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Decision 02-07-011 July 17, 2002

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of CALIFORNIA-AMERICAN WATER COMPANY (U-210-W), a California corporation, for an Order Authorizing Establishment of a Memorandum Account to Record Costs Associated with Security Measures Needed to Address Potential Terrorist Attacks.	Application 02-03-019 (Filed March 15, 2002)

O P I N I O N

Summary

This order denies California-American Water Company's (Cal-Am) request to establish a special and temporary Security Cost Memorandum Account.

The Applicant

Cal-Am is a public utility water corporation serving more than 175,000 customers and employing 239 people within ten divisions located in counties from San Diego County to Placer County. The water supply sources of Cal-Am include ground water wells, surface water supplies and purchased water. Its infrastructure includes thousands of miles of pipeline, large numbers of water treatment plants with related water production and transmission facilities, two water quality laboratories, extensive rolling stock and computer systems, and offices and corporate yards in each of its divisions.

Request

Cal-Am seeks authority to establish a Security Memorandum Account to record expenditures for security programs and projects it initiated subsequent to the September 11, 2001 terrorists attacks.[1] Cal-Am states that it is incurring those additional expenditures in direct response to government recommendations and mandates[2] to address potential terrorist attacks and to Cal-Am management's recognition of its obligation to protect from terrorist activities the water supplies, assets, and facilities of Cal-Am.

Cal-Am argues that none of the security expenditures covered by its application has been included in its prior rate case filings, existing rate case order, or tariffs now in effect. Absent its ability to track and seek recovery of those expenditures through future rates, Cal-Am states that those expenditures will adversely impact its current ability to earn its Commission-authorized rate of return. Also, Cal-Am believes the memorandum account comports with memorandum account threshold requirements, as set forth in the Commission's July 12, 2001 Resolution No. W-4276, which authorized a generator cost memorandum account for all water and sewer system utilities.[3]

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[1] Although Cal-Am did not provide specific details of its new security measures or associated costs, if requested, it will provide such details under seal.

[2] The government recommendations and mandates relied on by Cal-Am are the October 10, 2001 Federal Bureau of Investigation (FBI) Statement to Congress, the October 8, 2001 Presidential Executive Order 13228, and the September 14, 2001 Federal Energy Commission (FERC) Statement of Policy.

[3] The conditions are that the expenditure is caused by an event of an exceptional nature that is not under the utility's control; the expenditure cannot have been reasonably foreseen in the utility's last general rate case and will occur before the utility's next scheduled rate case; the expenditure is of a substantial nature in the amount of money involved; and, the customers will benefit by the memorandum account treatment.

Cal-Am concludes that the Security Memorandum Account is the appropriate means for it to seek future recovery of those expenditures not reflected in its rates while avoiding retroactive ratemaking treatment of those security expenditures being incurred since September 11, 2001. Those additional expenditures are estimated to total approximately $2,068,000 and include both capital and expense costs, as summarized in the following tabulation.

Time Period	Capital	Expense	Total
9/12/01 – 12/31/01	$ 429,000	$ 143,000	$ 572,000
1/01/02 – 12/31/02	818,000	678,000	1,496,000
Total	$1,247,000	$ 821,000	$2,068,000

Protest

The Office of Ratepayer Advocates (ORA) opposes the request on the basis that the inclusion of previously incurred security expenditures constitutes retroactive ratemaking, and that Cal-Am has failed to substantiate that the government recommendations and mandates and Commission threshold requirements it relied on demonstrate need for the memorandum account. ORA concludes that the application should be dismissed.

Discussion

It is a well-established principle of this Commission that ratemaking is done on a prospective basis. The Commission's practice is not to authorize increased utility rates to account for previously incurred expenses unless, before the utility incurs those expenses, the Commission has authorized the utility to book those expenses into a memorandum or balancing account for possible future recovery in rates.[4]

[4] See, for example, Southern California Water Co., 43 CPUC2d, 596 at 600 (1992).

By its reply to ORA's protest, Cal-Am withdraws its request to include the additional capital costs identified in its application. Such exclusion of capital costs reduces the amount to be included in the memorandum account from $2,068,000 to $821,000.

Cal-Am also uses its reply to clarify that the additional expense costs are not one time costs. Rather, such expense costs are being incurred on an ongoing basis. With the withdrawal of capital costs and clarification of ongoing expense costs, the retroactive ratemaking issue becomes moot, Cal-Am believes. However, the need for the proposed memorandum remains at issue.

