

Decision 06-07-034 July 20, 2006

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Union Pacific Railroad
Company, Keene Water System (0434W), for
Authorization to Increase Rates and for Interim
Rate Relief.

Application 04-11-004
(Filed November 4, 2004)

(See Attachment A for List of Appearances.)

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OPINION AUTHORIZING INITIAL RATES

In this decision, the Commission authorizes initial rates for Union Pacific Railroad (Union Pacific) on behalf of its Keene Water System (Keene), a Class D water utility with 37 customers. The Commission also orders certain steps to bring Keene into compliance with General Order (GO) 103. Keene is a Class D water utility serving the communities of Keene and Woodford in Kern County, southeast of Bakersfield. Most of the provisions of the ordering paragraphs of this opinion are stayed for 180 days to allow the parties to negotiate a more mutually beneficial outcome for this proceeding.

I. Background

The Keene Water System was constructed over 100 years ago by the Southern Pacific Railroad (predecessor of Union Pacific) to transport water from wells in the City of Tehachapi to the communities of Keene and Caliente that had grown up around the railway. The water was used for steam locomotives and by residents. Eventually, the railroad's water use declined but Southern Pacific continued to provide water for the Keene and Caliente residents. Water service to Caliente was discontinued in the 1980s. (Application of Union Pacific Company, Keene Water System 3-4 (Nov. 4, 2004).)

Water originally was pumped from wells in Tehachapi and transported to Keene by a gravity-flow pipeline. The pipeline originally ran through the railroad's tunnel between Tehachapi and Keene. In 1994, Southern Pacific expanded the tunnel bore to accommodate "double-stack" freight containers on rail cars. This construction resulted in discontinuance of the water pipeline. To provide water to Keene and Woodford, Southern Pacific drilled new wells in its

right-of-way near the two communities and connected those wells to the existing water distribution system.

In 1996, Union Pacific merged with SP Transportation Company, the successor in interest to the Southern Pacific Railroad, which thereby became the owner of the Keene Water System.

II. Commission Proceedings

On May 18, 2000, the Commission commenced an investigation to determine whether Keene is a public utility water system. In April 2002, the Commission issued Decision (D.) 02-04-017 finding that Keene is indeed a public water utility and directing the Commission's Water Division to complete a rate study for the system. In that decision, we characterized the water system as anomalous. (D.02-04-017 at 2.) Keene was ordered to provide water to all existing customers as of the commencement of the Order Instituting Investigation (OII), so long as they paid for the water. The Water Division submitted its rate study on April 17, 2003, finding that existing rates are insufficient to cover the costs of providing service. (Water Division, Response to the Request for Interim Rate Relief at 2 (Jan. 21, 2005).)

On June 12, 2003, the assigned Administrative Law Judge (ALJ) requested Keene to indicate whether it intended to file a formal rate application. Keene indicated that it intended to file such an application. The Commission closed the OII with the issuance of D.03-10-073 on October 31, 2003. The Commission ordered Keene to file its application but waived the requirement for filing a notice of intent.

On November 4, 2004, Union Pacific filed its rate application on behalf of the Keene Water System. The application was protested by the Stonybrook Corporation (a water user owning a 200-acre conference and educational center

known as La Paz), Bridget Beard (an individual water user), and the Commission's Water Division. The Kern County Fire Department appeared as an interested party.

A prehearing conference was held on January 11, 2005. The scoping memo for the proceeding was issued on January 13, 2005. The parties were notified of the possible availability of intervenor compensation. No one filed an intent to claim intervenor compensation.

During the prehearing conference, the assigned ALJ heard oral arguments on Keene's Motion Regarding Service of Notice of Rate Increase Application (Nov. 23, 2004). The motion asked for approval of the steps Keene had taken to provide notice of the ratesetting proceeding. The Stonybrook Corporation opposed the motion. The assigned ALJ granted the motion on the condition that Keene undertake additional steps to identify and provide notice to persons owning property receiving water from the Keene Water System. Keene complied with this order.

A well-attended public participation hearing was held for the customers of the Keene Water System in the community of Keene on the evening of February 7, 2005.

As part of its application, Union Pacific asked that the Commission immediately adopt, as an interim measure, the rates proposed by the Water Division in its April 2003 report. The Water Division and other protestants opposed the request. In D.05-04-028 (April 7, 2005), we adopted the assigned ALJ's draft decision and denied interim relief. We found that interim relief was not warranted because the "system has numerous problems . . . concerning the identity of water users, responsibilities for major parts of the distribution system, meter reading, and billing and collection procedures." *Id.* at 5.

The parties indicated they wished to try to settle the major issues in the proceeding. In response, the assigned ALJ scheduled a series of six workshops and telephonic conference calls to attempt settlement. All of the parties participated actively in these discussions. Other water users, representatives of the Tehachapi-Cummins Water District, and representatives of the California Department of Health Services (DHS) participated in all or some of the meetings. Throughout this settlement process, the participants worked diligently, constructively, and in good faith; but, ultimately, the parties were unable to reach a settlement. The discussions addressed strategies for improving the water supply and quality, responsibilities for the various sections of the distribution system, and identifying and billing water users. The settlement process, however, may have improved understanding and communication between the railroad and the community.

With an impasse in the settlement process, the matter proceeded to an evidentiary hearing held in Fresno on July 20 and 21, 2005. Michael Lyon and Rich Robinson testified for Keene Water System. Elena Perez testified for the Water Division. Emilio J. Huerta testified for the Stonybrook Corporation. Bridget Beard testified for herself.

The record closed on August 5, 2005; and, after briefing, the proceeding was submitted on September 21, 2005.

III. System Description

Three wells located in the Keene and Woodford area are the source of water for the system. No aquifers underlie the area; water is pumped from fissures in the mountainous rock formation. Pumped water is stored in two 50,000 gallon storage tanks. During dry summer periods, water production is often reduced. In these circumstances, Keene Water System must use the

services of a private carrier to haul water by truck from Tehachapi to refill the Keene tanks.

The system delivers water to seven meters: (1) a 2-inch connection serving a group of residential users known as the Upper Keene Group (approximately 10 users); (2) a 2-inch meter connection serving a group of predominately residential users known as the Lower Keene Group (approximately 32 users); (3) a 2-inch meter connection serving the Stonybrook Corporation; (4) a 2-inch meter connection serving the Kern County Fire Department; (5) a ¾-inch meter connection serving Tony Martin; (6) a ¾-inch connection serving Steve Cummins; and (7) a ¾-inch connection serving Bill Edwards (also known as Three Peaks Ranch). Some, but not all, of the residents in the Upper and Lower Keene Groups have submeters on their connections. Keene Water System historically has not assumed responsibility for the pipes and meters beyond the master meters serving the Upper and Lower Keene Groups.

In addition to the development of local wells made necessary by the railroad tunnel enlargement in 1994, Keene replaced the distribution system (upstream of the master meters) in the Keene and Woodford communities in 1997. This installation of six-inch PVC pipe cost \$609,226. Also, in 2000, Keene replaced a pipe serving the Three Peaks Ranch at a cost of \$7,087.

Keene does not seek rates to cover the development of local wells in 1994 or the 2000 replacement of pipe benefiting the Three Peaks Ranch. Keene does seek to include the cost of the 1997 distribution system replacement (\$609,226) in the rate base. Protestants Stonybrook and Beard maintain that the abandonment of the water pipeline from Tehachapi in favor of local wells was not a prudent decision. Protestants also object to the inclusion of the distribution system replacement in the ratebase.

IV. Questions Presented

Several of the issues identified in the scoping memo were resolved prior to the evidentiary hearing. The contested issues remaining to be resolved are:

1. Are the applicant's estimated revenues, expenses, rate base, and rate of return just and reasonable (all discussed under Ratesetting, Part V)?
2. Is the applicant's proposed rate design in the public interest (Part VI)?
3. Does the Commission have jurisdiction to determine whether the discontinuance of the Tehachapi pipeline and the associated drilling of wells were just and reasonable? If the Commission does have jurisdiction, were such actions just and reasonable and how do such actions affect applicant's rate application (Part VII)?
4. How should water be metered and billed? Additionally, should applicant be required to acquire and maintain distribution facilities (including individual meters) "downstream" of master meters. (Part VIII)?
5. Is applicant in compliance with applicable state and federal water quality standards and the provisions of General Order (GO) 103 (Part IX)?

