

Decision 10-12-058 December 16, 2010

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

Order Instituting Rulemaking on the Commission's Own Motion to Develop Rules and Procedures to Ensure That Investor-Owned Water Utilities Will not Recover Unreasonable Return on Investments Financed by Contamination Proceeds, Including Damage Awards, and Public Loans Received Due to Water Supply Contamination.

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

**DECISION MODIFYING AND ADOPTING VARIOUS RULES FOR THE ACCOUNTING TREATMENT OF CONTAMINATION PROCEEDS**

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**DECISION MODIFYING AND ADOPTING VARIOUS RULES FOR THE ACCOUNTING TREATMENT OF CONTAMINATION PROCEEDS**

**1. Summary**

This decision sets out the rules to govern the accounting and ratemaking treatment variously of local and federal government grants, government loans, damage awards, settlements, government orders and insurance proceeds received by an investor-owned water utility following contamination of its water supply. Earlier versions of these rules were proposed for review and comment by Decision (D.) 10-10-018, issued on October 18, 2010, which determined that the replacement plant funded by various classes of contamination proceeds covered in this rulemaking proceeding, Rulemaking 09-03-014, is to be treated as Contributions in Aid of Construction (CIAC) and, as such, excluded from rate base and the utility's ability to recover those replacement plant costs through rates. That decision adopted rules (Appendix A of D.10-10-018), which are further revised here, to govern the accounting and ratemaking treatment of contamination-related local and federal government grants, complementing a 2006 Commission decision, D.06-03-015, that accorded CIAC status to contamination-related state government grants.

With this decision the rulemaking proceeding R.09-03-014 is closed.

## 2. Background

This rulemaking was begun in March of 2009 to establish standardized rules and policies to govern the accounting and ratemaking treatment of various types of proceeds received by investor-owned water utilities (IOUs) after contamination of their water supplies.<sup>1</sup> After workshop sessions, a staff report and extensive comments,<sup>2</sup> Decision (D.) 10-10-018 was issued on October 18, 2010. That Decision determined that the replacement plant funded by various classes of contamination proceeds covered in this rulemaking proceeding is to be treated as Contributions in Aid of Construction (CIAC) and, as such, excluded from rate base and the utility's ability to recover those replacement plant costs through rates. That Decision adopted rules (Appendix A of D.10-10-018), which we further revise here as explained below, to govern the accounting and ratemaking treatment of contamination-related local and federal government grants, complementing a 2006 Commission decision, D.06-03-015, that accorded CIAC status to contamination-related state government grants. Not adopted in D.10-10-018, however, were detailed rules to govern the CIAC accounting treatment of the remaining types of contamination proceeds, namely, government loans, damage awards, settlements, government orders and insurance.

In response to the earlier proposed decision mailed on August 3, 2010, that presented detailed rules for adoption, several parties took the position that the rules contained in Appendices B and C fell outside the record. To allow the

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<sup>1</sup> See R.09-03-014.

<sup>2</sup> For a summary of the procedural history of these proceedings, see D.10-10-018, sec. 2.3, at 7-9.

parties to consider further those particular rules, D.10-10-018 ordered that a ruling scheduling comments be promptly issued. Such a ruling was immediately issued,<sup>3</sup> calling for comments by October 28, 2010, and replies by November 9, 2010. Comments were timely filed by the California Water Association (CWA)<sup>4</sup> and the Division of Ratepayer Advocates (DRA), respectively, and replies were also timely filed by them, as well as by The Utility Reform Network (TURN).

The later proposed decision, mailed on November 15, 2010, contained revisions based on those comments. The subsequent comments on that mailed version are summarized below in Section 7.

### **3. Discussion and Analysis of Filed Comments and Replies Concerning Rules in Appendices B (Government Loans) and C (Damage Awards, Settlements, Government Orders and Insurance Proceeds)**

#### **3.1. Proposed Appendix B (Government Loans)**

##### **3.1.1. Rule 1 (Repayment of Loans through Surcharges)**

The proposed Rule 1 calls for contamination-related government loans to be repaid by ratepayers via surcharges akin to the accounting method set out in Division of Water and Audit's Standard Practice U-13-W for loans from the Safe Drinking Water State Revolving Fund. The proposed rule contains an accounting example.

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<sup>3</sup> Administrative Law Judge (ALJ) Ruling Requesting Comments on Proposed Rules Concerning Two Categories of Contamination Proceeds, filed October 14, 2010.

<sup>4</sup> California American Water Company, California Water Service Company, Golden State Water Company, Park Water Company, San Gabriel Valley Water Company, Suburban Water Systems, and Valencia Water Company joined in the comments of CWA.

For CWA, the accounting example raised concerns about the treatment of administrative fees, the separate bank account requirement, recordation of uncollectible amounts, recovery for shortfalls, and the proper accounting category for recordation of the amortization of plant investment.<sup>5</sup> For the most part we find merit in those concerns of CWA. The Rule 1 of Appendix B that we adopt here addresses the amortization of administrative fees (including the ratebasing of fees paid up front and not recovered from loan proceeds), removes the separate bank account requirement, adds a footnote for recovery from ratepayers for uncollectible amounts, and includes needed references to Account 265.2 (Government Loan Contamination Proceeds).<sup>6</sup>

### **3.1.2. Rule 2 (No Return on Plant)**

Language has been added to this rule to make it clear that the preclusion of return on plant only extends to the extent that the plant is funded by contamination-related government loans.

### **3.1.3. Rules 3 (Rate Surcharge) and 5 (Capital Charges)**

CWA identified the need, and suggested the language, for an explicit recognition that “any shortfall in debt service or repayment that the utility has to cover should be immediately recoverable in rates.”<sup>7</sup> Because we are prescribing treatment of contamination proceeds, including government loans repayable

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<sup>5</sup> Comments of CWA on Proposed Rules in Appendices B and C to D.10-10-018 (hereafter Comments of CWA), at 2-4.

<sup>6</sup> While we are not requiring in this rule a separate bank account (urged in the Reply Comments of DRA, at 3), each utility will need to manage its tax-free funds so as to preserve their tax-free status. We agree with DRA that the particular numbers in the accounting example are for illustrative purposes only.

<sup>7</sup> Comments of CWA, at 4.

through surcharges, as CIAC, without ratebase recovery, we find CWA's position to have merit.<sup>8</sup> Rules 3 and 5 have been modified accordingly.

**3.1.4. Rule 4 ( Gain Upon Disposition of Plant)**

CWA took issue with the proposed rule that precluded water utilities from receiving gain on the disposition of contamination-related, government-loan-funded plant repaid through ratepayer surcharges. CWA argues that this rule "threatens a regulatory taking of public utility property."<sup>9</sup>

CWA views the ban on gains to be a violation of the Water Utilities Infrastructure Improvement Act of 1995, Sec. 789 et seq. of the Pub. Util. Code, specifically Sec. 790, which provides in part:

(a) Whenever a water corporation sells any real property that was at any time, but is no longer, necessary or useful in the performance of the water corporation's duties to the public, the water corporation shall invest the net proceeds, if any ... from the sale in water system infrastructure, plant, facilities, and properties that are necessary or useful in the performance of its duties to the public.

