, Opening and Reply Briefs, and Comments on the Settlement continually questioned the need for either of these projects. Mark West cites a DHS report that found Cal Am's existing capacity met the needs of its current customer base, but that Cal Am should continue efforts to acquire additional sources of supply in anticipation of new developments under construction.[12]

Cal Am provided several versions of water supply analysis, pursuant to General Order 103, for 2005, 2010 and 2015. All scenarios used a low growth factor and purchased water supply in both the high and low ranges. Even using figures representing low growth factors, all versions indicate a deficit in water supply except for the two 2005 versions using the high range of purchased water.[13]

Ultimately, DRA accepted Cal Am's position that the new well is needed to meet the current deficit in water supply for the district. The expanded treatment facility capacity will provide reliability and redundancy for the system, especially needed when the Faught Road Well is completed. Cal Am agreed to reduce the contingency factor for the Faught Road Well by 15% and for the Larkfield Well Treatment Plant by 10%.

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[12] Exhibit 32, p. 11.

[13] Exhibit 17, Glover Rebuttal Testimony, pp. 18-22.

TABLE 2:
SACRAMENTO DISTRICT UTILITY PLANT IN SERVICE (000s)

Project	Cal Am	DRA	Settlement
Network Replacement	$ 962.6	$ 240.0	$ 240.0 over 3 years
Services Replacement	1,869.0	570.0	1,200.0 over 3 years
Meter Replacement	461.0	55.5	258.0 over 3 years
Meters New	330.7	66.0	66.0 over 3 years
CPS 2007	355.0	299.0	299.0
CPS 2008	626.9	515.0	515.0
CPS 2009	813.0	132.0	132.0
Suburban Distr. and Supply Improvements	15,000.0	5650.0 (AL[14])	1,4450.0
Distribution Monitoring System Improvement	750.0/year	750.0 (AL)	750.0/year
Roseville Road Booster Station	2,463.0	1954.2	2,347.2
Parkway Purch.Water	3,300.0	1,300.0 (AL)	3,395.5
Cook Riolo Tank and Booster Station	3,993.0	3,993.0 (AL)	3,993(annual AL)
Arsenic Treatment Walnut Grove	2,602.4	1,908.7	2,540.9
Arsenic Treatment Isleton	3,601.7	2,901.7	3,550.2
Jackson Well, Booster Station	5,160.0	4,862 (AL)	5,014 (annual AL)
Fluoride in Suburban	2,435.9	2,264.0	2,264.0
Fluoride in Arden	905.0	822.0	822.0
Convert Flat to Metered	7,657.0	7,657.0 (AL)	7,657.0
Rehab Wells 2008 & 2009	2,203.8	1420.0	1,697.0
Fite Well	1,718.5	0.0	1,718.5 (AL)
Water Treatment Imprvt.	2,857.0	2,250.0	2,250.0
Small Main Replacement Program 2007-2009	4,610.0	4,610.0	4,610.0
Walnut Grove Well Rehab and Raw Water Main	710.0	710.0 (AL)	710 (AL)

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

[14] Advice Letter.

3.2.6. Depreciation Expense and Reserves

Depreciation Expense and Reserves are discussed in Section 3.6 of the settlement for each district. Both Cal Am's and DRA's original depreciation calculations contained errors which were corrected in the settlement. Ultimately, DRA agreed with Cal Am's position that depreciation accruals for forecasted years 2007 through 2009 should be calculated using rates approved by the Commission in prior rate cases. We find this section of the settlement reasonable.

3.2.7. Special Requests

The Special Requests are addressed in Section 3.7 of the settlement for each district. Because the special request numbering varied by district, this section will refer to the subject of the special request rather than the special request number.

3.2.7.1. Low-Income Program

These requests involve the Low-income Program Tariff. Cal Am agrees to provide Low-income Rate Assistance credit to non-profit group living facilities and migrant farm worker housing centers deemed qualified using the same criteria as that used for the California Alternative Rates for Energy program for gas and electric. Cal Am may require post-enrollment verification.

3.2.7.2. Conservation Balancing Account and Surcharge and Program Funding

The Conservation Program funding is an element of the Conservation Balancing Account sought by Larkfield and Sacramento.

The parties agree that the conservation budget will be in rates for the three-year rate case period at the maximum level allowed for Cal Am. Cal Am and DRA agree that budget estimates will not be escalated in attrition years.

Parties agree that the balancing account is subject to refund, Cal Am has the ability to move funds between Best Management Practices (BMP) as necessary, and Cal Am will provide all required California Urban Water Conservation Council reports to the Commission and DRA. The parties reached settlement on all the BMP expenses.

As previously discussed, Mark West, approves of the conservation programs, but believes the program costs should appear on customers' monthly bills rather than hidden in rates. If the surcharge appeared on bills every month, it would serve as a reminder to customers to utilize the program. Mark West also believes the conservation program should be required to provide results and the effects of conservation should be reflected in the Water Needs analysis. This is a rate design issue and will be considered in Phase II.

3.2.7.3. American Jobs Creation Tax Act

The parties agree that when the actual deduction amount has been determined, Cal Am will provide DRA with the figure.

3.2.7.4. Balancing and Memorandum Account Balances

The parties do not dispute these issues as they will be recovered according to Commission rules.

3.3 Cal Am's and DRA's Motion to Adopt the Settlement

Based on our review of the settlement and weighing it as an integrated document, we find it is reasonable in light of the whole record, consistent with the law, and in the public interest. Therefore, we grant Cal Am's and DRA's Motion, and adopt the settlement.