V. Ratesetting

The following discussion is organized around the three main components of cost-based ratemaking: net operating income, rate base, and rate of return. This is followed by a discussion of the utility's revenue requirement.

A. Net Operating Income

Net operating income is gross operating revenue less operating and maintenance expenses, depreciation, income taxes, and other operating taxes. The parties agree that an estimated 7 million gallons of water each year will be sold. Based on the rate design adopted herein, this volume will yield gross

operating revenues of \$120,121 (including \$3,704 as the value of water delivered to Three Peaks Ranch pursuant to a separate agreement).

For test year 2004, Keene estimates that expenses total \$101,220. The Water Division estimate is \$88,478. The Stonybrook Corporation and Beard estimate certain expense items but did not provide an overall estimate of expenses. The agreed-upon expenses are discussed first, followed by the expense categories where the parties disagree.

1. Areas of Agreement

The parties agree on Keene's requests in certain categories: \$1,500 for water testing, \$3,900 for chlorination, and \$6,100 for electricity and telephone. The Commission has reviewed these requests and finds them reasonable.

2. Labor Cost

Keene requests \$50,526 for labor costs. The Water Division proposes \$48,545. Stonybrook and Beard suggested that some work could be done at lower cost by contractors outside Union Pacific's collective bargaining units, but they offer no evidence on what savings such an arrangement would produce. The Commission adopts \$50,526.

The applicant and the Water Division agree on the total estimated hours of labor (1,600 hours; equivalent to 75% of one employee) and the salary rate. The only disagreement between Keene and the Water Division concerning labor costs is the appropriate fringe benefit rate. The Water Division proposed 47% based on a 2002 estimate. Robinson testified that the current overhead rate is 52.43% for the bargaining unit covering the employee who performs most of the water system work. As Keene argues, the water system historically has been a union shop and cannot be changed into a non-union shop just because this might be more advantageous to ratepayers. RT at 246; 17-247:10 (Perez); Keene

Reply Brief at 19. A fringe benefit rate of 53% is supported by the weight of the evidence, and that rate will be adopted here. The Commission also adopts the Water Division's position that Keene should read the individual water meters, and the labor necessary for this task is already included in the total estimated number of hours.

3. Vehicle Cost

Keene's amended request is that 75% of the costs (or \$9,000) of the vehicle assigned to the employee who performs most of the work on the water system be recovered in rates. The Water Division proposes \$6,850, allowing the recovery of 50% of costs based on 2001 information. Stonybrook proposes \$1,000.

The employee needs to have a vehicle in order to travel to the water system, perform work at the water system, and respond to emergencies from his home. Applying the same percentage for vehicular costs as labor cost (75%) for the employee who uses the vehicle is a reasonable allocation method. Using the Water Division's own figures, a 75% allocation (even using 2001 figures) would exceed the \$9,000 requested by Keene. The Commission adopts the \$9,000 request.

4. Technical Advisor

In the past, Keene has contracted with a private consulting firm concerning operation of the water system and compliance with DHS's requirements. As Keene has now assumed these responsibilities, this expense has been reduced. Both Keene and the Water Division agree on \$4,410 for the test year. Stonybrook proposes \$2,000 but fails to support this figure. The Commission accepts the \$4,410 request.

5. Permits and Monitoring

Keene requests \$6,784 for permits and monitoring, based on an average of expenses between 2000 and 2003. The Water Division suggests that \$1,443 should be recovered in rates and any additional expenses in this category be tracked in a memorandum account. The Water Division points out that the Commission's Resolution W-4327 allows Class B, C, and D water utilities to establish a memorandum account for these expenses and recover them on advice letters.

As discussed below, the system's water quality is of continuing concern to the Commission. More periodic testing may be required to ensure that the system is complying with GO 103 and applicable state and federal law. The memorandum account provides a practical means for tracking these monitoring expenses. The Commission allows \$1,443 for license and permit expenses. For expenses beyond this amount, Keene should use the memorandum account to track these expenses and to seek recovery through advice letters.

6. Materials and Supplies

Keene and the Water Division agree on the estimate of \$13,000. Stonybrook suggests half of this amount but does not provide any specific basis for its recommendation. The Commission accepts the \$13,000 request.

7. Legal Fees

Keene estimates that it will incur \$20,000 in legal costs for this ratemaking proceeding and proposes that this amount be amortized at \$3,000 per year until fully recovered. The Water Division agrees that both the total fees and amortization proposal are reasonable. Stonybrook proposes that legal fees not be allowed.

Reasonable legal fees incurred in a rate proceeding are normally recovered in rates. Keene's attorneys have diligently litigated this proceeding, and Stonybrook has demonstrated no reason why Keene's legal fees should not be recovered here. The amortization proposal is a reasonable method of allocating the costs of a multi-year rate proceeding over multiple years. The Commission accepts the \$20,000 request and instructs that this amount be amortized, without interest, at \$3,000 per year until fully recovered. Any ratesetting-related legal fees beyond \$20,000 should be booked to a memorandum account.

8. Expenses Not Requested

Keene has not requested recovery for property taxes, income taxes, insurance, or administrative/general expenses. This is because these expenses are integrated in overall Union Pacific expenses and the appropriate charges are not easily allocated to the Keene Water System. The Water Division suggests the recovery of \$800 in anticipated income tax expenses; but if Keene does not want to claim this expense in rates, ratepayers will benefit. The Commission accepts Keene's preferences concerning these categories.

B. Rate Base

Rate base is one of the more contentious issues between the parties but the debate revolved around only one important item. As rate base, Keene claims the amount of \$502,611, which represents the net plant cost of the 1997 pipeline replacement and relocation project undertaken before Keene was determined to be a public utility. To be clear, this is the distribution pipeline system within the Keene community (not including pipes "downstream" of master meters). This is not the 1993-94 project that resulted in the substitution of local wells for the water imported by pipeline from the City of Tehachapi. Keene does not seek rate

recovery for the costs of the 1993-94 project; nor does it seek recovery for a well replacement project in 1997, a pump replacement project in 1999, or a line replacement for Three Peaks Ranch undertaken in 2000.

The original cost of the 1997 distribution pipeline project was \$602,226. Keene estimates the useful life of this improvement to be 40 years. In determining net plant of \$502,611, Keene has subtracted \$106,000 in depreciation from 1997 to 2004.

The Water Division and other parties oppose the inclusion of any part of the 1997 pipeline project in rate base. The Water Division argues that Union Pacific has already expensed this project and that it would violate Generally Accepted Accounting Principles (GAAP) to capitalize this project retroactively. The Water Division also maintains that the 1997 project was an extension of the ill-conceived 1993-94 undertaking (see discussion, VII below), predominately advanced Union Pacific's interests, and only minimally benefited water users. Beard maintains that the 1997 project was undertaken principally to improve railroad operations by removing the pipeline from the railroad right of way where ongoing pipeline maintenance would interfere with train operations on this busy freight corridor.

No party contests the approximate 100-year age of the pre-1997 distribution pipeline and even Beard and Stonybrook tacitly admit that there were leaks in this system and health concerns. Michael Lyon indicated in prepared and oral testimony that DHS sought pipeline relocation and replacement, although Beard argues that DHS never directly ordered the replacement. The objectors argue that the replacement was primarily to remove the pipeline from the railroad right-of-way to the county road so that profitable

rail freight operations would not be disrupted by maintenance of the water system.

Rather than a nefarious scheme, the evidence supports the conclusion that pipeline replacement and relocation was a prudent management decision. The distribution system was old and an increasing number of repairs on the busy railroad right-of-way, to repair leaks and otherwise meet DHS concerns, would increase the cost and danger of such maintenance.

The railroad may well have benefited from the relocation; but protestants' arguments on this point are general and they did not attempt to quantify this assumed benefit in a way that can be factored into ratebase determinations. The Water Division, for instance, argues that the railroad benefited by "unburdening" its right-of-way so that it can now be sold or leased to other parties. This is conjecture, as no evidence was produced indicating that the railroad has or intends to do so. Testimony as to the cost and danger of conducting non-railway operations within the rail corridor suggests that few if any sales or leases will occur. The Water Division also argues that the new pipes made the water system more marketable, potentially enabling the railroad to sell and end its responsibility for the system. Even if evidence existed to support this motive, the resulting benefit appears to have been nil since the railroad paid for the pipeline replacement but has been unable to sell the system. Finally, the Water Division argues that the pipeline benefited the company because it enabled the railroad to meet its water delivery obligation to Three Peaks Ranch. Since the Commission adopts the Water Division's earlier recommendation to charge the water company for water delivered without cost to Three Peaks Ranch, pursuant to this arrangement, any such benefit is essentially cancelled.