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(b) All water utility infrastructure, plant, facilities, and properties constructed or acquired by, and used and useful to, a water corporation by investment pursuant to subdivision (a) shall be included among the water corporation's other utility property upon which the commission authorizes the water corporation the opportunity to earn a reasonable return.

(c) This article shall apply to the investment of the net proceeds referred to in subdivision (a) for a period of

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<sup>8</sup> See Appendix B, at 2, fn.4.

<sup>9</sup> Id. at 5.

8 years from the end of the calendar year in which the water corporation receives the net proceeds. The balance of any net proceeds and interest thereon that is not invested after the eight-year period shall be allocated solely to ratepayers.

In support of its position, CWA cites three of our gain-on-sales decisions (D.06-05-041, D.06-12-043 and D.07-09-021)<sup>10</sup> that were rendered after our decision that extended CIAC treatment to state grant proceeds (D.06-03-015). CWA correctly notes that in D.06-12-43 the “Commission specifically rejected the assertion that the Commission should not interpret § 790 as applying to proceeds from sales of CIAC-funded property.”<sup>11</sup> CWA also refers to the legislative history of the Water Utilities Infrastructure Improvement Act which emphasized the objective of having a uniform and predictable standard concerning the disposition of real property.<sup>12</sup>

We are persuaded by CWA’s arguments and cited authorities concerning the applicability of § 790. Section 790 leaves us with no discretion to prohibit gains on sale of real property acquired by contamination proceeds and no longer useful or necessary. Accordingly, we are revising proposed Rule 4, and counterpart rules in Appendices A and C, to conform to § 790.

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<sup>10</sup> Comments of CWA (12-6-10), at 10.

<sup>11</sup> Id. at 9-10, citing D.06-12-043, at 12, which stated that the Commission “does not consider whether or not property has been previously included in rate base. It applies to ‘any real property’ that was previously used and useful ‘at any time.’”

<sup>12</sup> Id. at 6-7.

**3.1.5. Rules 6 (Certain Expenses and Taxes) and 7 (Indirect Benefits as Projected Cost Savings)**

Rule 6, which provides that the reasonableness of operating expenses, administrative and general expenses is to be determined in the general rate case (GRC), has been modified at the suggestion of CWA<sup>13</sup> to accommodate a multiple-district GRC.

An insignificant word substitution has been made in Rule 7.

**3.1.6. Rule 8 (Ban on Spending Loan Funds for Expenses)**

The proposed Rules 8 and 9 required Tier 3 advice letters for Commission approval of funding-agency-authorized expenditure of loan funds and extensions of construction time limits, respectively. DRA and TURN want that level of advice letter scrutiny.<sup>14</sup> We conclude that the less cumbersome Tier 2 advice letter recommended by CWA<sup>15</sup> is suitable for those particular approvals<sup>16</sup> and Rules 8 and 9 have been so modified. With respect to Rule 8 we also changed the time frame from 45 days to 30 to accelerate the filing of an advice letter setting forth the accounting treatment excluding funding-agency-authorized expenses from the results of operations and the forecast of future expenses in a GRC.

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<sup>13</sup> Comments of CWA, at 6.

<sup>14</sup> Reply Comments of DRA, at 7, and Reply Comments of TURN, at 4-5. As to Rule 9, TURN observes that experience could provide a basis for later reducing the scrutiny to a Tier 2 advice letter.

<sup>15</sup> Comments of CWA, at 7.

<sup>16</sup> Under G.O. 96-B, §5.3 (General Orders), the Division of Water and Audits retains discretion to reject an advice letter without prejudice, prompting the utility to resubmit its request through a higher tier advice letter or an application.

**3.1.7. Rules 10 (Ban on Utility/Affiliate Work on Facilities), 11 (Competitive Bidding) and 12 (Miscellaneous Matters)**

CWA argues that the complete ban against participation by a utility or its affiliate entity in engineering or installing contamination-related, government-loan-funded facilities is “inefficient, impractical and unnecessary.”<sup>17</sup> CWA contends that for a “loan-funded project of modest scale, it is certainly inefficient for a utility to have to conduct a third-party procurement request for proposals for tasks that it normally performs in-house with existing staff.”<sup>18</sup> CWA notes that the reasonableness of utilities procurement decisions is reviewed as a matter of course in their GRCs. DRA believes the ban is necessary to check “self-dealing.”<sup>19</sup>

We find CWA’s arguments for efficiency and practicality to be persuasive and accordingly have deleted Rule 10 and modified Rule 12. To avoid duplication we also have merged Rule 12 into Rule 9. Rule 9 contains competitive bidding safeguards and limits sole-source contracts to special circumstances where justification is shown.

**3.1.8. Rules 13 (Work Done Prior to Loan) and 14 (Tangible and Intangible Property)**

We are clarifying Rule 13 to make it clear that a water utility can use loan funds for work done prior to execution of the loan agreement only when the

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<sup>17</sup> Ibid. TURN thinks a complete ban “may be overkill.” Reply Comments of TURN, at 5.

<sup>18</sup> Ibid.

<sup>19</sup> Reply Comments of DRA, at 8.

loan-funding agency has authorized that use. Rule 14 has been modified to conform to § 790.

**3.1.9. Rule 15 (Notice to the Division of Water and Audits and DRA)**

CWA suggests that accelerating the notice period concerning dispositions and encumbrances from 45 days to 30 days to match that provided in D.06-05-041 (gain from sales).<sup>20</sup> We do think that lessening the period for notifying Division of Water and Audits (DWA) and DRA to 30 days fosters efficiency and Rule 15, as well as the counterpart rules in Appendices A and C, are being so modified. We also are making it clear in Rule 15 and those counterpart rules that the notice is to be in writing. CWA also correctly notes that the reference to the encumbrance of loan-funded plant in Rule 15 should be deleted because it unnecessarily duplicates the provisions of Sec. 851. That deletion is being made here and in the counterpart provisions in Appendices A and C.

**3.1.10. Rule 16 and 19 (Transfer or Sale of Assets; Adjusted Fair Market Value)**

CWA seeks the deletion of these rules<sup>21</sup> for the reasons it opposed the earlier no-gain-on-sale version of Rule 4 discussed above. CWA also contends that these particular rules would impose a cumbersome disincentive on water utilities:

The complex and costly calculations and procedures these rules would require will surely destroy water utilities' already challenged incentive to go to the substantial efforts required to

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<sup>20</sup> Comments of CWA, at 8.

<sup>21</sup> Id. at 9.

obtain funding for needed projects through government loans.<sup>22</sup>

Since we have concluded in Section 3.1.4 above that § 790 is applicable, Rule 16 has been revised to allow for gain on sale of real property not used or necessary. Rule 19 (Fair Market Value Valuation) has been revised to conform with § 790.

**3.1.11. Rule 18 (Information in Annual Report)**

No significant comment on Rule 18 was received and it remains as proposed.