4. Issues Not included in the Settlement

4.1. Cost of Capital

4.1.1. Return on Equity

The United States Supreme Court established the standard for setting a fair rate of return in *Bluefield*, *Hope,* and *Duquesne*.[15] These decisions establish that a public utility is entitled to earn a fair return on the value of property invested to serve the public. The return should equal the return on investments in comparable companies and should be adequate to establish confidence in the financial stability of the company, maintain its credit standing, and attract necessary investment capital. Although these decisions establish the constitutional standard for a fair return, determining what ROE meets that standard requires the analysis of many factors.

Cal Am's requested ROE is based on the average of two market-based financial models yielding an ROE ranging from 9.1% without a risk adjustment, to 15.7% including a risk adjustment of 3.3%. Because Cal Am is not a publicly traded company, both Cal Am and DRA applied market-based models to the stock of similar business risk companies to determine the cost of equity for those companies. The companies are: American States Water, California Water, Aqua America, Connecticut Water, Middlesex Water, and San Jose Water Corp. Cal Am included a seventh company, Southwest Water Corp., in the group it used. Cal Am also estimated the cost of equity for two additional groups of utilities.

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[15] *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia (Bluefield)* 262 U.S. 679, 692-693 (1923), *Federal Power Commission v. Hope Natural Gas Company* (*Hope*), 320 U.S. 591, 603, (1944), and *Duquesne Light Co. v. Barasch* (*Duquesne*) 488 U.S. 299, 310 (1989).

The two groups are seven regulated gas[16] and seven regulated electric[17] utilities. Cal Am states it used the gas and electric utility estimates strictly as a reasonableness check for its water utilities calculations. Cal Am's risk component was determined by examining the risk in the cost of equity estimates compared to the risk in Cal Am's capital structure. These models provide a range of ROE estimate results.

Cal Am used the Discounted Cash Flow (DCF) model and Capital Asset Pricing Model (CAPM) in its analysis. To determine the DCF based ROE, Cal Am used the Constant Growth DCF model and the Multi-Stage DCF. The Constant Growth Model assumes the company has a constant payout ratio and earnings rate, and a Multi-Stage DCF model assumes investors expect near-term, non-constant growth and long-term constant growth.[18] The two DCF models yielded 8.9% and 9.2% results for an average 9.1% DCF method cost of equity.

The CAPM model concludes that the expected return on a risky asset is equal to the sum of the prevailing risk-free interest rate and market risk premium adjusted for the riskiness of the investment relative to the market. It assumes all investors hold efficient portfolios moving in lock step with the market and the portfolios differ only in their sensitivity to the market.[19] The

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[16] Cascade Natural Gas, Keyspan Corp., Northwest Natural Gas, Nicor Inc., Piedmont Natural Gas, South Jersey Industries, and Southwest Gas.

[17] Central Vermont Public Service, Cleco Corporation, DPL Inc., Empire District Electric, Green Mountain Power, Hawaiian Electric, IDACORP, Inc., and Westar Energy.

[18] The multi-stage DCF model uses near-term forecasts for the comparable companies and long-term forecasts of the gross domestic product from 1929 to 2005.

[19] Exhibit 4, p. 23.

CAPM analysis averages the results of the historical market risk premium (12.5%) and current market risk premium (12.2%) yielding an average 12.4% CAPM cost of equity. Both results shift upward when a capital structure risk adjustment is added.

DRA also used two market-based models, the DCF and Risk Premium (RP). The RP model used by DRA includes the risk investors associate with common stock and applied them to six of the comparable water utilities also used by Cal Am.[20] DRA's DCF analysis yields an ROE of 9.41%, and its RP analysis yields an ROE of 10.51%. DRA averages these two percentages to arrive at a recommended ROE of 9.96%. DRA opposes a risk adjustment.

DRA provided a table comparing the recommended and adopted ROE's of Class A water companies in all GRC's since 2003.[21] We include it here as Table 3.

[20] DRA does not include Southwest Water in its analysis.

[21] DRA Reply Brief, p. 5.

TABLE 3:
RECOMMENDED AND ADOPTED ROEs SINCE 2003

Decision No.	Company	DRA Recommended ROE	Company Recommended ROE	Adopted ROE
03-02-030	Cal Am	9.97%	11.00%	10.25%
03-05-078	Suburban	9.04%	12.00%	9.84%
03-08-069	Apple Valley Rancheros	9.53%	12.00%	10.10%
03-12-039	Great Oaks	9.28%	10.95%	9.78%
04-03-039	So Cal Water	9.41%	12.45%	9.90%
04-05-023	Cal Am	9.48%	11.20%	9.79%
04-07-034	San Gabriel	9.43%	12.25%	10.10%
05-12-020	Apple Valley Rancheros	9.85%	11.60%	10.15%
06-01-025	So Cal Water	9.35%	11.30%	9.80%
07-06-024	Valencia	9.57%	11.75%	10.19%
07-08-030	Cal Am	9.69%	11.60%	10.00%
	Average	9.51%	11.65%	9.99%
Current App.	Cal Am	9.96%	11.50%	

The table indicates that for the past eleven GRCs, the adopted ROEs range from a low of 9.78% to a high of 10.25% with an average of 9.99%. DRA asserts its recommended ROE of 9.96% is consistent with the average Commission adopted ROE of 9.99% and urges the Commission to adopt it.