While the railroad benefits from the 1997 project are uncertain, there is no doubt that Keene water users benefited substantially by the replacement of a century-old leaking system with a new system. This project would have been necessary regardless of the fate of the Tehachapi-Keene pipeline. Without tangible and convincing evidence indicating that some of the pipeline cost should be allocated to the railroad, the Commission authorizes the inclusion of the net plant of \$502,611 in rate base.

The Water Division's concerns that Union Pacific has already expensed the 1997 project are misplaced. Tax and utility accounting are generally separate regimes. For example, a regulated utility may be authorized by the Commission to charge for income tax on calculated revenues as if it were a stand alone water system, even though it is part of a holding company that has a totally different tax situation.

The evidence is sketchy at best as to how Union Pacific handled the 1997 pipeline costs for tax purposes. Even if expensed, the protestants have not demonstrated how ratepayers might be harmed. While the Water Division suggests that this violates GAPP, the Division offers no citations to GAPP provisions, Commission General Orders, or standard procedures that are violated. The decisions cited by the Water Division refer to attempts by utilities to both expense and depreciate assets in the ratesetting process. Such an error is not present here.

Based on the opinion evidence of its expert, the Water Division also argues that Keene was imprudent in "not replacing the line before it became 100 years old." RT 282 (Perez). If Keene had earlier replaced the pipeline, or had engaged in more active maintenance over the years, costs of the 1997 project may have been less than the amount Keene now seeks to add to rate base. However,

the Water Division does not offer any financial or engineering evidence indicating what specific maintenance was imprudently postponed or, with proper ongoing maintenance, what savings might have resulted.

C. Rate of Return

At present rates, Keene would be receiving a negative 20.98% return on rate base (net operating loss of \$105,450 ÷ average rate base of \$502,611). Keene seeks a rate of return of 2.39% on rate base. Since the Water Division's position is that the water system should have zero rate base, it has not taken a position on Keene's request of 2.39%. The Water Division does indicate, however, that if the Commission allows the company's requested ratebase, the Division does not oppose a 2.39% rate of return. Stonybrook and Beard do not take a specific position on rate of return.

The Commission recently adopted Resolution W-4524, updating the method of calculating rate of return and, where applicable, rate of margin for Class C and D utilities. The resolution revised Standard Practice SP-U-3-SM, which includes guidance on how to calculate returns for these small water utilities. For 2005, the revised Standard Practice indicates an average rate of return of 12.90% for Class D utilities, such as Keene. If a Class D utility has little rate base (which would be the case here if Keene's 1997 improvements were not included in rate base), the utility would be entitled a rate of margin of 24.63%, on the average. (Res. W-4524 at Att. A, pp. 1, 5 (Mar. 17, 2005).)

Given an average rate of return of 12.90% for Class D water utilities, Keene's proposed 2.39% rate of return is fair and reasonable. The company has indicated that it seeks such a low rate because it recognizes that water users will pay much more for their water as a result of this proceeding.

VI. Rate Design

Keene currently charges a flat rate of \$4 per thousand gallons of water used. The Commission's Standard Practice U-7-W allows recovery of 50% of the utility's fixed costs in the service charge for Class A and B water companies, 65% for Class C, and 100% for Class D. However, Keene seeks only to recover 50% of its revenue requirement through a service charge and the balance through commodity charges. The Water Division does not object to this 50% proposal, but the Division also indicates that it does not oppose Stonybrook's and Beard's proposal to recover 100% of the utility's revenue requirement through commodity charges.

Stonybrook and Beard argue that their 100% commodity charge proposal will encourage conservation, avoid penalizing residents who are absent for long periods, avoid charging water users for water they do not actually receive (such as the result of outages), and allow water users to mitigate rate increases by reducing their use.

Water conservation is normally a beneficial goal, but in the case of this small water utility, commodity pricing may result in so much conservation that insufficient revenues are generated to meet the utility's revenue requirement. (*See, e.g., CPUC Water Action Plan at 7 (Nov. 9, 2005).*) Also, some costs exist even when a customer is not using water and must be paid so that the customer does have water service when he or she returns. The result of this scenario may be inattention to maintenance or deterioration of services or increased commodity charges. Rates recouping one-half of the revenue requirement through a service charge provide financial stability to this small water utility and allow water users to more accurately estimate their bills.

The Commission rejects the proposals for 100% commodity charges and adopts Keene's rate design proposal: 50% service charge with the balance recovered in a commodity charge. Beard's concerns that a 50% service charge penalizes water users who leave for periods when water is unavailable should be addressed, as they are in this decision, by steps to improve water supply reliability – not by depriving the small system of needed revenues. The Commission determines that this rate design is in the public interest.

VII. Discontinuance of the Tehachapi-Keene Pipeline

Both Stonybrook and Beard strenuously argue that the discontinuance of the Tehachapi-Keene pipeline (approximately 12 miles in length) in 1994, while it may have financially benefited the railroad, was imprudent as to the customers of the water system. They also maintain that the opportunity to enlarge the tunnel, through which the pipe ran, to accommodate "double-stack" container freight cars was the real reason for this discontinuation – not the poor condition of the pipe itself. They argue that their replacement sources of water have proved to be inadequate.

A. Commission Jurisdiction

A preliminary issue is whether the Commission has jurisdiction to examine the reasonableness and prudence of discontinuing the pipeline and forcing the community to rely on new sources that have proven to be inadequate. At first look, the pipeline was discontinued in 1994 and the Commission's decision finding Keene to be dedicated to public use (D.02-04-017) was issued on April 8, 2002 – suggesting that the Commission might not have jurisdiction to reach back eight years. Upon closer examination, D.02-04-017 does not decide the specific date upon which the company was dedicated to public use. The

decision lists three facts supportive of the Commission's finding of an implied dedication to public use: predominately community use of the water since the 1960s, the drilling of a replacement well in 1994 for the primary benefit of the community, and the company's application in 1996 for a franchise to construct a pipeline on a county roadway to furnish water. (D.02-04-017, at 10.)

The Commission's decision denying rehearing also does not specifically determine the date upon which Keene was dedicated to public use, but the rehearing decision does consider the 1994 project to have been a critical demonstration that, at least as early as 1994, Keene was a public utility. (D.02-08-075, at 7-8 (the owners' activities concerning the 1994 project "support the Decision's finding that by its conduct, Union Pacific dedicated the Keene Water System to public use").) Further, the decision specifically indicates that "whether Union Pacific's capital expenditures for this project were necessary or reasonable[,] that issue will be addressed in the rate case." (*Id.*) In D.02-08-075, the Commission assumed that the railroad's prudence in undertaking the 1994 project would not escape scrutiny but would be examined here. Keene is properly considered to have been a public utility water system, at least as early as 1994, under Public Utilities Code Section 2701. The Commission has jurisdiction to determine the prudence of the 1994 project and does so as part of this proceeding.

B. Reasonableness & Prudence of 1994 Project

The 1994 project actually consists of two activities, both of which are subject to prudence review. The first is Keene's decision to discontinue the pipeline from Tehachapi. The second is Keene's decision on replacement sources of water.

The Water Division and other objectors believe Keene was imprudent in discontinuing the pipeline. They rely on evidence that pipeline water was of good quality and supply, especially when compared to existing sources. However, two considerations support the conclusion that discontinuance was reasonable and prudent. First, the pipeline was a century old and in great need of repair. (RT 132:2-11 (Lyon).) The Water Division argues that the pipeline would have been in better condition if it had been properly maintained over the years. The pipeline, however, was built to supply water for steam locomotives and, especially in the early years, likely was not maintained in the same manner as a pipeline conveying potable water. Second, the Interstate Commerce Commission-ordered tunnel enlargement largely destroyed the existing system. (RT 132:17-28 (Lyon).) Because pipeline repairs in a busy railway tunnel had always been problematic, Keene was justified to consider alternative methods of supplying water. If the system had continued to obtain its water from Tehachapi, however, the conveyance would have followed an entirely different route. Even Stonybrook's 1999 report calculates the replacement cost at a minimum of \$4 million. (RT 312:17-18 (Huerta).) The Water Division's estimate of \$523,000 is based on a 6.2 mile pipeline to a location no longer available for water supply. (Exhibit No. 309.) Keene reasonably pursued other options to replacing the Tehachapi pipeline.