**3.2. Proposed Appendix C (Damage Awards, etc.)**

**3.2.1. Preface (Proceeds to Fund Remediation and Replacement Plant) and Rule 1 (No Return on Plant)**

CWA offers a helpful hypothetical accounting example for insertion near the front of the Appendix C, similar in concept to the accounting example set out in Appendix B. We have adopted that suggestion, numbering it Rule 1 and renumbering the rules that follow.

Rule 2 (previously Rule 1) is being modified, per CWA's suggestion,<sup>23</sup> to add the qualifiers, "remediation and replacement," for "plant"<sup>24</sup> and to make it clear that the ban on return only applies to the extent that the remediation and replacement plant is funded by contamination proceeds.

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<sup>22</sup> Ibid.

<sup>23</sup> Comments of CWA, at 10.

<sup>24</sup> We disagree with TURN's contention (Reply Comments of TURN, at 8-9) that those qualifiers are not meaningful and with DRA's position that recognition of the fact that some projects are funded by a mix of contamination proceeds and shareholder investment implies the pre-approval by the Commission of investment decisions. Reply Comments of DRA, at 11.

**3.2.2. Rule 2 (Gain on Disposition)**

As to Rule 2 (now renumbered as Rule 3), CWA repeats the arguments it made against the rules pertaining to no gain upon disposition in Appendix B (government loans). Our acceptance in Section 3.1.4 above of the argument that § 790 is applicable leads us to revise newly numbered Rule 3 to conform to § 790 in the same manner that we revised Rule 4 in Appendix B.

**3.2.3. Rule 3 (Recordation of Proceeds)**

CWA correctly notes that this rule (now renumbered as Rule 4) lacks a provision for recordation in a Commission-authorized memorandum account pending the recordation in a specified sub-account when the time has arrived for expenditure of the proceeds. The rule has been modified accordingly, precluding an unnecessary and unwarranted reduction in rate base.<sup>25</sup> The rule is also being revised to make an exception for gains resulting from utility shareholder investments that are covered by § 790.

**3.2.4. Rules 4 (Certain Expenses and Taxes),  
5 (Indirect Expenses) and 6  
(Calculation of Depreciation)**

No changes have been suggested or made in Rule 4 (now renumbered as Rule 5). The addition of the qualifiers “remediation and replacement” have been added to the term “plant” in Rules 5 and 6 (renumbered as Rules 6 and 7).

**3.2.5. Rule 7 (Tax Treatment of  
Depreciation Expense)**

CWA identified a significant tax liability issue<sup>26</sup> in Rule 7 (now renumbered as Rule 8) that called for the flow through to ratepayers of benefits

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<sup>25</sup> See D.10-10-018, at 56.

<sup>26</sup> Comments of CWA, at 13-14. Both DRA (Reply Comments of DRA, at 12) and TURN (Reply Comments of TURN, at 10-11) are in accord that this tax issue has to be cured.

derived from depreciation expense tax deductions. The federal Internal Revenue Code<sup>27</sup> allows for the deduction of accelerated depreciation only if the depreciation expense is normalized for ratemaking purposes. We have revised this rule, using language suggested by CWA, so that it is consistent with the normalization requirement of the Internal Revenue Code.

**3.2.6. Rules 8 (Tangible and Intangible Property) and 9 (Notice to the Division of Water and Audits and DRA)**

No changes have been suggested or made in Rule 8 (now renumbered as Rule 9). At the suggestion of CWA, we are accelerating, as we did above in Appendix B, the notice period concerning dispositions and encumbrances in Rule 9 (renumbered as Rule 10) from 45 days to 30 days to match that provided in D.06-05-041 (gain from sales).

**3.2.7. Rules 10-13 and 15 (Transfer or Sale Assets; Adjusted Fair Market Value)**

CWA seeks the deletion of these rules (renumbered 11, 12, 13, 14 and 16, respectively) on the same grounds asserted in connection with proposed Rule 4 of Appendix B and proposed Rule 2 (now 3) of Appendix C, namely, violation of § 790 and the imposition of a cumbersome disincentive on water utilities. We are revising newly numbered Rules 11, 13 and 16 so that they conform to § 790 but we make no revisions in response to alleged disincentives as we do not view them to be such. As to Rule 13 (now 14), we are changing the period for giving notice to the Division of Water and Audits and DRA from 45 days to 30 days, consistent with counterpart changes we are making elsewhere in Appendices A, B and C.

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<sup>27</sup> 26 U.S.C. 168(i)(9), pertaining to normalization rules.

### **3.2.8. Rule 14 (Information in Annual Report)**

We are adding the qualifiers “remediation and replacement” to the term “plant” in this rule (now numbered 15) as we did to others (above) at CWA’s suggestion.

## **4. Revisions Made in Appendix A (Local and Federal Government)**

Although we adopted rules for local and federal contamination-related grant proceeds in the form of Appendix A to D.10-10-018, some of the revisions that we are making to proposed Appendices B and C in the instant decision in response to the Opening Comments and Reply Comments call for counterpart changes to be made in Appendix A. Accordingly, we have revised Appendix A in the following respects. The earlier no-gain-on-disposition feature in Rules 2, 14, 16 and 19 has been revised to conform to § 790. In Rule 6, the time period for filing an advice letter disclosing accounting treatment that excludes certain expenses has been changed from 45 days to 30 and the level of the advice letter has been reduced from Tier 3 to Tier 2. Rule 8 (tax treatment of depreciation expense) has been revised to conform with the normalization rules (see 3.2.5. above). Rules 9, 10 and 11 (competitive bidding and ban on utility/affiliate work on facilities) have been variously modified and deleted to accommodate utility/affiliate participation in project work. Rules 9 and 12 have been merged, with the levels of advice letters changed from Tier 3 to Tier 2 because that provides a more appropriate level of scrutiny for the subjects involved.

The periods for giving written notice to the Division of Water and Audits and DRA under Rule 19 (now numbered 17, involving the letter of commitment and execution of funding agreement) have been changed from 45 days to 30, consonant with the notice period changes in Appendices B and C.

## **5. Trigger for Rate Adjustments Related to a Memorandum Account**

In D.10-10-018, at 53-54, we adopted a combined trigger approach as a default mechanism for avoiding delays in the making of rate adjustments to recover litigation expenses tracked in memorandum accounts. That default mechanism was not included in the ordering paragraphs of D.10-10-018, however, an oversight that we cure in this decision (see Ordering Paragraph 2 below).

## **6. Conclusion**

This decision follows upon the earlier decision, D.10-10-018, in this rulemaking. The earlier decision resolved the larger policy issues in the proceeding relative to the accounting treatment of contamination proceeds (i.e., CIAC treatment rather than rate based treatment of proceeds; availability of memorandum accounts; and the definition and allocation of net proceeds). This decision, in contrast, focuses on the detailed rules of implementation that are to govern the actual on-the-books (and, concerning memorandum accounts, off-the-books) accounting. We do not believe that there factual issues concerning these rules of implementation that require the evidentiary hearings requested by CWA.<sup>28</sup>

This and the earlier decision are to be read together. This decision explicitly modifies some specific rules adopted and proposed by the earlier decision in Appendices A, B and C. Otherwise the two decisions are intended to be complementary.