Cal Am includes VS growth (also call SV growth) in its calculations. VS growth represents the company's dividend growth rate through the sale of stock. Cal Am claims the VS growth rate is required when the company is not expected

to issue new shares at prices equal to book value.[22] DRA argues that the VS growth rate is unnecessary in calculating sustainable growth because DRA's results are the average of DCF and RP models. The DCF model uses both current and future stock prices and therefore captures the effects of the higher stock prices.[23]

Another factor considered in setting the ROE is interest rate trends. Cal Am estimated the risk-free interest rate to be 5.0%. This estimate is based upon an average of intermediate-term U.S. Treasury security constant maturity rates published by the Federal Reserve.[24] DRA used Data Resources Inc. (DRI) forecasts for years 2008 - 2010, 10-year and 30-year Treasury bill rates of 5.28% and 5.53%, respectively.[25] We have relied on DRI forecasts in the past, most recently in D.07-08-030 where DRI's forecast for 2007 - 2009 was 5.2% for 10-year Treasury bills and 5.41% for 30-year Treasury bills.

DRA provides an assessment of Cal Am's total risk by the Standard and Poors (S&P) rating agency.[26] S&P evaluates a company's risk in order to assign a credit rating which is a direct measure of its ability to attract capital. Cal Am's parent company American Water Capital Company is rated A- by S&P. Ratings of AAA through BBB are considered investment grade.

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[22] Exhibit 4, Tab 11, p. 18.

[23] Exhibit 29, Tables 2-2 & 2-5.

[24] www.federalreserve.gov.

[25] Exhibit 29, Table 2-6.

[26] DRA Opening Brief, pp. 9 & 10.

As a result of our examination of the parties financial models, interest rates, authorized ROEs for other companies and credit worthiness of Cal Am, we find an ROE of 10.15% is fair and reasonable.

Cal Am is seeking a 3.3% leverage adjustment to account for increased risk. A company's total risk is a combination of the business and financial risk it faces. Business risk relates to the uncertainty in estimating a company's future operating income. Uncertainty regarding the weather and possible contamination that could affect water supply are business risks. Cal Am is a regulated utility and therefore part of its business risk is regulatory risk. The Commission has implemented a variety of measures to reduce the regulatory risk of water companies. Those measures include Balancing Accounts for purchased water and power, and pump taxes. Memorandum Accounts are another means used to reduce risk and protect earnings from regulatory lag. There are Memorandum Accounts for Safe Drinking Water Act compliance, catastrophic events, water quality, and Construction Work in Progress (CWIP).

The level of regulatory risk eliminated by Memorandum and Balancing Accounts was the subject of extensive Cal Am cross-examination of DRA's witness. The DRA testimony asserts that the Commission has virtually eliminated regulatory risk.[27] Ultimately, the DRA witness allowed that some regulatory risk was beyond the Commission's power to eliminate.[28]

Financial risk is determined by the amount of debt in the capital structure. Usually, the bigger the debt in the capital structure, the more financial risk there

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[27] Exhibit 29, p. 3 -1.

[28] RT pp. 262 – 274.

is. Cal Am states that its capital structure has significantly more debt and therefore reflects greater financial risk than that of the sample water utilities. It asserts that any estimate of the cost of equity relying on market data for the sample water utilities must be adjusted to reflect the financial risk associated with Cal Am's capital structure if it is to constitute a fair rate of return in this proceeding.[29] It requests an additional 3.3% to account for the company's financial risk in order to attract investors.

Although DRA agrees that water companies with highly leveraged capital structures are higher risk and in some circumstances a leverage adder may be reasonable, DRA asserts no adjustment is necessary here. DRA points out that Cal Am's parent company enjoys a credit rating of A- and issues Cal Am's debt securities.

We do not grant Cal Am's request for a leverage adjustment of 3.3%. The debt to equity ratio, although higher than the comparable water companies, does not adversely affect the S&P credit rating of its parent company. Further, since Cal Am's parent company issues its debt securities, its debt to equity ratio is something wholly within Cal Am's control. Finally, Cal Am has offered no evidence that its high debt to equity ratio has hindered its ability to attract investors. Similarly it has provided only one instance where the Commission has denied recovery of costs through Memorandum and Balancing Accounts.[30]

Finally, in D.06-11-050 we denied a leverage adjustment, finding that Cal Am was no riskier than comparable water companies and that Cal Am

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[29] Exhibit 4, p. 31.

[30] In D.03-09-022, the Commission denied Cal Am's request for CWIP on its Coastal Water Project desalination plant.

shareholders are rewarded for the lower equity ratio through the amortization of the Citizen's acquisition premium. Also, in the RWE[31] merger proceeding Cal Am claimed ratepayers would benefit from the savings on cost of capital, specifically from increased leverage. In D.07-08-030 we found the reasons given in D.06-11-050 for denying a leverage adjustment still applicable and we continue to do so.

To summarize, we deny Cal Am's request for a leverage adjustment. We find Cal Am's capital structure reasonable since its parent company still enjoys an A- rating and there is no evidence that it has been unable to attract investors. We also find an ROE of 10.15% falls within the range of the financial models calculated by the parties, is consistent with the ROEs adopted in other proceedings, is comparable to the returns on investments of like companies, and comports with Cal Am's creditworthiness. The 10.15% ROE is fair and reasonable because it is adequate to assure confidence in the company's financial health, maintain its credit standing, and attract capital investment. This ROE will be effective for the term of this rate case, may be updated in the upcoming Cost of Capital proceeding and implemented under the existing rate making mechanisms.

4.2. Infrastructure Replacement System Surcharge

Cal Am seeks implementation of an ISRS. An ISRS produces revenue to offset costs associated with replacement or repair of non-revenue generating

[31] RWE, known as Rheinisch-Westfälisches Elektrizitätswerk until 1990, is a Germany-based public utility that acquired American Water Works.

capital projects such as mains, pumping equipment, water treatment equipment, meters and hydrants as well as other fixed costs.[32]

Cal Am believes an ISRS will address regulatory lag, which results in earnings attrition, because the current rate case process only provides for annual rate adjustments, regardless of when the projects are completed. Cal Am contends the current use of balancing accounts to offset earnings attrition may not result in complete recovery.