The railroad's actual selection of an alternative water supply for the community does not demonstrate the same reasonableness or prudence, especially when the basic drinking and household water needs of Keene residents were at stake. The company indicates that it hired a local well driller to advise it as to potential well locations, leading to the drilling of three wells. Keene provided no information as to the qualifications of this individual.

(RT 141 (Lyon).) Given the impending shift in the community's sole water source, Keene would have been prudent to have retained an experienced hydro-geologic consulting firm before deciding to rely on local wells. There is no evidence that company engaged this level of expertise.

The result has been unreliable water supplies of inferior quality. Keene suggests that, due to the deteriorating pipeline, it had little time to make the transition. Also, Keene argues that it did not have eminent domain powers to acquire more promising well sites. The pipe was in poor condition, but there is no evidence that it was in danger of imminent collapse. If Keene lacked the necessary powers to effectively provide water to the community, it should have recognized, as the Commission later did for it, that it was a public utility. Upon securing a certificate of public convenience and necessity, Keene could have exercised eminent domain powers to obtain the land or water needed.

Pursuant to Public Utilities Code Sections 761 and 2701, the Commission determines as follows: In 1994 and thereafter, during which Keene held itself out as a public utility, the company failed to exercise reasonable and prudent care in efforts to secure substitute water supplies of sufficient quantity and quality.

Finding unreasonableness and imprudence, the Commission has the authority to order curative measures. (Pub. Util. Code § 761.) Since the consequences of this unreasonable and imprudent decision manifest themselves in poor water quantity and quality, as documented in a subsequent discussion (*see* Part IX), the Commission relies on GO 103's requirements to fashion the appropriate remedial measures for this unreasonable and imprudent decision. In its briefing, the Water Division urges that the Commission order Keene to fund a new solution, such as a new well, after diligent research. We order, at Keene's

expense, a more comprehensive hydrologic and engineering assessment of possible measures to improve water supply reliability and quality. Because the nature and cost of the remedial measures cannot be known until this assessment is complete, we reserve the ratesetting implications concerning these measures until another proceeding.

VIII. Metering and Billing

This section discusses three separate but related questions: (1) who are customers of the system; (2) should the applicant be required to acquire and maintain distribution facilities (including individual meters) “downstream” of existing master meters; and (3) how should water service be actually metered and billed to individual users?

A. Existing Customers

A persistent problem has been identifying the actual water users in the Keene system. This problem is largely result of water being delivered and billed to master meters serving the Upper Keene and Lower Keene areas, with incomplete information about who actually uses the water downstream of the master meters. This problem was one of the reasons the Commission refused to grant interim rate relief earlier in this proceeding.

During summer 2005, Stonybrook and Beard conducted a survey of their community to determine the water users on the Keene system. This information was supplied to Union Pacific and, by stipulation, this list of customers was submitted by Union Pacific as late-filed Exhibit No. 6 (Aug. 5, 2005). This list should supersede the list of customers originally set forth in Conclusion of Law 6 of D.02-04-017.

In its briefing, the Water Division points out that D.02-04-017, in determining Keene to be a public utility, required the company to continue

providing water to all existing customers as of the commencement of the OII (May 18, 2000) that resulted in the decision. However, as the Water Division observes, “As a practical matter it is not known who was a customer as of the date of the initiation of the OII, nor is it known today.” (Water Division Opening Brief at 33 (Sept. 2, 2005).) The Water Division suggests that the Commission’s desire to provide continuing service to prior customers can best be achieved by using Exhibit No. 6 as the date by which “all existing customers” will be defined. We agree with this suggestion since Exhibit No. 6 is the product of a recent, collaborative, and systematic effort to identify water users based on the best information available to the parties. Our prior decision should be superseded to now specify that Keene has the obligation to service existing customers as identified in Exhibit No. 6 (Sept. 9, 2005).

B. Facilities Downstream of Master Meters

Keene delivers water to master meters serving residents living in the Upper Keene and Lower Keene areas. The company does not own and has not been responsible for the maintenance of facilities “downstream” of these master meters. It is unclear how many of the households have individual meters or how accurate these meters might be. Keene has billed for water delivered to each of the master meters – not to the individual residents in the Upper Keene and Lower Keene areas. In the past, a resident in each of these communities has volunteered to collect money from neighbors to pay the Keene water bill; but, over time, this practice has become irregular and has resulted in underpayments or no payment at all.

The pertinent questions are whether Keene should assume the ownership and maintenance of water distribution facilities downstream of the master meters, enter into service relationships with individual customers,

assume responsibility for reading individual meters, and submit individual bills. Because these steps will add to the water users' costs, the parties explored the possibility of residents continuing to maintain and manage these downstream facilities themselves. This possibility is no longer viable. At the commencement of this proceeding, the Water Division proposed that Keene "immediately install meters for each end user in the system and be responsible for the operation and maintenance of the delivery system all the way to the end user, including the meter." (Water Division Opening Brief at 32.) More recently, Beard indicates, "The [Keene] historic practice of billing only one individual for each of these areas via 'master meters' no longer works. No one in Upper Keene or Lower Keene is willing to assume this responsibility because of the lack of authority to disconnect any water user who does not pay for his or her water." (Beard Opening Brief at 6 (Sept. 2, 2005).)

The parties sought to negotiate the details of Keene's assumption of the downstream distribution facilities. Keene and Stonybrook reached an agreement (set forth as Appendix A, Keene Reply Brief (Sept. 21, 2005)) although the other parties have not indicated whether they also agree. The terms and conditions of the Keene-Stonybrook proposal provide a practical and reasonable basis for Keene assuming responsibility for these facilities and they are adopted in this decision with slight modification as to timing:

1. Each customer in Upper Keene will have its own water meter no later than 180 days following the end of the stay period imposed in Ordering Paragraph 16. If the customer does not install a meter by that date, the company is authorized to do so. All meters will be in place no later than 270 days following the end of the stay period imposed in Ordering Paragraph 16. Keene will bill the individual

customers for the meters it installs.¹ Each customer will have six months to pay for the customer's meter.

2. Also, no later than 270 days following the end of the stay period imposed in Ordering Paragraph 16, Keene will improve the downstream distribution system. Customers must grant the company the necessary easements.
3. Keene is authorized to file a ratebase offset that reflects the cost of these capital expenditures (except for the water meters paid for by the customers). The company is authorized a 2.39% rate of return on these expenditures (which is acceptable to the Water Division).
4. All these transitional steps are subject to GO 103 and any applicable standards of practice promulgated by the Water Division.

The details of these transitional steps are set forth in the ordering paragraphs.

Another question is how to bill water users in Upper Keene and Lower Keene during this transition. The goal is to bill based on metered service as soon as reasonably possible. Once an accurate, functioning water meter is installed for a customer, Keene is authorized to bill the customer the applicable rates approved in this decision.

One difficulty is in determining water bills for customers until their water meters are installed. Without meters, no method is precise, but a reasonable effort must be made to ensure that unmetered customers pay their fair share. During this interim period, Keene should estimate the quantity of water delivered, for each billing cycle, to unmetered customers downstream of a

¹ During settlement discussions, the Tehachapi-Cummins Water District offered to assist in the acquisition of water meters. Keene and water system customers are encouraged to ascertain whether this assistance is still available.

master meter (calculated as the quantity delivered at the master meter, less the quantity delivered to metered customers downstream of master meter, less a fair proportion of conveyance losses). We authorize Keene to allocate equally the commodity cost of this unmetered water (plus a service charge) to the owners of those separately owned properties receiving water, without meters, during that billing cycle. Before commencing to bill for unmetered water for the first time, Keene shall file an advice letter describing its proposed methodology.