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<sup>28</sup> Comments by CWA, at 15-16.

## **7. Comments on Proposed Decision**

The proposed decision of the assigned Commissioner in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments, focusing on the issues of gain on sale and the applicability of §790, were filed on December 6, 2010, by DRA and by CWA,<sup>29</sup> and reply comments were filed on December 13, 2010 by those same entities. As noted in Section 3.1.4 and elsewhere above, in response to CWA's arguments and criticisms we have revised the relevant rules<sup>30</sup> in Appendices A, B, and C to allow for gain on sale of real property, previously acquired with contamination proceeds and not used and not necessary, pursuant to § 790.

## **8. Assignment of Proceeding**

John A. Bohn is the assigned Commissioner and Gary Weatherford is the assigned Administrative Law Judge in this proceeding.

### **Findings of Fact**

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

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<sup>29</sup> Joined by California American Water Company, California Water Service Company, Golden State Water Company, Park Water Company, San Gabriel Valley Water Company, San Jose Water Company, Suburban Water Systems and Valencia Water Company.

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

3. An earlier decision, D.10-10-018, issued on October 18, 2010, in the instant proceeding determined that contamination proceeds arising from local and federal government grants, government loans, damage awards, settlements, government orders and insurance are likewise to be treatable as CIAC. That decision left this proceeding open to receive comments on proposed implementing rules. Such comments were received and reviewed.

4. In D.06-05-041, D.06-12-043 and D.07-09-021, the Commission considered and applied the Water Utility Infrastructure Improvement Act of 1995, Public Utilities Code § 789 et seq. as it relates to the ratemaking treatment of gains on sale of certain water utility property, including property funded by CIAC.

### **Conclusions of Law**

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

2. We should adopt rules that govern the accounting and ratemaking treatment of new plant (replacing contaminated plant) funded by local and federal government grants, government loans, damage awards, settlements, government order or insurance proceeds that meet the twin objectives of assuring a fair and reasonable allocation of proceeds between ratepayers and

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<sup>30</sup> See Rules 2, 14 and 16 of Appendix A; Rules 4 and 16 of Appendix B; and Rules 3, 4.5 and 11 of Appendix C.

shareholders, and assuring that ratepayers only pay a return on used and useful plant in service funded by shareholders.

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

4. Appendix A of D.10-10-018, containing rules pertaining to contamination-related proceeds arising from local and federal government grants, should be superseded by a new Appendix A that is compatible in relevant respects with Appendices B and C that have been revised in response to comments.

5. To reduce delays in cost recovery of contamination-related litigation expenses tracked in memorandum accounts, the Commission should adopt a combined trigger default mechanism as described in D.10-10-018, at 52: cost recovery can occur when whichever of the following occurs first, reaching the monetary threshold of 2% of revenue requirement or the elapsing of three years from the date the memorandum account was established. An IOU may seek by application a different, customized interim cost recovery mechanism. Litigation related expenses recovered from ratepayers should be subject to refund upon the IOU obtaining a damage award.

6. The Water Utility Infrastructure Improvement Act of 1995 applies to the sale or transfer by a water corporation of real property that was at any time, but is no longer, necessary or useful in the performance of the of the water corporation's duties to the public, where the real property was funded in part or in whole by contamination proceeds.

**O R D E R**

**IT IS ORDERED** that:

1. Contamination-related local and federal government grants and loans, and damage awards, settlements, government ordered funds and insurance proceeds, all of which are to be treated as Contributions in Aid of Construction under Decision 10-10-018, shall be accounted for in the manner set forth in the implementing rules in Appendices A, B and C to this decision. Appendices A, B and C are adopted. Appendix A of D.10-10-018 is no longer in effect.

2. A combined trigger default mechanism is adopted, as described in Decision 10-10-018, at section 5.5.2.3., whereby an investor-owned water utility may request cost recovery, through either a Tier 3 Advice Letter or a pending General Rate Case, of the balance in a contamination-related litigation expense memorandum account after either of the following has occurred: the balance in the memorandum account exceeds 2% of the utility's authorized revenue requirement or three years have elapsed since the date the memorandum account was established. An investor-owned water utilities may seek by application a different, customized interim cost recovery mechanism. Litigation related expenses recovered from ratepayers shall be subject to refund upon the investor-owned water utilities obtaining a damage award.

3. Rulemaking 09-03-014 is closed.

This order is effective today.

Dated December 16, 2010, at San Francisco, California.

MICHAEL R. PEEVEY

President

DIAN M. GRUENEICH

JOHN A. BOHN

TIMOTHY ALAN SIMON

NANCY E. RYAN

Commissioners

## APPENDIX A

### RULES FOR THE ACCOUNTING OF LOCAL AND FEDERAL CONTAMINATION GRANT FUNDS

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

1. No return shall be earned by Commission-regulated water utilities (Utilities) on grant-funded plant to the extent that the plant is funded by local or federal grants.

2. No gain shall be recovered by utilities on the disposition of local and Federal grant-funded plant except for gains from the sale of real property, previously acquired with contamination proceeds but no longer used and not necessary, covered by §790 of the Public Utilities Code.

3. When Grant Funds are received from the funding agency, the utility must place these funds in a separate account that is restricted to Grant Funds only. On the books of the company, it shall record the funds as a Debit to Account 121-3 - Cash-Miscellaneous Special Deposits and a Credit to Account 265.1 - Publicly Funded Grant Plant.<sup>1</sup> As the grant- funded plant is being constructed, the utility shall record those dollars expended as a Debit to Account 100-3 - Construction Work in Progress (CWIP) and a Credit to Account 121-3 - Cash-Miscellaneous Special Deposits. When the authorized plant has been constructed, a second set of entries shall be recorded as a Debit to Account 100-1 - Utility Plant in Service and a Credit to Account 100-3 - Construction Work in Progress. Account 265.1 shall follow the following rules:

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<sup>1</sup> Class B, C and D water utilities shall use Account 271.1 instead of Account 265.1.

- 3.1. This account shall include only publicly funded grants.
- 3.2. The records supporting the entries to this account must be so kept that the utility can furnish information as to the purpose of each grant, and shall be segregated between depreciable and non-depreciable property.
- 3.3. Depreciation accrued on the depreciable portion of properties included in this account shall be charged to this account rather than to Account 503, Depreciation, and the charges to this account to continue until such time as the balance in this account applicable to such properties has been completely amortized. (See Utility Plant Instruction 3.F.)<sup>2</sup> The balance in the account applicable to non-depreciable property shall remain unchanged until such time as the property is sold or otherwise retired. At time of retirement of non-depreciable property, which was acquired by Grant Funds, the costs thereof shall be credited to the appropriate plant account and charged to this account in order to eliminate any credit balance in the grant account applicable thereto.
- 3.4. It is intended under the provisions contained in the preceding paragraph that the credit balance in the account will be written off over a period equal to the actual service life of the property involved. The net salvage realized on the retirement of grant-funded property shall be recorded as a credit to Account 250, Reserve for Depreciation of Utility Plant.