The recovery mechanism Cal Am proposes is a surcharge, capped at 10% over three years, applied to the Commission authorized service and volume price portion of customers' bills. It would be calculated quarterly, utilizing actual costs for completed projects placed into operation. An advice letter detailing the calculations would be filed with a 15-day Water Division review period before the surcharge becomes effective. Cal Am claims the 15-day review period is adequate since the surcharge calculations will be based on a process to record capital expenditures that has been in place for many years and is familiar to staff.[33]

Cal Am discusses the 5%-capped surcharge mechanism utilized in Pennsylvania. It distinguishes the Pennsylvania example from the higher 10% sought in this case because Pennsylvania rate cases may occur with greater frequency and the surcharges are therefore rolled into rate base sooner. It asserts that in California, the Cal Am surcharge will be in effect for three years before

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[32] Exhibit 3, p. 4.

[33] Exhibit 3, Tab 4, p. 10.

being reset and therefore actually results in an annual surcharge only slightly higher than 3%.

Cal Am lists the customer safeguards in its proposal such as price caps, audits, resetting the price cap to zero, and customer notification processes.[34] Cal Am asserts that a more predictable revenue stream will allow it to spread costs more evenly between GRCs and minimize some rate shock produced by the current GRC process.[35] The company also lists the reasons alternative regulation such as an ISRS is vital to Cal Am's operation. The reasons include identifying a revenue stream for capital improvement, greater planning flexibility, providing specific customer information regarding capital expenditure funding, offsetting capital expenditure revenue loss due to conservation efforts, and improved offsetting of earning attrition over current processes.[36]

DRA opposes Cal Am's request for an ISRS. It asserts that Cal Am's application did not identify, inventory or quantify the age or condition of specific plant infrastructure warranting an ISRS.[37] Without identifying the specific projects, DRA characterizes the ISRS as an "automatic rate adjustment" for capital investment and believes without specific project information, it is premature to consider such a funding mechanism.

DRA lists the steps it considers necessary to develop a sufficient plan, such as a multiple year forecast quantifying the number of wells, water treatment plants, distribution mains, criteria used to determine when facilities will need

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[34] *Id.*, p. 15.

[35] *Id.*, p. 19.

[36] *Id.*, p. 16.

[37] Exhibit 25, pp. 11-16.

replacement; estimates or forecasts identifying the level of capital investment planned; and the effect of national security or drinking water standards on infrastructure replacement.[38]

DRA describes the mechanism based on depreciation rates used by other utilities to replace infrastructure. The mechanism utilizes a straightforward calculation of the depreciation rate and a replacement rate that eventually replaces 100% of the system. Cal Am provided no system replacement rate for its ISRS proposal. Although DRA supports Cal Am's intent to develop a replacement plan, it believes adopting an alternative ratemaking mechanism prior to the development of a plan is unwise.

DRA questions Cal Am's claim of the benefits of a reliable revenue stream, believing it is no more accurate or predictable than traditional ratemaking. The current regulatory framework includes the ISRS-eligible project in rate base and the revenue stream is created there. In fact, DRA claims the current regulatory framework is more predictable since Cal Am will know what its base rates will be for three years, rather than having to wait until a project is completed to trigger a surcharge.

DRA dismisses Cal Am's claims that the ISRS reduces base rates or that an ISRS is needed to assure customers that a portion of their bill is being used for infrastructure replacement. DRA disagrees with Cal Am's claim of a rate base reduction. DRA asserts that although factually true in the short term, under Cal Am's proposal customers will start seeing the first of multiple and increasing surcharges as soon as the second quarter of a GRC cycle. DRA points out that

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[38] *Id.*

only one customer voiced concern about system replacement and that concern highlighted Cal Am's lack of a replacement plan, not lack of identified funding.

DRA contends that Cal Am's ISRS proposal results in less regulatory oversight and therefore more risks than safeguards to ratepayers. First, DRA disputes Cal Am's claim that a 10% cap is less than other states' caps due to the longer GRC cycle in California. DRA counters that the Pennsylvania (PA) DSIC surcharge of 5% is actually less, because PA utilities file rate cases every two years resulting in an annual surcharge of 2.5%. Cal Am's proposed 10% rate cap over three years results in an annual surcharge of 3.33%. DRA further claims the 10% cap is based on a comfort level within the company rather than on estimated capital project costs. DRA also finds the 15-day review period problematic. DRA contends the 15-day review period is insufficient to ensure proper Water Division staff review of advice letters involving substantial sums.

Cal Am has argued that no regulatory oversight would be lost under its ISRS proposal; it would merely occur after project completion rather than prior to implementation. DRA maintains that after the fact disallowance is politically unpopular and once a project has been completed, there is no room for Cal Am to alter its position. DRA claims it becomes an "all or nothing" proposition eliminating the flexibility inherent in the current system. As an example, DRA cites the proposed settlement in this GRC which resulted in an overall 34% reduction in the revenue requirement sought by Cal Am.[39]

Both Cal Am and DRA cite potions of the National Association of Regulatory Utility Commissioners (NARUC) February 25, 1999, resolution in

[39] The average is calculated using all four districts in the GRC. DRA Opening Brief, p. 23, Table 2.

support of their respective positions. Cal Am claims the resolution endorses the use of DSIC to tackle the job of replacing water system infrastructure. DRA quotes the NARUC resolution's many other "policies and mechanisms" to "help ensure sustainable practices in promoting needed capital investment and cost-effective rates."[40] DRA points out that the Commission currently utilizes nearly all the policies or mechanisms identified by the NARUC Resolution.