IX. General Order 103

GO 103 sets forth the Commission's rules governing water service and the minimum standards for design and construction. The Scoping Memo identified compliance with GO 103 and applicable state and federal water quality standards as issues to be resolved in this proceeding. We address two issues that implicate GO 103 requirements: water quantity (including service interruptions and pipeline pressure) and water quality (including reporting obligations).

A. Water Quantity

GO 103 provides minimum standards for the quantity of water available from a utility. Section III(4) specifies that the quantity of water to be delivered to customers from all sources "be sufficient to supply adequately, dependably and safely the total requirements of all customers under maximum consumption" Additionally, the "[c]ombined flow from sources of supply and storage capacity should be adequate for four consecutive days of maximum use."

GO 103 also requires an utility to "make all reasonable efforts to prevent interruptions to service and when such interruptions occur [to] endeavor to reestablish service within the shortest possible delay consistent with safety to customers and the general public." GO 103 at § II(a)(2).

The evidentiary record discloses numerous interruptions of service, some extending for several days or weeks. The interruptions appear to result from unreliable summer well supply coupled with increased summer demand. The interruptions are so common that the railroad has contracted for stand-by service to haul water by truck from Tehachapi. Keene concedes these problems. (Keene Opening Brief at 26-27.) The evidence indicates, however, that several days may pass before a water shortage is detected by the company and substitute water arrives. Also, it is unclear whether the company has a water hauling service on stand-by or must arrange for hauling each time a shortage occurs.

Shortly before the evidentiary hearing, Keene informed its customers that the system was “experiencing a severe water shortage. . . . because ordinary demands and requirements of water consumers cannot be satisfied without depleting the water supply to the extent that there would be insufficient water for human consumption, sanitation, and fire protection.” (Exhibit No. 330: Water Shortage Emergency Notice.) This notice is the company’s additional admission that, without hauling water, the system is incapable of reliably supplying even minimal customer needs, much less customers’ total requirements under more severe water supply periods.

In addition to this most recent event, other service interruptions support the conclusion that water supply is often inadequate. The company often is tardy in recognizing and responding to these incidents. Some residents are often without water for days during dry summer periods.

GO 103 requires adequate water pressure throughout the system. (GO 103 §§ II(3)(a) & III(4).) The testimony and DHS documents indicate that this service obligation is also frequently violated. Keene concedes that the system may have insufficient pressure to adequately serve Upper Keene

residents. (Keene Opening Brief at 26.) The company has pledged to explore economic ways to increase water quantity and/or water pressure to alleviate water supply interruptions. (*Id.* at 27.)

B. Water Quality

GO 103 also requires that water be “wholesome, potable, in no way harmful or dangerous to health and, insofar as practical, free from objectionable odors, taste, color, and turbidity.” GO 103 also requires that the utility comply with the drinking water standards of the U.S. Environmental Protection Agency and the laws and regulations of the state or local Department of Health Services. (GO 103 § II(1)(a).)

Violation of GO 103’s “wholesome and potable” water quality standards was readily observed by examination of a recent water sample collected by Beard and accepted into evidence as Exhibit No. 329. The sample was collected in a pint-sized jelly jar. If the jar is undisturbed, a ¼ inch thick brown layer settles to the bottom with clear water above. With one shake of the jar, however, the solids are suspended in the water to a consistency of deeply brewed tea. Water of this same orange-brown color appears in a series of five photos taken by Beard on May 15 and July 13, 2005, at 29461 Woodford-Tehachapi Road and accepted into evidence as Exhibit No. 315. In her protest, Exhibit No. 300, Beard summarizes the condition, “To this day, the quality of the water provided by [Keene] varies constantly. One day it may be orange and stain everything and the next day the chlorine may be so strong, the water will bleach clothing.” (Exhibit No. 300, at 7.)

GO 103 also requires that the utility comply with the drinking water standards of the U.S. Environmental Protection Agency and the laws and regulations of the state or local Department of Health Services. (GO 103 § II(1).)

In recent years, the company has failed to satisfy many DHS obligations concerning water quality and reporting, as summarized in a DHS letter dated December 8, 2004: (1) failure to submit monthly reports from November 2003 to November 2004); (2) continuous violation of the 2 mg/L Maximum Contaminant Level (MCL) for naturally occurring fluoride; (3) a history of non-complying with public notification of the fluoride condition; (4) failure during part of 2004 to submit require monthly fluoride samples to DHS; (5) failure to submit the 2003 Annual Report to the drinking Water Program; (6) failure to submit the 2003 Consumer Confidence Report; (7) failure to conduct the summer 2004 Disinfection Byproduct Rule monitoring report; (8) low system pressure upon occasion; and (9) failure to submit the required response to DHS's October 2003 field inspection. (Exhibit No. 312; *see also* Exhibit No. 317 (DHS memo of call with Union Pacific attorney discussing many of these deficiencies).)

Keene was formally cited by DHS in December 2003 for failure to comply with the total coliform MCL during November 2003 although this problem apparently was solved by repairing the system chlorinator and flushing the system. (Exhibit No. 313 (June 10, 2002, letter).) Keene also was served with a notice of violation in June 2002 indicating that the company had failed to properly monitor for nitrates. (*Id.*)

Especially troubling are material inaccuracies in recent Water System Monthly Reports of Water Production submitted to DHS. Under GO 103, Keene is obligated to satisfy DHS testing requirements which include providing accurate and complete Water System Monthly Reports of Water Production. Keene's Water Supply Permit also imposes this reporting obligation. As indicated by Exhibit No. 311, DHS determined that reports of "tank levels and peak out flow gmp [gallons per minute] are seldom changed from month to

month. For example, on the 18th day of February, March and April the Reading [sic] Inches, Tank Level Ft. and the Peak Out Flow GPM are the same for every month. Every Log Report from the beginning of 2005 is almost identical; the only thing that changes is the time of day of the peak flow.” (Exhibit No. 311.) DHS indicated that “it doesn’t seem possible that the report is the same every month.” (*Id.*) This is alarming evidence either of Keene’s inattention to its obligation to report accurately to DHS or of Keene’s intent to mislead regulators.

Keene admits that the water system occasionally exceeds the MCL for fluoride, a primary drinking water standard, as well as the MCLs for iron and manganese and color criteria, all secondary standards. (Keene Opening Brief at 27-29.)

Since April 2002, the date established by the assigned ALJ to ascertain compliance with GO 103, Keene has frequently been in noncompliance with important water quality and service requirements set forth in GO 103. This would be troublesome in normal circumstances since these standards constitute the minimum service criteria for public utilities to satisfy. Here, however, the violations are even more troubling since Keene shifted from the Tehachapi pipeline to local wells with insufficient regard about the water supply and quality consequences to residents and, with this shift, should have taken even more safeguards to ensure that service did not deteriorate. In 2002 to 2004, however, the company decreased rather than increased its scrutiny of system operations. In this proceeding, Union Pacific management has been engaged in discussing the many problems facing the system with the community; and that attention is encouraging. Such an effort is not sufficiently encouraging, however, to avoid explicit Commission direction to improve water supply and quality. Our direction is set forth in the ordering paragraphs.

X. Other Issues

Keene had originally requested authority to amortize water hauling expenses booked to a memorandum account established pursuant to the Commission's Resolution No. W-4502 (Oct. 7, 2004). As of now, there is no balance in the account to amortize. No Commission action is required at this time.

XI. Comments on Proposed Decision

On June 6, 2006, the principal hearing officer's proposed decision was filed with the Commission and served on the parties in accordance with Section 311(d) of the Public Utilities Code and Rule 77.1 of the Rules of Practice and Procedure. Opening and reply comments were submitted by Union Pacific, the Water Division, and Beard on the proposed decision.

Union Pacific Comments

Union Pacific comments that the proposed decision used an incorrect number of customers to calculate the rate design for test year 2004. Union Pacific is correct. The proposed decision used an older figure of 47 customers, rather than the results of a community survey conducted during 2005 that identified 37 customers. The rate design has been modified based on this smaller customer base. Other issues concerning the customer base are discussed in response to Beard's comments, below.