4. Operating expenses, administrative and general expenses, and taxes associated with grant-funded plant, but not funded with Grant Funds, shall be allowed, if determined to be reasonable by this Commission. The reasonableness

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<sup>2</sup> Utility Plant Instruction 3.F. "Utility plant contributed to the utility or constructed by it from contributions to it of cash or its equivalent shall be charged to the utility plant accounts at cost of construction. There shall be credited to the depreciation and amortization reserve accounts the estimated amount of depreciation and amortization applicable to the property at the time of this contribution to the utility. The difference between the amounts included in the utility plant account and the reserve accounts shall be credited to Account 265.1."

of these costs shall be determined in the general rate case that addresses the results of operations for the district in which these expenses occur.

5. Any indirect benefits resulting from grant-funded plant such as reductions in operating expenses resulting from infrastructure improvements must be projected as cost savings and imputed into the utilities' revenue requirement.

6. Unless the utility has received authorization from the funding agency, Grant Funds shall not be spent on expenses. Grant Funds that are expended for expenses authorized by the funding agency must not be included in the determination of the Results of Operations and the forecast of future expenses in a general rate case. Within 30 days after a funding agency authorizes a utility to spend Grant Funds on expenses the utility must file a Tier 2 advice letter filing that sets forth an accounting treatment to exclude such expenses from the Results of Operations and forecast of future expenses in a general rate case.

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

8. In calculating income tax expenses for ratemaking purposes, the utilities must recognize depreciation expense deductions for income tax purposes and flow through to their customers any benefits derived from the tax deductions in the most direct fashion that is consistent with the normalization method of accounting for public utility property established by the Internal Revenue Code Section 167.

9. In the event construction or study completion time limits are not established by the funding agency, then the following provisions are reasonable and should apply:

- Construction of the project must start within one year after execution of the funding agreement;
- The project shall conclude within three years after execution of the funding agreement;
- Utilities must seek Commission approval for extensions of time limits at least two months prior to the expiration of those limits or risk loss of undelivered funding;
- Extension requests may be submitted by a Tier 2 advice letter to the Commission's Division of Water and Audits Director;
- A minimum of three competitive bids shall be required unless justification is provided showing why the minimum could not be met;
- If the utility does not choose the lowest bid, it must provide a detailed justification explaining why it chose not to accept the lowest bid; and
- Utilities should be allowed to enter sole source contracts under special circumstances. Utilities must seek by a Tier 2 advice letter filing a waiver for sole source contracts.

10. Water utilities shall use a competitive bidding process specified by the funding agency when awarding contracts for the construction of grant-funded projects. If the funding agency does not require specific competitive bidding process the utility shall use the competitive bidding process set forth in the above Rule # 9.

11. Water utilities may not use Grant Funds for work done prior to the execution of the grant funding agreement unless the funding agency has authorized this use. To the extent approval is given to use grant funds for work already performed such activity shall be accounted for pursuant to the accounting procedures set forth in this appendix for grant work not yet undertaken. At the time of the utility's next general rate case, the utility shall provide as part of its filing sufficient information for the Commission to review and determine the appropriate ratemaking treatment for any work performed that was not authorized by the funding agency.

12. These rules apply to all tangible property funded with Grant Funds. In determining the proceeds in each of the following types of sales, the cost of disposal shall be deducted from the amount received in arriving at the final amount received. In cases of intangible property, such as the intellectual property of a study, the utility shall request the Commission to individually review the matter in the utility's general rate case or, sooner if requested, by separate application.

13. In order to ensure that the Commission has prior review and approval over all grant-funded plant transactions, water utilities shall notify in writing the Director of the Division of Water and Audits and the Director of the Division of Ratepayer Advocates 30 days prior to the disposition and encumbrance of grant-funded plant.

14. The following rule shall apply to the sale or transfer of an asset, district, or total utility to another Commission-regulated water utility. If the asset to be sold or transferred has been paid for with Grant Funds in whole or part, the purchasing utility shall record a non-rate base asset in Account 265.1. The asset should sell or transfer at fair market value, subject to § 790 of Public Utilities Code.

15. When grant-funded plant is sold to a publicly-owned water provider that will deploy the asset to provide water service to the public, the public interest integrity of the grant is preserved, and the rules governing the transaction from the selling utility's position would be the same as if the sale were to a Commission-regulated water utility.

16. When grant-funded assets are sold to an entity other than a utility or public water provider, such as private unregulated companies or cities or counties exercising eminent domain powers for purposes other than acquiring a

municipal water system, the public interest integrity of the grant is not preserved. In these instances, the appropriate treatment is for the buyer to pay fair market value and for the selling utility to remit all proceeds received from the sale of the grant-funded asset to the original funding agency, or another designated agency, except as § 790 of the Public Utilities Code provides otherwise.

17. For plant wholly funded by a grant, as well as for the partially funded portion of a plant, the utility must notify in writing the Director of the Division of Water and Audits within 30 days after the utility signs a letter of commitment with the agency administering the fund and again within 30 days after completing the funding agreement execution with the responsible agency. For any portion of plant that is paid for by non-grant funds, the utility must obtain Commission approval in its general rate case or through separate application.

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

19. When the “fair market value” asset valuation of a district or total utility is difficult or impossible to perform without the grant-funded plant, the grant-funded plant must be deducted from the “fair market value” of the total utility that has been determined by the valuation, except for the sale of real property previously acquired with contamination proceeds but no longer used and not necessary, covered by § 790 of the Public Utilities Code. Since the value of the grant-funded plant in the valuation has most likely been inflated, the selling utility should inflate the depreciated book value of the grant-funded plant

using the Handy-Whitman index.<sup>3</sup> This inflated value of grant-funded plant should be deducted from the “fair market value” of the utility. This “Adjusted Fair Market Value” would then be used to determine the reasonable purchase price of the asset.

**(END OF APPENDIX A)**

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<sup>3</sup> The Handy-Whitman index is a widely recognized publication which reflects the costs of different types of utility construction.

## APPENDIX B

### RULES FOR THE ACCOUNTING OF GOVERNMENT CONTAMINATION LOAN FUNDS

These rules shall apply to all transactions involving government contamination loan funds (Govt. Loan Funds).

1. All government contamination loan funds shall be repaid by ratepayer contributions through surcharges similar to the accounting method used by the Commission for loans from the Safe Drinking Water State Revolving Fund as set forth in Water Division’s Standard Practice U-13-W and summarized in the example below:<sup>1</sup>

Assumptions:

Total Loan Amount:	\$154,500	
Loan Proceeds to the Utility:	\$150,000	
Administrative Fee:	\$ 4,500 <sup>2</sup>	
Term of Loan:	15 years with semi-annual payments	

a) Utility receives loan proceeds from government. Proceeds are recorded both in a cash account and, if authorized by the Commission, in a memorandum account. Set up the administrative fee as a prepaid asset to be amortized over life of loan.