We find that the reliance Cal-Am places on specific government recommendations and mandates does not justify the establishment of a memorandum account. The FBI Statement before Congress says that, although it is possible for a water supply to be contaminated with a biological agent that causes illness or death of victims, it is not probable; moreover, the contamination of a water reservoir with a biological agent would likely not produce a large risk to public health because of the dilution effect, filtration, and disinfection of the water.[5]

The other government documents that Cal-Am relied on also fail to provide a basis for establishing a memorandum account to track extraordinary expenses for security measures. Presidential Executive Order 13228 merely lists the functions of the newly created Office of Homeland Security and the FERC Statement of Policy assures energy companies, not water companies, that the

[5] Page 3 of Exhibit D to the application.

FERC will approve recovery of "prudently incurred costs" necessitated by security measures.[6]

ORA also contends that the proposed memorandum account does not comply with Commission threshold requirements for establishing such accounts because the expenditures fail to satisfy the third condition. That condition requires the expenditures to be of a substantial amount of money. ORA compares the estimated security expense costs for 2002 to forecasted annual operating expenses, Tab E to the application. This comparison shows that the estimated security expense costs amounts to 1.1%[7] of estimated annual expenses, a percentage considered by ORA to be insignificant.

With the subsequent clarification from Cal-Am that those additional expense costs are ongoing, we add the 2001 expense costs to the 2002 expense costs to arrive at a 1.4%[8] impact on the ongoing annual expenses of Cal-Am. This latter result, without reflecting tax benefits to be derived from the additional expense costs, would impact the average customer's monthly bill by less than $0.40.[9]

According to ORA, Cal-Am has or will shortly have General Rate Cases (GRCs) before the Commission for five of its districts comprising more than 47%

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[6] Exhibit C to the application and page 4 of the application, respectively.

[7] 2002 expense costs totaling $678,000 divided by forecasted annual operating expenses totaling $61,240,782.

[8] Ongoing expense costs totaling $821,000 (2001 expense costs of $143,000 plus 2002 expense costs totaling $678,000) divided by annual operating expenses totaling $61,240,782.

[9] Ongoing expense costs totaling $821,000 divided by 175,000 customers and divided by twelve months.

of the utility's total annual revenue generated in California. ORA contends that, to the extent such expenditures are approved and the GRCs are completed on a timely basis, those security expenditures would be reflected in base rates as of January 1, 2003. ORA concludes that Cal-Am should seek recovery of those security expenditures in its upcoming GRC filings on a prospective basis.

Cal-Am subsequently acknowledged that several of its districts are undergoing GRCs. However, it asserts, without providing any details, that a sizeable portion of the expenses are being incurred in districts not the subject of current GRCs.

To assess the need of Cal-Am for establishing the Security Memorandum Account we briefly review our ratemaking process for water utilities. The recovery of expenditures through rates for water utilities is based on future test year rate of return ratemaking.[10] This means that the rates of Cal-Am are based on estimated rate base and expenditures for a future test year. Actual rate base and expenditures can and do change between the time rates are set and the time events occur.

There is no requirement of the utility to spend exactly, or only, the projected amount on each rate base or expenditure component used to set rates. Similarly, there is no requirement or guarantee that the utility earn its authorized rate of return. In other words, if a utility fails to earn its authorized rate of return, ratepayers are not assessed the short-fall, and if the utility earns more than authorized, it does not rebate the excess to ratepayers.[11]

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[10] See, for example, Financial and Operational Risks of Commission-regulated Water Utilities, 43 CPUC 2d, 568 at 600 (1992).

[11] See, for example, All Water and Sewer System Utilities, Order Authorizing a Generator Cost Memorandum Account, Resolution W-4276 at 4 and 5.

We leave the fine-tuning of a utility's operation to the discretion of its management. Management discretion is exercised in allocating total dollars for capital and expense items to those areas where the capital and expense is most necessary, as dictated by constantly evolving priorities. This discretion also affects whether the utility realizes its authorized rate of return.

As previously discussed, memorandum accounts are available to track specific expenditures for future consideration of their recovery in rates. Based on the criteria used by Cal-Am, those expenditures recorded in a memorandum account for future recovery are: caused by an event of an exceptional nature outside of the utility's control; not reasonably foreseen in the utility's last GRC; substantial in the amount of money involved; and, beneficial to the customers.

Clearly, the terrorists' activities of September 11, 2001, satisfy the exceptional nature and not reasonably foreseen criteria. However, irrespective of whether government recommendations and mandates required Cal-Am to incur additional security expenditures, the amount of expenditures involved is not a substantial amount. Here, we find that the additional expenditures are not clearly required (at least on the bases cited by Cal-Am) and constitute less than 2.0% of projected operating costs. Our ratemaking assumes that utility management can and will reassess its priorities to deal with developments of this magnitude. Specifically, Cal-Am may utilize management discretion to allocate funds for capital and expense items to those areas where the expenditure is most necessary, and also to attain its authorized rate of return.