Union Pacific questions the basis upon which the proposed decision concluded that the company, in its operation of Keene, operated as a public utility "[a]s of 1994, if not before . . ." (Conclusion of Law 1.) The company complains that this determination is not supported by any facts or by the record. The comment misses the underlying point made by the proposed decision. In D.02-08-075, the Commission previously determined, as a matter of fact and law,

that Union Pacific was holding itself out as a public utility at least as early as 1994. The decision based its conclusion on numerous factors that all occurred in 1994 or earlier: since the 1960s, water was sold primarily for the community and not the railroad; Keene had been declared a public water system in 1972; the company acquiesced and continued to provide service in the face of litigation pending in 1989; and, in 1994, the Tehachapi pipeline “was removed and replaced with a primary benefit of the community, and not the railroad.” (D.02-08-05, at 5-7.) Even before discussing the 1996 franchise agreement, the Commission in D.02-08-075 concludes, “Here, the focus is on the owner’s activities, which support the Decision’s finding that by its conduct, Union Pacific dedicated the Keene Water System to public use.” (*Id.* at 7-8.) Almost as an afterthought, the Commission discusses the 1996 agreement as “additional evidence that Union Pacific assumed the role of a public utility.” (*Id.* at 8.) We have no need now to revisit the determination of public utility status that we made in D.02-08-075.

The company also challenges the conclusion that it failed to exercise reasonable and prudent care when it sought to secure an alternative water supply after removing the pipeline from Tehachapi. The company argues that it retained an experienced well driller, the initial wells produced almost twice the current annual consumption, and the company was limited in the locations where it could drill. The company adds that, at the time, it was unclear even to the Commission itself whether the company was a public utility with eminent domain powers.

During the evidentiary hearing, Union Pacific produced very little information about the qualifications of the well driller or the research that went into the determining where to drill in a complex, geologically fractured

landscape. We have already discussed Union Pacific's separate comment questioning the basis for concluding that it had made an implied dedication of its system to public use in 1994, if not before. Suffice it to say, it is improbable that a sophisticated railroad, regularly engaged in real estate transactions in numerous states, would need to conclude that its well drilling locations were limited to its own right-of-way.

Union Pacific argues that the decision overstates the severity of the water quality and supply problem, yet the company agrees with the proposed order: to prepare at its expense a comprehensive hydrologic and engineering assessment of possible measures to improve water supply reliability and quality. Part IX of this decision enumerates the Keene's numerous deficiencies in meeting the water quantity and quality requirements of GO 103. These problems need not be repeated here. The preponderance of the evidence, as evaluated by the assigned ALJ, contradicts Union Pacific's minimization of the problems. The Commission is encouraged, however, by the company's expressed willingness to understand the studies necessary to address these problems.

Union Pacific comments that its rate of return on Commission-ordered improvements to the distribution system downstream of the master meters (see Ordering Paragraphs 5-9) should be that of other Class D companies, rather than the 2.39% set forth in the proposed decision. Earlier in the proceeding, the company proposed the rate of 2.39% because it recognized that customers would be paying much more for their water. That result is certainly has come true, as indicated in the rate design set forth in Appendix C. Until the operation of this water system is improved in the manner contemplated in this decision, there is no reason to vary the rate of return on these improvements.

Finally, Union Pacific requests clarification of whether the 180-day stay in effectiveness of the ordering paragraphs also applies to the required hydrologic and engineering assessment, which is due within 180 days of the decision (Ordering Paragraph 11). We intend that the assessment begin immediately because the results of that assessment are likely to inform the parties in their negotiations during the stay period. While the assessment is underway, we expect Union Pacific to regularly share the information produced by the assessment with the other parties.

Union Pacific's suggested specific modifications to the findings of fact, conclusions of law, and ordering paragraphs are adopted or rejected as indicated in those respective sections of this decision.

Water Division Comments

The Water Division argues that the selection of an alternative water supply to the 1994 pipelines removal was imprudent (see Beard comments, below), supports the conclusions about metering and billings, supports the steps outlined to water safety and reliability, and pledges to play a constructive role in attempting to achieve a mutually beneficial resolution during the stay period.

The Water Division argues, however, that the inclusion of the 1997 pipeline replacement and relocation project violates the prohibition against retroactive ratemaking. The facts and law do not support such a conclusion. Any recovery of rates based on this net asset is prospective from the 2004 test year. This decision does not authorize the recovery of any rate payments, between 1997 and 2004, based on the pipeline project.

D.05-06-011 and D.03-05-076, cited by the Water Division, are also not supportive of its argument. The discussion of retroactivity in D.05-06-011 is dicta since the dispute concerned the pass-through of reimbursements for customer-

initiated tree-removal and not general rates. The decision also concluded that retroactive ratemaking did not incur since the utility would actually incur the tree-removal reimbursement costs after Commission authorization of a Catastrophic Event Memorandum Account. Similarly, D.03-05-076 discusses retroactive ratemaking only in the context of establishing a memorandum account allowing the utility “to record debits or credits only prospectively from the date the account is authorized. In that way, if recorded costs are subsequently approved for recovery in rates, there will be no confusion or entanglement of issues regarding retroactive ratemaking.”² This decision is faithful to that principle in that rate recovery is authorized prospectively from the 2004 test year based on the depreciated value of the asset.

The Water Division also argues that the 1997 project was imprudent because pipeline replacement would not have been necessary if proper maintenance had occurred over the century it had been in operation. Part V(B) of this decision addresses the Water Division’s conjecture, which appears to be an argument that capital assets can have perpetual utility.

Beard Comments

Beard, a water user, argues that the evidence of water quality violations for the last 12 years should have been admitted into evidence. The assigned ALJ properly limited the evidence of water quality violations to those occurring after April 2002, when the Commission adopted D.02-04-017 culminating an order instituting an investigation (OII) proceeding into whether Keene was a public utility. During hearings in February 2001 in the OII, the Commission considered

² D.03-05-076, *9, n 5, *citing In re Southern California Edison Co.*, D.99-11-057 (Nov. 18, 1999), 1999 Cal. PUC LEXIS 769.

evidence of water quality violations. To probe extensively into pre-2002 water quality violations in this proceeding would be repetitively of the earlier proceeding.

Beard also argues that the 1994 discontinuance of the pipeline from Tehachapi was imprudent and that the cost of replacing only portions of the existing pipe in the railroad tunnel would have been less. Predominate among the factors supporting the railroad's discontinuance of the existing pipeline are the Interstate Commerce Commission's requirement that the tunnel be widened for larger freight shipments and the problems associated with servicing and maintaining a pipeline in an active railroad corridor located in a tunnel.

Beard comments that the decision erroneously concludes that no aquifer exists in the area and points to evidence of an aquifer. Groundwater certainly is present in the area as water is withdrawn from local wells. Union Pacific is being ordered to undertake a hydrologic and engineering assessment to determine, among other things, whether groundwater pumping may be relied upon for water supply reliability and quality and, if so, at what location.

Beard also questions what customer list is being used to determine existing customers. This decision, including the rate design, is based on late-filed Exhibit No. 6 (as submitted by Union Pacific on August 5, 2005) – not on any document provided later by the Water Division. The decision has been modified to correct the date of the exhibit.

XII. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and John E. Thorson is the assigned ALJ and principal hearing officer in this proceeding.

Findings of Fact

General

1. On April 8, 2002, the Commission issued D.02-04-017, finding that Keene Water System is a public water utility. Rates were not established in that decision.

2. On November 4, 2004, Union Pacific Railroad filed its rate application on behalf of the Keene Water System.

3. The application has been protested by the Stonybrook Corporation, Bridget Beard (an individual water user), and the Commission's own Water Division.

4. Keene Water System serves approximately 37 users, some of whom have multiple connections.

Ratesetting: Gross Revenues

5. For test year 2004, an estimated 7 million gallons of water each year will be sold yielding, based on the rate design adopted herein, gross operating revenues of \$120,121.

Ratesetting: Expenses

6. Adjusting for the determinations made in this decision, Keene's allowable expenses total \$108,109.

7. For test year 2004, the parties agree on these expenses: \$1,500 for water testing, \$3,900 for chlorination, and \$6,100 for electricity and telephone. These expense projections are reasonable. Keene does not seek recovery for property or income taxes in this proceeding. The separation of these expenses from overall Union Pacific Railroad finances is not cost-effective.