If an ISRS is adopted for Cal Am, DRA requests that additional safeguards be implemented.[41] DRA's recommended additional safeguards include;

- Supporting documentation in the Advice Letter filing allowing Water Division staff and DRA to confirm projects were completed and the surcharge correctly calculated.
- Pay customers interest on ISRS over-collections.
- Customer notification prior to implementation.
- Supplemental information required in annual reports.
- Annual audit and reconciliation.

Mark West also opposes the proposed ISRS, posing various questions regarding the surcharge level, project and expenditure approval, and generally characterizing the proposal as a "blank check."[42]

The Commission adopted the Water Action Plan on December 15, 2005. The Plan includes six key principles: safe water; high quality water; highly reliable water supplies; efficient use of water; reasonable rates; and viable utilities. One of the six objectives adopted to meet the principles was to promote

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[40] Exhibit 43, p. 1.

[41] In D.07-08-030, the Commission adopted a Pilot DSIC program for Cal Am's LA District which included numerous safeguards.

[42] Exhibit 32, pp. 4 and 5.

water infrastructure investment. The Water Action Plan recognizes the need for a regulatory process that ensures companies develop long-term plans regarding aging infrastructure, includes plan review, and provides the necessary funding.

Cal Am's witness refers to the need for infrastructure replacement plans and the folly of waiting for all plant to fail or be near failure. The witness calls it "a disaster waiting to happen."[43] We agree it is a prudent course of action, however, Cal Am has not provided an actual plan beyond seeking a 10% surcharge. Further, Cal Am has not provided any evidence that either the Larkfield or Sacramento district infrastructure is currently at or near the failure point.

As envisioned by the Water Action Plan, an infrastructure replacement plan is inherently beneficial to both ratepayers and water utilities. It assures customers there is a plan for long-term, reliable delivery of high quality water for a known price and provides the water utilities with a clearly defined revenue stream for infrastructure replacement costs. Unfortunately, Cal Am's proposal consists mainly of establishing a revenue stream via a surcharge. Cal Am has not identified capital project costs or a long-term replacement strategy providing the essential link to the requested 10% surcharge. Cal Am believes the ISRS will allow it to determine the amount of funds available for capital projects and this will aid the company in determining what projects should be undertaken. Conversely, we believe a strong asset management strategy identifies needed capital improvements first, and then determines the revenue necessary to complete the projects. Therefore, we do not adopt Cal Am's ISRS proposal.

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[43] *Id.*, p. 20.

In D.07-08-030, we implemented a pilot DSIC program for Cal Am's Los Angeles District. The program provides Cal Am with the desired revenue stream, yet contains multiple safeguards to ensure the Commission retains regulatory oversight. This pilot program is intended to send a strong signal regarding our commitment to long-term capital asset management planning, including the development of infrastructure replacement strategies.

We will not implement the pilot DSIC program in the Larkfield and Sacramento districts at this time. We adopted the pilot program with the intention that, if successful in meeting our Water Action Plan objectives, a similar surcharge mechanism could be considered for other Cal Am districts and other Class A water utilities. In the absence of evidence establishing urgency or financial need, we believe the current regulatory structure is sufficient. It will provide the necessary regulatory oversight and revenue for capital projects in the Larkfield and Sacramento districts until we can determine the success of our pilot DSIC program. The pilot program will be fully reviewed in the next Los Angeles District GRC.

We are committed to providing incentives for water utilities to more efficiently fund infrastructure investment. To that end, we encourage Cal Am to use the time until its next GRC to refine its asset management plan to include information such as:

- A multiple-year forecast indentifying the number, age and condition of wells, water treatment plants, distribution mains, and other infrastructure components;
- Criteria for a long-range replacement strategy;
- Forecasts of the level of capital investment needed;
- Impacts of national security on drinking water standards and infrastructure; and,

- The necessary funding mechanism.

4.3. Larkfield and Sacramento District Consolidation

Cal Am's application seeks to consolidate the Larkfield and Sacramento districts in order to "mitigate" the substantial Larkfield District rate increase needed to fund capital projects in Larkfield. As proposed by Cal Am, the Larkfield and Sacramento district consolidation would result in a substantial *decrease* in Larkfield customers current rates even though this application seeks a revenue requirement *increase* for the Larkfield District. The company proposal does more than mitigate a high cost; it distorts the relationship between costs and price signals.

DRA's protest of the application specifically cites our denial of a similar request for consolidation in Cal Am's previous application.[44] At the PHC, DRA renewed its objection to the inclusion of district consolidation in the scope of this proceeding, claiming that adequate justification is lacking in the present application to revisit the issue so soon and consolidation should not be considered in this proceeding. Mark West, of the Larkfield area, echoed DRA's objections. Despite these protests, the consolidation proposal was included in the scope of this proceeding because the Water Action Plan had been issued since the last GRC for these districts and it was reasonable to review the circumstances *vis a vis* the policy objectives in the water strategic plan.

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[44] D.05-09-020 denied Cal Am's request for rate consolidation of the Sacramento and Larkfield districts.

Cal Am cites the Water Action Plan as support for consolidation.[45] DRA disputes Cal Am's claim that the Water Action Plan supports its consolidation proposal and outlines other mechanisms that it believes achieve the same result. DRA relies heavily on the 1992 Guidelines for Combining Water Utility Districts for Ratemaking and Public Utilities Commission Reporting Purposes (DRA Guidelines or Guidelines).[46] The Guidelines established four criteria to be used when evaluating requests for consolidation. They are:

- **Proximity** - Although it is not necessary for districts to be contiguous, they should be in close proximity to each other. A distance of no greater than 10 miles apart is suggested.
- **Rates** – The present and future rates of the districts should be close, with no more than a 25% difference. Phasing the rates may be necessary to lessen the rate impact.
- **Water Supply** – The supply mix between well and purchased water should be similar for the districts to minimize possible future rate impacts due to the cost of purchased water.
- **Similar operations** – The districts should be operated in a similar manner, such as using the same district management and billing system.