	<u>Debit</u>	<u>Credit</u>
Cash Account	\$150,000	
Other Deferred Charges	4,500	
Other Deferred Credit- Govt. Loan		\$154,500

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<sup>1</sup> Specific USOA account numbers will vary by utility.

<sup>2</sup> Any administrative fees taken out of loan proceeds shall be amortized over the life of the loan with the unamortized amount charged to Account 146 Other Deferred (Debits) Charges and excluded from rate base. The same process shall be followed for any administrative fees paid up-front by a utility that was not taken out of loan proceeds except that such fees may be included in rate base.

- b) Plant is constructed with Government loan proceeds. Plant is to be depreciated over life of loan.

Plant in Service (Accounts 301-341) \$150,000<sup>3</sup>

Cash Account \$150,000

- c) Monthly billing of customers for ordinary revenue of \$4,000 plus Government loan surcharge of \$1,850 (\$9.25 surcharge x 200 customers = \$1,850).

Accounts Receivable - Customers \$ 5,850

Water Revenue \$ 4,000

Govt. Loan Contamination Proceeds 1,850

- d) Monthly collections of customer receivables from 188 customers. Consists of \$3,760 of regular revenue and \$1,739 of Government Loan surcharge revenue.

Cash Account \$ 5,850

Accounts Receivable - Customers<sup>4</sup> \$ 5,850

- e) Government loan surcharge collections are transferred monthly to an account with a fiscal agent.

Special Deposits - Fiscal Agent \$ 1,850

Cash Account \$ 1,850

- f) Semi-annual payment of principal and interest to Government Agency by fiscal agent and \$150 semi-annual amortization of administrative fees (\$4,500 divided by 30 semi-annual payments (15 years time 2 semi-annual payments equals \$150).

Interest Expense - Govt. Loan \$ 7,725

Other Deferred Credit-

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<sup>3</sup> Intent is that the entire \$150,000 loan proceeds shall be offset by Account 265.2 - Surcharge - Government Loan Contamination Proceeds for Class A water utilities, and Account 271.2 for Class B, C and D water utilities.

<sup>4</sup> To the extent that any portion of the surcharge is deemed uncollectible those amounts shall be recoverable from ratepayers as an adjustment to the quantity surcharge.

Govt. Loan	2,325	
Special Deposits – Fiscal Agent		\$ 10,050
Govt. Loan Amortization Expense	\$ 150	
Deferred Charges		\$ 150
g) Credit of interest earned on surcharge collections deposited with fiscal agent.		
Special Deposits – Fiscal Agent	\$ 100	
Non-Utility Income – Interest		\$ 100
h) Annual amortization of 15 year Government plant (\$150,000 divided by 15 years = \$10,000). Amortize in lieu of booking depreciation.		
Govt. Loan Amortization Expense	\$ 10,000	
Accumulated Amortization – Govt. Loan		\$ 10,000

2. No return shall be earned by Commission-regulated water utilities (Utilities) on plant to the extent that it is funded by government contamination loans repaid through ratepayer surcharges.

3. A rate surcharge shall be established which provides for a period of one year an amount of revenue approximately equal to the periodic payment which includes principal and interest. Any surplus surcharge revenue shall be refunded to ratepayers and any shortfall in debt service shall be recovered in rates. The annual adjustments to the surcharge shall be made through a Tier 2 Advice Letter filing.

4. No gain shall be recovered by utilities on the disposition of plant to the extent that it has been funded by government contamination loans repaid through ratepayer surcharges, except for gains from the sale of real property, previously acquired with contamination proceeds but no longer used and not necessary, covered by § 790 of the Public Utilities Code.

5. Capital charges for a government contamination loan shall be offset by a quantity surcharge which shall last as long as the loan. The charges shall not be

intermingled with other utility charges; special accounting requirements, including a refund condition and a shortfall provision, are necessary to ensure that there are no unintended windfalls or losses to utility owners.

6. Operating Expenses, Administrative and General Expenses, and Taxes associated with government contamination loan-funded plant, shall be allowed, if determined to be reasonable by this Commission. The reasonableness of these costs shall be determined in the general rate case that addresses the results of operations for the district or districts to which these expenses relate.

7. Any indirect benefits resulting from government contamination loan-funded plant such as reductions in operating expenses resulting from infrastructure improvements must be projected as cost savings in calculating the utility's revenue requirement.

8. Unless the utility has received authorization from the funding agency, government contamination loan funds shall not be spent on expenses. Loan Funds that are expended for expenses authorized by the funding agency must not be included in the determination of the Results of Operations and the forecast of future expenses in a general rate case. Within 30 days after a funding agency authorizes a utility to spend Loan Funds on expenses the utility must file a Tier 2 advice letter filing that sets forth an accounting treatment to exclude such expenses from the Results of Operations and forecast of future expenses in a general rate case.

9. In the event construction or study completion time limits are not established by the funding government agency, then the following provisions are reasonable and should apply:

- Construction of the project must start within one year after execution of the funding agreement;

- The project shall conclude within three years after execution of the funding agreement;
- Utilities must seek Commission approval for extensions of time limits at least two months prior to the expiration of those limits or risk loss of undelivered funding;
- Extension requests may be submitted by a Tier 2 advice letter;
- A minimum of three competitive bids shall be required unless justification is provided showing why the minimum could not be met;
- If the utility does not choose the lowest bid, it must provide a detailed justification explaining why it chose not to accept the lowest bid; and
- Utilities should be allowed to enter sole source contracts under special circumstances. If the utility chooses a sole-source contract, it must provide a detailed justification explaining why it did so.

10. Water utilities shall use a competitive bidding process specified by the funding government agency when awarding contracts for the construction of government loan-funded projects. If the funding government agency does not require specific competitive bidding process the utility shall use the competitive bidding process set forth in Rule 9 above.

11. Water utilities may use Loan Funds for work done prior to the execution of the loan agreement only when the funding government agency has authorized this use. To the extent approval is given to use loan funds for work already performed such activity shall be accounted for pursuant to the accounting procedures set forth in this appendix for loan work not yet undertaken. At the time of the utility's next general rate case, the utility shall provide as part of its filing sufficient information for the Commission to review and determine the appropriate ratemaking treatment for any work performed that was not authorized by the funding agency.

12. These rules apply to all tangible property funded with Loan Funds. In determining the proceeds in each of the following types of sales, the cost of

disposal shall be deducted from the amount received in arriving at the final amount received. In cases of intangible property, such as the intellectual property of a study, the utility shall request the Commission to individually review the matter in the utility's general rate case or, sooner if requested, by separate application.

13. In order to ensure that the Commission has prior review and approval over all government loan-funded plant transactions, water utilities shall provide written notice to the Director of the Division of Water and Audits and the Director of the Division of Ratepayer Advocates 30 days prior to the disposition of loan-funded plant.

14. The following rule shall apply to the transfer or sale of an asset, district, or total utility to another Commission-regulated water utility. If the asset to be sold or transferred has been paid for with Loan Funds in whole or part, the utility transferring or selling the asset may not receive compensation for the portion of the asset that has been funded with Loan Funds except for gains from the sale of real property previously acquired with contamination proceeds but no longer used and not necessary, covered by § 790 of the Public Utilities Code, and the purchasing utility shall record a non-rate base asset as a separate component of Account 265.2. The asset should sell or transfer at fair market value, subject to § 790 of the Public Utilities Code.