8. For test year 2004 expense categories where the parties do not agree, the following expense projects are supported by the evidence and are reasonable:

- a. \$50,526 for labor costs (1,600 hours including the cost of meter-reading ordered in this decision). Fringe benefits should be calculated at 53%.
- b. \$9,000 for the employee's vehicle cost.
- c. \$4,410 for the technical advisor (Department of Health Safety requirements)
- d. \$1,443 for license and permit expenses. For expenses beyond this amount, Keene should use the memorandum account to track these expenses and to seek recovery through advice letters. This decision authorizes the memorandum account requested by Keene in Advice Letter No. 2.
- e. \$13,000 for materials and supplies.
- f. \$20,000 for legal fees incurred in this proceeding with this amount being amortized, without interest, at \$3,000 per year until fully recovered. Any ratesetting-related legal fees in excess of \$20,000 should be booked to a memorandum account, which is authorized by this decision, pending subsequent Commission review.

Ratesetting: Ratebase

9. The parties disagree about whether the 1997 distribution pipeline replacement project should be included in ratebase. The original cost of the 1997 distribution pipeline project was \$602,226. Keene estimates the useful life of this improvement to be 40 years. In determining net plant of \$502,611, Keene has subtracted \$106,000 in depreciation from 1997 to date.

10. The 1997 distribution pipeline replacement project was a reasonable and prudent decision. The benefits to the railroad are outweighed by the benefits to the water users of an updated water distribution system, and the protestants have offered no evidence quantifying how any benefits to the railroad could be quantified.

11. For test year 2004, the water system's ratebase should be \$502,611.

12. Keene's proposed rate of return of 2.39% is well below the average rate of return of 12.90% normally authorized for Class D water utilities.

Ratesetting: Rate Design

13. Keene's revenue requirement for test year 2004 is \$120,121 based on the calculations herein.

14. While the Commission's Standard Practice U-7-W allows a Class D utility to recover of 100% of the utility's fixed costs through the service charge, Keene has asked only to recover 50% of its fixed costs through the service charge and the balance through commodity charges.

15. In the case of this small water utility, using commodity pricing exclusively may result in so much conservation that insufficient revenues are generated to meet the utility's revenue requirement with detrimental effects on the utility's operations (at a time when improvements are already necessary in those areas).

16. In furtherance of the public interest, and to benefit consumers, the Commission rejects the proposals for 100% commodity charges and adopts the rate design proposal made by Keene of 50% service charge and the balance through a commodity charge.

Tehachapi-Keene Pipeline

17. In 1994, if not before, Keene had impliedly dedicated the water system for public use.

18. In D.02-07-075, the Commission indicated that Keene's prudence in replacing the Tehachapi-Keene Pipeline would be examined in a subsequent ratemaking proceeding, such as this pending proceeding.

19. Keene discontinued use of the pipeline in 1994 because the conveyance was 100 years old and the Interstate Commerce Commission had ordered the enlargement of the tunnel through which the pipeline ran.

20. The cost of replacing this pipeline would have been \$4 million or more. If this cost were added to the Keene ratebase, the financial impact through rates would be detrimental to ratepayers.

21. Keene has failed to prove that it engaged competent technical assistance in analyzing water supply options upon the discontinuance of the pipeline, that it systematically studied alternative well locations, or that it explored other water supply options.

22. The three wells that Keene drilled have provided unreliable water supplies of inferior quality.

23. Having taken actions as early as 1994 to hold the water system out for public use, Keene failed to apply for a certificate of public convenience and necessary so that it would have had the formal powers of eminent domain to acquire land or water necessary for reliable supplies of clean water.

Metering and Billing

24. During summer 2005, Stonybrook and Beard conducted a survey to verify who is a customer of the system. The results of this survey are set forth in Exhibit No. 6 (Aug. 5, 2005). This list of customers is the most accurate information available and should be deemed the list of "existing customers" referred to in D.02-04-017 for whom the company has a continuing service obligation. This list should also be used for rate allocation purposes.

25. All parties support Keene assuming ownership and maintenance of water distribution facilities downstream of the master meters, entering into service relationships with individual customers, and assuming responsibility for reading individual meters and submitting individual bills.

26. Keene's assumption of the ownership, maintenance, and management of water distribution facilities downstream of the master meters (including meter

reading and billing) is the most practical, efficient, and fair method to perform these necessary water system functions.

General Order (GO) 103

27. Water service is frequently interrupted, with some interruptions extending for several days or weeks. The interruptions appear to result from unreliable summer well supply coupled with increased summer demand. Interruptions may be also result from problems with customer-owned facilities that are downstream of Keene's master meters. The interruptions are so common that the railroad has contracted for stand-by service to haul water by truck from Tehachapi. Several days may pass before a water shortage is detected by the company and substitute water arrives.

28. Water pressure throughout the system is frequently inadequate.

29. Water delivered through the system is frequently discolored and contains orange-brown solids.

30. In recent years, the company has failed to satisfy many DHS obligations concerning water quality and reporting, as summarized in a DHS letter dated December 8, 2004: (1) failure to submit monthly reports from November 2003 to November 2004); (2) continuous violation of the 2 mg/L Maximum Contaminant Level (MCL) for naturally occurring fluoride; (3) a history of non complying with public notification of the fluoride condition; (4) failure during part of 2004 to submit require monthly fluoride samples to DHS; (5) failure to submit the 2003 Annual Report to the drinking Water Program; (6) failure to submit the 2003 Consumer Confidence Report; (7) failure to conduct the summer 2004 Disinfection Byproduct Rule monitoring report; (8) low system pressure upon occasion; and (9) failure to submit the required response to DHS's October 2003 field inspection.

31. Keene was formally cited by DHS in December 2003 for failure to comply with the total coliform MCL during November 2003.

32. Keene was served with a notice of violation in June 2002 indicating that the company had failed to properly monitor for nitrates.

33. From February to April 2005, Keene submitted required monthly reports to DHS that contained data that was unchanged from month-to-monthly, a highly improbable event in a dynamic hydraulic system. The erroneous submissions indicate either negligence or misrepresentation.

34. Keene admits that the water system occasionally exceeds the MCL for fluoride, a primary drinking water standard, as well as the MCLs for iron and manganese and color criteria, all secondary standards.

Other Issues

35. As of the date of the hearing, there is no balance in the water hauling memorandum account to amortize.

Conclusions of Law

General

1. As of 1994, if not before, the Keene Water System was operated as a public utility as defined by Public Utilities Code Section 2701.

2. Keene Water System is a Class D water company.

3. The Commission has jurisdiction to review the prudence of the 1994 pipeline project pursuant to Public Utilities Code Section 761.

Ratesetting

4. The revenue requirement of \$120,121, based on the calculations herein, is just and reasonable.

5. The 1997 distribution pipeline replacement project was a reasonable and prudent decision. The net plant cost of this project should be included in ratebase.

6. For test year 2004, the water system's ratebase of \$502,611 is just and reasonable.

7. Keene's proposed rate of return of 2.39% is just and reasonable.

Rate Design

8. Keene should be allowed to recover 50% of its fixed costs through the service charge and the balance through commodity charges, as calculated with reference to the Commission's Standard Practice U-7-W. The Commission determines that this is in the public interest.

Tehachapi-Keene Pipeline

9. The Commission has jurisdiction to determine the reasonableness and prudence of replacing the Tehachapi-Keene Pipeline in this proceeding.

10. Keene was reasonable and prudent in discontinuing the existing Tehachapi-Keene Pipeline.

11. Keene was unreasonable and imprudent in its selection of alternative water sources to replace water from the Tehachapi-Keene Pipeline.

12. Keene's unreasonableness and imprudence manifests itself, in part, in its violations of GO 103. In providing an appropriate remedy for Keene's unreasonableness and imprudence, Keene should be ordered to undertake remedial measures to comply with GO 103.

Metering and Billing

13. Exhibit No. 6 (Aug. 5, 2005) is an updated, accurate list of those existing customers who are entitled to continuing service by the Keene Water System, as contemplated by D.02-04-017. Exhibit No. 6 supersedes the list of customers

originally set forth in Conclusion of Law 6 of D.02-04-017. Exhibit No. 6 should be used for rate allocation purposes.

14. Keene should assume the ownership, maintenance, and management of water distribution facilities downstream of the master meters (including meter reading and billing).