The Guidelines also state that districts should not be consolidated for the express purpose of having one district subsidize another. Moreover, consolidation of non-adjacent districts can only be consolidated in exceptional cases. Cal Am, itself, testified that there are no shared benefits for Sacramento. The DRA Guidelines were developed by parties who appear before us and have

[45] Exhibit 9, Tab 9, p. 38.

[46] The Guidelines were developed by DRA and the industry as a means to review requests for consolidation of districts.

guided us in the past. They are reasonable and useful and should be viewed in conjunction with the Water Action Plan in reading our decision. The arguments and set of facts presented in this case do not warrant an override of these Guidelines. High rates, in and of themselves, do not necessarily require intervention. If costs, deemed reasonable, are high, we have ratemaking and amortization mechanisms to address rate shock. Furthermore, if costs are high, it is appropriate to signal those costs in order to encourage sound water usage and efficient capital investment.

Cal Am does not dispute that the Larkfield and Sacramento district consolidation proposal fails to meet all four of the DRA Guidelines.[47] Larkfield is still 120 miles from Sacramento and Larkfield's rates are still substantially higher than Sacramento's.[48] However, to show that the proposal is in accordance with two of the Guidelines, Cal Am asserts that the two districts have a mix of well and purchased water and are similarly operated since they share management and billing systems.

DRA disagrees with that assertion and contends that the water supply mix argument does not meet the Guidelines. DRA, instead, argues that, although both districts use a mix of well and purchased water, Larkfield purchases 33% of its supply and Sacramento only 3%. Therefore, according to DRA, the utility's consolidation proposal continues to fail the Guidelines for three of the four criteria .[49]

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[47] Exhibit 7, Tab 15, p. 38.

[48] In the earlier request for consolidation, Larkfield's rates were 93% higher than Sacramento's.

[49] Exhibit 25, pp. 12-3 & 12-4.

To further buttress its proposal, Cal Am cites instances where the Commission authorized consolidation in cases where the guidelines were not met.[50] Cal Am specifically refers to D.00-06-075 in which we granted rate consolidation for eight Southern California Water Company (now referred to as Golden State Water Company) districts that were 1) not interconnected, 2) had varied water sources, and 3) ranged from 5 to 163 miles apart. DRA points out, fairly, that there is a big distinction between those situations and the present case. In D.00-06-075, the Commission authorized consolidation based on the need for rate relief in impoverished areas. The facts in this case do not show Larkfield to be an impoverished area.

DRA's witness Brooks, in listing the many reasons to reject the consolidation proposal, testified to the long-term effects of decoupling rates and prices and argued that such subsidies encourage development in areas where water may be expensive or scarce. To rebut that concern, Cal Am likens its consolidation proposal to the subsidy programs in energy and telecommunications, where one group of ratepayers subsidizes another. This analogy does not apply. All ratepayers benefit from an interconnected system in the telco and energy examples. There is no such shared benefit to the Sacramento customers or to water users in general.

Another argument in support of its consolidation proposals is one that cites the subsidies currently occurring *within* the Sacramento District. The Sacramento District is comprised of many separately acquired, independent water systems that are not all within 10 miles of each other. However, customers

[50] Exhibit 9, Tab 9, pp. 41 & 42.

served by the various independent water systems within the Sacramento District all pay the same rate for water. There was no issue presented in this case as to the current organization of the districts, so there is no need to address whether the current system serves the best interest of the district ratepayers. Evidence has not been presented to suggest additions to the Sacramento District are reasonable.

Cal Am refers to the water revenue adjustment mechanism (WRAM) as an example of the authorized decoupling of costs and rates. Those mechanisms are granted with a statewide policy goal in mind and on a limited basis. Generally speaking, water company rates ***are*** based on the cost of providing service but revenues are set on the basis of return on investment independent on sales. This argument is in apposite.

Surprisingly, public opinion regarding the consolidation is mixed. At the PPH in Larkfield, where close to 100 residents attended, virtually all were opposed to the consolidation, even though it would mean lower rates. All written communication sent to the Public Advisor's office prior to the Larkfield PPH also voiced opposition to the proposed consolidation. After the PPH, Cal Am implemented a public information campaign providing information about the impact of the consolidation and referred to it as a "cost sharing" plan. Cal Am provided customers with postage-paid postcards preaddressed to the Commission. The postcards were pre-printed with the message "I support the cost sharing plan because:" and provided blank lines for customers to complete the thought. Not surprisingly, after that outreach effort, the concept of a reduced water bill was embraced and hundreds of postcards were received in support of the plan. In the last few months, the vast majority of the postcards received by

the Commission have favored the consolidation. Only a few used the blank lines to express opposition.

In Sacramento turnout was low at both PPH sessions, but all attendees were opposed to the consolidation. Cal Am has not implemented a similar information campaign in Sacramento and all written communication received from Sacramento district residents has been self-initiated and has expressed opposition to the consolidation. Cal Am's witness Stephenson was asked by Mark West to list the quantifiable benefits of consolidation to Sacramento ratepayers. Mr. Stephenson's response was "there are none."[51]

You would expect ratepayers who are being asked to pay higher rates to subsidize another district to object to the consolidation. Similarly, you would expect support for the consolidation from the ratepayers who benefit from the resulting decreased rates. The only real surprise is the divided opinion in the Larkfield District. Mark West's interest is in retaining local control of the water district and there is an ongoing effort to determine the feasibility of acquiring the district from Cal Am. Mark West fears consolidation will obscure the direct costs of operating the Larkfield District and remove local control, adversely impacting the efforts to acquire the district. The fact remains that at least part of the Larkfield community wants to preserve their options, and would not welcome the consolidation.