15. When government loan-funded plant is sold to a publicly-owned water provider that will deploy the asset to provide water service to the public, the public interest integrity of the loan is preserved, and the rules governing the transaction from the selling utility's position would be the same as if the sale were to a Commission-regulated water utility.

16. When government loan-funded assets are sold to an entity other than a utility or public water provider, such as private unregulated companies or cities or counties exercising eminent domain powers for purposes other than acquiring a municipal water system, the public interest integrity of the loan is not preserved. In these instances, the appropriate treatment is for the buyer to pay fair market value and for the selling utility to apply all proceeds received from the sale of the government loan-funded asset paid by ratepayer surcharges to the benefit of ratepayers, except as § 790 of the Public Utilities Code provides otherwise.

17. For plant wholly funded by Loan Funds, as well as for the partially funded portion of a plant, the utility must notify the Director of the Division of Water and Audits within 30 days after the utility signs a letter of commitment with the agency administering the loan and again within 30 days after completing the loan agreement execution with the responsible agency. For any portion of plant that is paid for by non-government loan funds, the utility must obtain Commission approval in its general rate case or through separate application.

18. All utilities that receive Loan Funds must provide the following information regarding its loan-funded plant in its Annual Report to the Commission: (1) Amount of Loan Funds received, (2) Amount of Loan Funds spent in the year covered by the Annual Report, (3) Amount of ratepayer surcharges billed and received, (4) Amount of loan repaid by ratepayer surcharges and (5) Description of plant constructed with Loan Funds.

19. When the "fair market value" asset valuation of a district or total utility is difficult or impossible to perform without the loan-funded plant, the government loan-funded plant must be deducted from the "fair market value" of the total

utility that has been determined by the valuation, except for the sale of real property previously acquired with contamination proceeds but no longer used and not necessary, covered by § 790 of the Public Utilities Code. Since the value of the loan-funded plant in the valuation has most likely been inflated, the selling utility should inflate the depreciated book value of the loan-funded plant using the Handy-Whitman index.<sup>5</sup> This inflated value of loan-funded plant should be deducted from the “fair market value” of the utility. This “Adjusted Fair Market Value” would then be used to determine the reasonable purchase price of the asset.

**(END OF APPENDIX B)**

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<sup>5</sup> The Handy-Whitman index is a widely recognized publication which reflects the costs of different types of utility construction.

**APPENDIX C**  
**RULES FOR THE ACCOUNTING OF WATER CONTAMINATION**  
**PROCEEDS**

These rules shall apply to all transactions involving contamination proceeds from damage awards, settlements, government order, or insurance (Water Contamination proceeds) and the use of such proceeds to fund remediation and replacement plant sufficient to meet the requirements of General Order 103-A.

1. From the time that a utility receives Water Contamination proceeds until the time that plant funded by such proceeds is no longer necessary or useful for public utility service, such proceeds shall be accounted for in the manner summarized in this rule by application of the following assumptions:

**Assumptions:**

Water Contamination proceeds to Utility (including Commission awarded 100% of Net Proceeds to Utility of \$50,000)	\$200,000
Utility Participation from Separate Funds:	\$ 50,000
Fair Market Value of Plant Sold in 20 <sup>th</sup> year	\$100,000
Utility Plant Depreciable Life - Book	30 Years
Utility Plant Depreciable Life - Tax	25 Years
Federal Income Tax Rate	35%

- 1.1. Utility receives Water Contamination proceeds.

	<u>Debit</u>	<u>Credit</u>
Account 121.3 Cash-Misc. Special Deposits	\$150,000	
Account 120 Cash-Account	50,000	
Account 242 Other Deferred Credits		\$200,000

1.2. Plant is constructed with Water Contamination proceeds (including Utility's share of net proceeds) and additional \$50,000 participation by Utility. As a result, Plant is funded 60% by Water Contamination proceeds (\$150,000 divided by \$250,000) and 40% by Utility (\$100,000 divided by \$250,000).

Account 100.3 Construction Work in Progress	\$250,000
Account 121.3 Cash-Misc. Special Deposits	\$150,000
Account 120 Cash-Account	100,000

1.3. Plant is placed in service.

Account 301-341 Utility Plant in Service	\$250,000
Account 100-3 Construction Work in Progress	\$250,000

1.4. Record Water Contamination proceeds of \$150,000 to Designated Contribution Account (265.3, 265.4, 265.5.1, 265.5.2, or 265.6, as detailed in Ordering Paragraph 2 of Decision 10-10-018)

Account 242 Other Deferred Credits	\$200,000
Account 265 Designated Contribution Account <sup>1</sup>	\$150,000
Account 401 Miscellaneous Credits to Surplus	50,000

1.5. Annual depreciation of 30 year Plant (\$250,000 divided by 30 years equal \$8,333 per year). Continue depreciation until sold in the 20<sup>th</sup> year (\$8,333 times 20 years equal \$166,666). Record 60% (60% times \$166,666 equal \$100,000) to designated Contribution Account, and 40% (40% times \$166,666 equal \$66,666) to Depreciation Expense Account.

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<sup>1</sup> Class B, C and D water utilities shall use primary Account 271 instead of primary Account 265.

Account 265 Designated Contribution Account	\$100,000
Account 503 Depreciation Expense	66,666
Account 250 Accumulated Depreciation	\$166,666

1.6. Balance of deferred income taxes in 20<sup>th</sup> year at 35% tax rate (tax depreciation of \$200,000 (\$250,000 divided by 25 years times 20 years equal \$200,000) less book depreciation of \$166,666 equal \$33,334 times 35% equals \$11,666).

Account 228 Income Taxes Payable	\$ 11,666
Account 258 Deferred Income Taxes	\$ 11,666

2. No return shall be earned by Commission-regulated water utilities (Utilities) on remediation and replacement plant funded by Water Contamination proceeds to the extent that it is funded by such proceeds.
3. No gain shall be recovered by utilities on the disposition of remediation and replacement plant funded by Water Contamination proceeds, except for gains from the sale of real property, previously acquired with contamination proceeds but no longer used and not necessary, covered by § 790 of the Public Utilities Code.
4. When Water Contamination proceeds are received by a utility, they shall be recorded both in a cash account and, if authorized by the Commission, in a memorandum account. Once the proceeds have been invested in remediation and replacement Plant that has been placed in service, it must place these funds in a designated account, as specified in this order, and transactions associated with each account shall be restricted to the types of proceeds only. On the books of the company, it shall record the funds as a Debit to Account 121-3 - Cash-Miscellaneous Special Deposits and a Credit to Account 242 - Other Deferred Credits. As remediation and replacement plant funded by Water Contamination proceeds is being constructed, the utility shall record those dollars expended as a Debit to Account 100-3 - Construction Work in Progress (CWIP) and a Credit to Account 121-3 - Cash-Miscellaneous Special Deposits. When the remediation and replacement plant has been constructed and placed in service, a second set of entries shall be recorded as a Debit to Account 100-1 - Utility Plant in Service and a Credit to Account 100-3 Construction Work in Progress. The

designated account (e.g., account 265.3, "Damage Award Contamination Proceeds") shall follow the following rules:

- 4.1 The respective account shall include only designated Water Contamination proceeds to that account.
- 4.2 The records supporting the entries to this account must be so kept that the utility can furnish information as to the purpose of the Water Contamination proceeds and shall be segregated between depreciable and non-depreciable property.
- 4.3 Depreciation accrued on the depreciable portion of properties included in each respective account shall be charged to the designated account rather than to Account 503, Depreciation, the charges to each respective account shall continue until such time as the balance in the account applicable to such properties has been completely amortized. (See Utility Plant Instruction 3.F.1)<sup>2</sup> The balance in the account applicable to non-depreciable property shall remain unchanged until such time as the property is sold or otherwise retired. At time of retirement of non-depreciable property, which was acquired through Water Contamination proceeds, the costs thereof shall be credited to the appropriate plant account and charged to the applicable Water Contamination proceeds designated account in order to eliminate balances in both accounts.
- 4.4 It is intended under the provisions contained in the preceding paragraph that the credit balance in the designated Water Contamination proceed account will be written off over a period equal to the actual service life of the property involved. The net salvage realized on the retirement of property funded by Water Contamination proceeds shall be recorded as a credit to Account 250, Reserve for Depreciation of Utility Plant.

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<sup>2</sup> Utility Plant Instruction 3 F. "Utility plant contributed to the utility or constructed by it from contributions to it of cash or its equivalent shall be charged to the utility plant accounts at cost of construction. There shall be credited to the depreciation and amortization reserve accounts the estimated amount of depreciation and amortization applicable to the property at the time of this contribution to the utility. The difference between the amounts included in the utility plant account and the reserve accounts shall be credited to each respective account as specified in this order."

- 4.5 Any net proceeds from a sale of real property that once was but is no longer necessary or useful for utility service should be accounted for consistent with the requirements of Public Utilities Code § 790 for those gains that resulted from utility investments.
- 4.6 In the event water contamination proceeds result from a partial or interim disposition of a cause of action, the utility may elect, with the Commission's prior authorization, to defer booking these entries until completion of litigation and appeals. Such deferral shall not negatively impact ratepayers and shall require the utility to establish a Commission-authorized memorandum account to record and accrue interest on relevant revenues, investments, and expenses.
5. Operating Expenses, Administrative and General Expenses, and Taxes associated with plant funded through Water Contamination proceeds shall be allowed, if determined to be reasonable by this Commission. The reasonableness of these costs shall be determined in the general rate case that addresses the results of operations for the district in which these expenses occur.
6. Any indirect benefits resulting from remediation and replacement funded by Water Contamination proceeds such as reductions in operating expenses resulting from infrastructure improvements must be projected as cost savings and imputed into the utilities' revenue requirement.
7. Depreciation on remediation and replacement plant funded by Water Contamination proceeds must be calculated using the existing methodology detailed in the Commission's Standard Practice U-4. Water Contamination proceeds used to acquire land should not be amortized or included in this category as well as other non-depreciable property such as water rights.
8. In calculating income tax expenses for ratemaking purposes, the utilities must recognize depreciation expense deductions for income tax purposes and flow through to their customers any benefits derived from the tax deductions in the most direct fashion that is consistent with the normalization method of accounting for public utility property established by the Internal Revenue Code Section 167.
9. These rules apply to all tangible property funded through Water Contamination proceeds. In determining the proceeds in each of the following types of sales, the cost of disposal shall be deducted from the amount received in arriving at the final amount received. In cases of intangible property, such as the intellectual property of a study, the utility

shall provide as part of its general rate case filing sufficient information for the Commission to individually review the matter in the utility's general rate case, or sooner if requested by separate application.

10. In order to ensure that the Commission has prior review and approval over all transactions associated with plant funded by Water Contamination proceeds, water utilities shall provide written notice to the Director of the Water Division and the Director of the Division of Ratepayer Advocates 30 days prior to the disposition of plant funded by Water Contamination proceeds.
11. The following rule shall apply to the transfer or sale of an asset, district, or total utility to another Commission-regulated water utility. If the asset to be sold or transferred has been paid for with Water Contamination proceeds in whole or part, the utility transferring or selling the asset may not receive compensation for the portion of the asset that has been funded by Water Contamination proceeds, except as § 790 of the Public Utilities Code provides otherwise. The purchasing utility shall record a non-rate base asset in the appropriate contribution sub-account designated in Ordering Paragraph 2 of D.10-10-018. The asset should transfer at fair market value, subject to § 790 of the Public Utilities Code.
12. When plant funded by Water Contamination proceeds is sold to a publicly-owned water provider that will deploy the asset to provide water service to the public, the rules governing the transaction from the selling utility's position would be the same as if the sale were to a Commission-regulated water utility.
13. When plant funded by Water Contamination proceeds is sold to an entity other than a utility or public water provider, such as private unregulated companies or cities or counties exercising eminent domain power for purposes other than acquiring a municipal water system, the public interest integrity of the plant funded by Water Contamination proceeds is not preserved. In these instances, the appropriate treatment is for the buyer to pay a fair market value and for the selling utility to retain all funds for the benefit of the ratepayer and submit an application for authority to apply such funds to the benefit of ratepayers, except for gains from sale of real property, previously acquired with contamination proceeds but no longer used and not necessary, covered by § 790 of the Public Utilities Code.
14. For plant wholly funded by Water Contamination proceeds, as well as for the partially funded portion of a plant, the utility must notify the Director of the

Water Division within 30 days after the utility receives the funds. For any portion of plant that is paid for by non-Water Contamination proceeds, the utility must obtain Commission approval in its general rate case or through separate application.

15. All utilities that receive Water Contamination proceeds must provide the following information regarding plant funded by Water Contamination proceeds in its Annual Report to the Commission: (1) Amount of Water Contamination proceeds received, (2) Amount of Water Contamination proceeds spent in the year covered by the Annual Report, and (3) Description of remediation and replacement plant and other plant constructed with Water Contamination proceeds.
16. When the "fair market value" asset valuation of a district or total utility is difficult or impossible to perform without the plant funded by Water Contamination proceeds, the plant funded through these proceeds must be deducted from the "fair market value" of the total utility that has been determined by the valuation, except for the sale of real property previously acquired with contamination proceeds but no longer used and not necessary, covered by § 790 of the Public Utilities Code. Since the value of the plant funded by Water Contamination Proceeds in the valuation has most likely been inflated, the selling utility should inflate the depreciated book value of the plant using the Handy-Whitman index.<sup>3</sup> This inflated value of such plant should be deducted from the "fair market value" of the utility. This "Adjusted Fair Market Value" would then be used to determine the reasonable purchase price of the asset.

**(END OF APPENDIX C)**

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<sup>3</sup> The Handy-Whitman index is a widely recognized publication which reflects the costs of different types of utility construction.