Cal-Am has not substantiated the need to establish the Security Memorandum Account. To the extent Cal-Am wishes to pursue recovery of additional security costs, the issue should be addressed in upcoming GRCs. The request of Cal-Am for authority to establish the Security Memorandum Account is denied.

Procedural Matters

Pursuant to Rule 6(a)(1), Cal-Am requested that this matter be classified as a ratesetting proceeding and that hearings not be held, asserting that all necessary information to issue a decision has been included in its application or been incorporated by reference. By Resolution ALJ 176-3084, dated March 21, 2002, the Commission preliminarily determined that this was a ratesetting proceeding and that no hearings were expected.

Notice of this application appeared in the Commission's Daily Calendar of March 20, 2002. Although a protest was filed by ORA, we find no reason to hold a public hearing and no reason to change the preliminary determinations made in Resolution ALJ 176-3084. The preliminary ratesetting categorization set forth in Resolution ALJ 176-3084 is affirmed.

The scope of this proceeding is set forth in the application. Our order today confirms that Administrative Law Judge Galvin is the presiding officer.

Comments on Draft Decision

The assigned Administrative Law Judge's (ALJ) draft decision in this matter was filed with the Docket Office and mailed to all parties of record in accordance with Section 311(g)(1) of the Public Utilities Code and Rule 77.7 of the Commission's Rule of Practice and Procedure (Rules).

Rule 77.3 specifically requires comments to focus on factual, legal, or technical errors in the draft decision, and when citing such errors, requires the party to make specific references to the record. Rule 77.4 further requires that comments including the proposal of specific changes to the draft decision also include suggested Findings of Fact and Conclusions of Law that are believed to comport with those changes. Finally, Rule 77.2 requires parties that file comments on a proposed decision to serve a copy on all parties, and to serve separately the assigned Commissioner and ALJ.

ORA timely filed and served a copy of its comments on the proposed decision. Although Cal-Am timely filed its comments, it did not serve a copy on the assigned ALJ. As evidenced by its certificate of service, Cal-Am also did not serve ORA. Irrespective of Cal-Am's improper service of comments; the comments filed by both Cal-Am and ORA were carefully reviewed and considered. Other than correction of a typographical error, no changes have been made to the proposed decision.

Findings of Fact

1. Cal-Am seeks to include in the Security Memorandum Account approximately $821,000 of the $2,068,000 estimated additional security expenditures it has incurred or expects to incur since the September 11, 2001 terrorist attacks and in response to government recommendations and mandates. The additional security expenditures were not included in prior rate case filings, existing rate case orders, or tariffs now in effect.

2. The prohibition of retroactive ratemaking precludes Cal-Am from recovering through future rates its additional security expenditures incurred from September 11, 2001 to the effective date of this order.

3. Cal-Am utilizes the memorandum account threshold requirements set forth in Resolution W-4267 to justify establishing the Security Memorandum Account.

4. The FBI statement relied on by Cal-Am finds that it is not probable for a water supply to be contaminated with a biological agent that causes illness or death of victims. The FBI statement also finds that the contamination of a water reservoir with a biological agent would likely not produce a large risk to public health.

5. The Presidential Executive Order relied on by Cal-Am lists the functions of the newly created Office of Homeland Security.

6. The FERC Statement of Policy relied on by Cal-Am assures energy companies that the FERC will approve the recovery of prudently incurred costs necessitated by security measures.

7. The additional security expenditures represent less than 2.0% of total operating expenses and impact the average customer's monthly bill by less than $0.40.

8. The recovery of expenditures through rates for Commission-regulated water utilities is based on future test year rate of return ratemaking.

9. There is no requirement that a utility to spend exactly, or only, the projected amount on each rate base or expenditure component used to set rates.

10. If a utility fails to earn its authorized rate of return, ratepayers are not assessed the shortfall, and if the utility earns more than authorized, it does not rebate the excess to ratepayers.

11. Management discretion is exercised in allocating total dollars for capital and expense items to those areas where the capital and expense is most necessary, and in attaining the utility's authorized rate of return.

12. Today's order should be made effective immediately, so that Cal-Am's ratemaking issues can be clarified.

Conclusion of Law

Cal-Am has not substantiated the need to establish the Security Memorandum Account.

O R D E R

IT IS ORDERED that:

1. California-American Water Company's request to establish the Security Costs Memorandum Account is denied.
2. Application 02-03-019 is closed.

This order is effective today.

Dated July 17, 2002, at San Francisco, California.

LORETTA M. LYNCH
President
HENRY M. DUQUE
CARL W. WOOD
GEOFFREY F. BROWN
MICHAEL R. PEEVEY
Commissioners