Although the acquisition of the Larkfield District is outside the scope of this proceeding, it provides context for the opposition of a segment of Larkfield's residents. Mark West was also active in the last GRC proceeding, opposing the

[51] RT, p. 158.

proposed consolidation of the Larkfield and Sacramento districts even though lower rates would result. It is unclear how much progress has been made in the effort to acquire the district, but both county and state government representatives from the area have voiced opposition to the consolidation even though it would result in lower rates to their constituencies. Local public officials weighed in.

The Guidelines and the Water Action Plan are to be utilized in examining the proposal before us. The DRA Guidelines state that districts should not be consolidated for the express purpose of having one district subsidize another. The Water Action Plan identifies a number of objectives it should strive to meet in its overall policies. Cal Am would like us to focus on one item under heading *"Objective: Set Rates that Balance Investment, Conservation and Affordability"* where the Water Action Plan states:

> 2. Develop policies to subsidize high cost areas, either through some variation of a "High-Cost" Fund or through consolidation of districts or rates.

Under the same Water Action Plan heading, "*Objective: Set Rates that Balance Investment, Conservation and Affordability"* in item 1, it states the Commission is committing to:

> 1. Review utility rate case requirements from the perspective of long-term investment and conservation, as well as shorter-term rate impacts

Therefore, the Commission cannot look at any **one** policy objective in isolation of the others. While a "direct subsidy" from Sacramento customers to Larkfield customers would mathematically address the rate problem of a high

cost (or low density) area, it would do so at the expense of other policy objectives. The Commission must always balance the need to set reasonable rates, to promote efficient infrastructure investment, and to strengthen conservation. Adoption of low-income programs, advancement of conservation rates and infrastructure surcharges are but some of the many regulatory policies being implemented to accomplish these goals. Affordability issues have, in the past, been the impetus for considering subsidies. The problem of high cost, by itself, does not translate into a Commission remedy or action. Nor has it been shown that the proposed subsidy is a superior solution. Given the recent concerns with water supplies in the state of California[52], introducing a subsidy that could skew the value of water should be done with great caution. While the Water Action Plan opened the door for a renewed consideration of subsidies, it did so along with a multitude of other policy objectives to be balanced. We have not been presented with a record in this proceeding that would weigh the need to mitigate rates for a low density community heavier than the need to charge cost based rates.

DRA prepared a comparison document illustrating the impact of the Cal Am full consolidation proposal.[53] In the comparison, Larkfield District bills decrease from approximately $56 per month to $33 per month.[54] Although this comparison exhibit is based on the higher revenue requirement requested in Cal

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[52] Colorado River related issues and pending orders, and Delta pumping decisions.

[53] Exhibit 35.

[54] Exhibit 35 included the rate impact on the Sacramento District, but we were unable to duplicate the results and thus do not include them here.

Am's application, it illustrates the rate impact of consolidating a small district into a much larger one. Although this decision adopts a lower revenue requirement and thus consolidation would require a lower subsidy from the Sacramento District, we find the consolidation as proposed by Cal Am unacceptable. We are unwilling to adopt the proposed consolidation because it results in a large decrease to Larkfield customers' existing bills, at a time when the subsidizing district is facing an almost 26% increase.

Therefore, we do not adopt the Cal Am consolidation proposal as we cannot justify Sacramento district customers funding a rate decrease for Larkfield residents.

4.3.1. Administrative and General Expense

Cal Am and DRA reached agreement on all aspects of A & G expense except those discussed below.

4.3.2. Employee Pensions and Benefits

The two items in dispute in this section are health care premium costs and employee awards. The primary difference between the parties' health care premium cost estimates is the use of different inflation factors. Cal Am estimated Group Health Insurance costs using an escalation factor of 8% for 2007 and an increase of 9% for 2008 based on historical trends in health care premiums.[55] DRA calculated the health insurance costs using the CPI-U for group insurance, citing D.04-06-018 as the basis for that calculation. Cal Am contends that DRA has mistakenly concluded that health insurance premiums are categorized as insurance and therefore linked to the CPI-U, rather than as

[55] Sacramento District Exhibits A-D & F, Final Application, Chapter 6.

pension and benefits under the Commission's Uniform System of Accounts and linked to the Labor factor.[56]

Under cross-examination, DRA's witness Greene was asked to examine historical data based on the cost of health insurance. After examining the costs and percentage increases from 2002 through 2006, DRA's witness stated that he was "wrong in using the CPI-U numbers."[57]

We agree. The historical data more accurately reflects the actual costs the company has incurred for its employees' health insurance premiums and is the appropriate way to calculate future expenses for that item.

DRA also objects to the inclusion of employee awards in company expenses.[58] Although DRA believes employees should be recognized for their work, it believes the awards are not necessary to operate the utility and were inappropriately charged to ratepayers.[59]

Cal Am's witness testified that these expenses serve a vital business purpose and benefit customers by fostering increased employee productivity and creating a sense of valued contribution that promotes employee retention.[60]

We agree with Cal Am that the awards serve a business purpose by fostering and rewarding employee productivity and that ultimately ratepayers benefit from such programs. Additionally, the amount of the awards at issue here are so small, they have a negligible impact on rates.

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[56] Cal Am Opening Brief, p. 44.

[57] RT, p. 406: 24-25.

[58] Exhibit 25, p. 4-2 & 4-3.

[59] DRA Opening Brief, p. 44.

[60] Exhibit 18, p. 10:15-17.

4.3.3. Regulatory Expense

DRA asserts that Cal Am's estimates for regulatory expense are excessive, although it acknowledges that considerable regulatory expense is involved in GRC proceedings. One of DRA's primary objections to the expense estimates involve the regulatory expense for 2008, a year in which it asserts Cal Am will not have any regulatory expenses.[61]

Cal Am contends that its costs are based on the actual expenses incurred in preparing for this rate case, as well as the costs for its most recent GRCs in other districts. Cal Am regulatory expense estimates used the actual prior costs for outside consultants, legal assistance, witness training, company labor and expenses, and management level expenses. Cal Am goes on to point out that the new Rate Case Plan had not been issued at the time this application was filed and this proceeding has been bifurcated to address rate design in a second phase, two events that add significantly to its regulatory expense. Neither of these expenses was anticipated nor included in the original filing.[62]

While Cal Am's requested regulatory expenses are higher than previous years, there is some justification for the increases as actual historical expenses are the basis for the estimates. DRA's argument regarding the lack of expenses in 2008 completely disregards the fact that the new Rate Case Plan requires Cal Am to file GRCs for its Larkfield and Sacramento districts in November 2008.[63] Also, at DRA's request, this proceeding was bifurcated, requiring additional time and

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[61] Exhibits 25, p. 4-5, Exhibit 26, p. 4-5, Exhibit 27, p. 4-4 and Exhibit 28, p. 4-4.

[62] Cal Am Opening Brief, p. 46.

[63] Although the new Rate Case Plan had not been issued when DRA's original protests and reports were filed, DRA's position did not change once it was issued.

attendant expense on Cal Am's part to prepare for a second phase of the proceeding that will extend into 2008.

We adopt Cal Am's regulatory expense figures because they include the now-known 2008 expenses associated with the bifurcation of this proceeding and the timing of the new Rate Case Plan.

5. Comments on Alternate Proposed Decision

The alternate proposed decision of Commissioner Bohn in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were filed on _____ and reply comments were filed on _____ by _____.

6. Assignment of Proceeding

John A. Bohn is the assigned Commissioner and Linda A. Rochester is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. This decision resolves the revenue requirement phase of Cal Am's GRC application for its Larkfield and Sacramento districts.

2. On July 6, 2007, Cal Am and DRA filed a partial settlement of the revenue requirement issues.

3. The debt to equity ratio contained in the settlement of 58.16% to 41.84% for Test Year 2008, 58.32% to 41.68% for Escalation Year 2009 and 58.83% to 41.17% for Escalation Year 2010 is reasonable.

4. The cost of debt contained in the settlement for 2008, 2009 and 2010, of 6.20%, 6.25% and 6.29% respectively, is reasonable.

5. We find the Operation and Maintenance section of the settlement reasonable.

6. The Administration and General Expenses section of the settlement is reasonable.

7. The Utility Plant in Service section of the settlement is reasonable.

8. We find the Depreciation and Expense Reserves section of the settlement reasonable.

9. The Special Requests section of the settlement is reasonable.

10. The settlement viewed as an integrated agreement is reasonable in light of the whole record, consist with the law and in the public interest.

11. A Return on Equity of 10.15% is reasonable based on the record and is commensurate with return on investments in comparable companies and sufficient to (a) assure confidence in the financial integrity of Cal Am, (b) maintain its credit and (c) attract necessary capital investment.

12. A leverage adjustment to the ROE for increased financial risk is not warranted.

13. Although development of a long-term infrastructure replacement strategy is essential to ensuring reliable, high quality service and water, Cal Am has not justified its request for an Infrastructure System Replacement Surcharge (ISRS) absent a plan identifying the capital projects it will fund.

14. Cal Am's proposed ISRS reduces the ratepayer safeguards of our existing regulatory structure.

15. Our existing regulatory structure for approving capital projects is adequate for the Larkfield and Sacramento districts.

16. Cal Am's consolidation proposal for the Larkfield and Sacramento districts is not justified.

17. Cal Am's employee pension and benefit expenses relating to health care premiums are reasonably based on historical expenses and appropriately use a labor inflation factor.

18. Cal Am's employee pension and benefits expense related to employee awards is appropriately charged to ratepayers.

19. Cal Am's regulatory expense is reasonable.

20. This proceeding remains open for the Phase II Rate Design.

Conclusions of Law

1. The settlement agreement filed by Cal Am and DRA is reasonable in light of the whole record, consistent with the law, in the public interest and should be adopted.

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

3. An ROE of 10.15% is reasonable in light of the whole record, consistent with the law, in the public interest, and should be adopted.

4. We should not adopt Cal Am's consolidation proposal for the Larkfield and Sacramento districts.

5. Cal Am's figures for employee pensions and benefits expenses and regulatory expenses are reasonable and should be adopted.

O R D E R

IT IS ORDERED that:

1. The Motion of California-American Water Company and the Division of Ratepayer Advocates for adoption of the settlement agreements as to certain issues on the revenue requirements for Larkfield and Sacramento districts filed on July 6, 2007, and attached as Attachment A, is granted.

2. The Larkfield and Sacramento districts' revenue requirement tables, attached as Attachment B, are adopted.

This order is effective today.

Dated _____, at San Francisco, California.

INFORMATION REGARDING SERVICE

I have provided notification of filing to the electronic mail addresses on the attached service list.

Upon confirmation of this document's acceptance for filing, I will cause a Notice of Availability of the filed document to be served upon the service list to this proceeding by U.S. mail. The service list I will use to serve the Notice of Availability of the filed document is current as of today's date.

Dated March 25, 2008, at San Francisco, California.

/s/ ELIZABETH LEWIS
Elizabeth Lewis