General Order 103

15. Keene has violated numerous provisions of GO 103, § II.

16. The remedial measures set forth in the ordering paragraphs are necessary and reasonable for bringing Keene into compliance with GO 103.

O R D E R

IT IS ORDERED that:

1. The summary of earnings and rates for test year 2004 are authorized in conformance with this decision and as set forth in Appendices A through D. Keene Water System is authorized to file in accordance with General Order (GO) 96-A (or its successor), and to make effective on no less than five days' advance notice, a tariff containing the test year 2004 increase as provided in this decision. The revised rates shall apply to service rendered on or after the tariff's effective date.

2. Subject to pro forma tests after the 2004 increases are effective, Keene also is authorized to file in accordance with GO 96-A (or its successor), and to make effective on not less than five days' advance notice, a tariff setting forth rates for years 2005 and 2006, calculated in conformance with this decision. The revised rates shall apply to service rendered on or after the tariff's effective date.

3. Union Pacific shall continue to provide water to all existing customers who are identified in Exhibit No. 6 (Aug. 5, 2005), Application 04-11-004, so long as the water consumed is paid for.

4. Keene shall prepare and file, as an advice letter, a service agreement in accordance with GO 103 and the Water Division's standard practice. Once the service agreement has been approved, Keene shall require existing customers to sign the agreement; and if they do not, service may be terminated in accordance with GO 103.

5. Each customer in Upper Keene and Lower Keene will have its own operable meter no later than 180 days following the end of the stay period imposed in Ordering Paragraph 16. If a customer does not have a meter by that date, Keene shall install such meter and bill the customer the cost for such meter and installation. Each customer shall have six months to pay for the meter. If a customer refuses to allow Keene to install a water meter, Keene may terminate water service to such customer. All meters in Upper Keene and Lower Keene will be installed no later than 270 days following the end of the stay period imposed in Ordering Paragraph 16.

6. No later than 270 days following the end of the stay period imposed in Ordering Paragraph 16, Keene will improve the distribution system downstream of the current master meters used to serve Upper Keene and Lower Keene. The owners of properties served by Keene shall grant Keene in timely fashion the necessary easements in a recordable form for the installation and maintenance of such facilities. If a property owner refuses to grant such easements, Keene may terminate service to such property, as provided by the applicable provisions of GO 103.

7. Keene will not be responsible for the repair and maintenance of distribution facilities downstream of the master meters used to serve Upper and Lower Keene until such time as it has improved the facilities.

8. Keene is authorized to file a ratebase offset which reflects the full cost of these capital expenditures (other than the water meters, which are chargeable to individual customers) in its ratebase. Keene is authorized to earn a rate of return of 2.39% on these facilities and to collect immediately the revenue requirement associated with these facilities via a surcharge.

9. Where applicable, GO 103 and any applicable provisions of the Water Division's standards of practice also apply to these distribution system improvements.

10. Within two years of the end of the stay period imposed in Ordering Paragraph 16, Keene shall complete those remedial measures necessary to bring the water system into compliance with GO 103 and applicable state and federal water quality standards (including those deficiencies determined in this decision).

11. The company shall retain, at its own expense and not at ratepayer expense, one or more qualified outside consultants to prepare (with community and Water Division input) a hydrologic and engineering assessment of possible measures to improve water supply reliability and quality. Using these consultants' recommendations, Keene shall prepare a plan, within 180 days of the effective date of this decision, indicating how it proposes to improve water supply reliability and quality. The plan must identify the proposed remedial measures that will bring the water system into compliance with GO 103, and applicable state and federal water quality standards, within two years of this decision. The plan will estimate costs and identify any applications Keene

intends to file for certificates of public convenience and necessary or for ratemaking. Keene shall submit an informational copy of this plan to the Water Division and shall make one or more complete copies of the plan available to ratepayers and the Keene community.

12. After a 30-day opportunity for comments by the Water Division, ratepayers, and the Keene community, Keene shall modify the plan as necessary and immediately proceed to implement the plan. Keene shall report quarterly to the Water Division, ratepayers, and the Keene community on its progress. Keene shall also provide a final report to the Water Division, ratepayers, and the Keene community once the work is completed, indicating how the system, as improved, substantially complies with GO 103.

13. After an opportunity for comments by ratepayers, the Water Division will review Keene's final report. If the Water Division believes the water system still does not substantially comply with GO 103 (unless a good and sufficient reason for noncompliance is demonstrated), the Water Division may recommend the filing of an order instituting investigation or other appropriate proceeding.

14. Any work actually undertaken pursuant to the plan may be booked to a memorandum account. Keene may seek to recover these expenditures upon separate application or these expenditures will be subject to a reasonableness review during a subsequent rate proceeding. In reviewing the reasonableness of these expenditures, the Commission should at that time also consider and give deference to Findings of Fact 19-21 and Conclusions of Law 11-12 of this decision.

15. Memoranda accounts are also authorized for the booking of license and permit expenses and legal fees in excess of those approved in this decision. Advice Letter No. 2, which tracks permits and monitoring costs, is approved.

16. To allow the parties to negotiate a mutually beneficial resolution to the issues in this proceeding, the provisions set forth in all preceding ordering paragraphs (with the exception of Ordering Paragraphs 11 and 15) are stayed for 180 days after the effective date of this decision (“stay period”). During the stay period, however, Union Pacific shall continue to provide water to all existing

customers who are identified in Exhibit No. 6 (Aug. 5, 2005), Application 04-11-004. At the conclusion of this 180-day stay period, the provisions will come into full force and effect without any further action of the Commission.

17. Application 04-11-004 is closed.

This order is effective today.

Dated July 20, 2006, at San Francisco, California.

MICHAEL R. PEEVEY
President
GEOFFREY F. BROWN
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
Commissioners

ATTACHMENT A
List of Appearances

ATTACHMENT A
LIST OF APPEARANCES

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ATTACHMENT A
LIST OF APPEARANCES
(END OF ATTACHMENT A)

APPENDICES

APPENDIX A

UNION PACIFIC'S KEENE WATER SYSTEM

SUMMARY OF EARNINGS

Test Year 2004

	Utility Estimated		Division Estimated		Adopted Rates
	Present Rates	Proposed Rates	Present Rates	Proposed Rates	
<u>Operating Revenues</u>					
Metered Rate	\$28,000	\$128,450	\$28,000	\$128,450	\$120,121
<u>Operating Expenses:</u>					
Labor	50,526	50,526	48,545	48,545	50,526
Vehicle	12,000	12,000	6,580	6,580	9,000
Technical Advisor/ DHS related expenses	4,410	4,410	4,410	4,410	4,410
Test Water Samples	1,500	1,500	1,500	1,500	1,500
Chlorination	3,900	3,900	3,900	3,900	3,900
Hauling	0	0	0	0	0
Monitor System & Permits (DHS Fee)	6,784	6,784	1,443	1,443	1,443
Materials & Supply	13,000	13,000	13,000	13,000	13,000
Electricity & Telephone	6,100	6,100	6,100	6,100	6,100
Legal Fees	20,000	3,000	3,000	3,000	3,000
Subtotal	118,220	101,220	88,478	88,478	92,879
Depreciation Expense	15,230	15,230	0	0	15,230
Income Tax Expense	<u>0</u>	<u>0</u>	<u>800</u>	<u>9,000</u>	<u>0</u>
Total Expenses	133,450	116,450	89,278	97,478	108,109
Net Revenue	(105,450)	12,000	(61,278)	30,972	12,012
<u>Rate Base</u>					
Average Plant	609,226	609,226	0	0	609,226
Aver. Depr. Reserve	106,615	106,615	0	0	106,615
Net Plant	502,611	502,611	0	0	502,611
Less: Contributions	0	0	0	0	0
Advances	0	0	0	0	0
Rate Base	502,611	502,611	0	0	502,611
Rate of Return	Loss	2.39%	0	0	2.39%

(END OF APPENDIX A)

APPENDIX B

UNION PACIFIC'S KEENE WATER SYSTEM

Schedule No. 1

GENERAL METERED SERVICE

Test Year 2005

APPLICABILITY

Applicable to all metered water service.

TERRITORY

The Cities of Keene and Caliente and vicinity, Kern County.

RATES

Quantity Rate:

All water, per 1,000 gallons\$8.86 (I)

Per Meter
Per Month

Service Charge:

For 5/8x3/4-inch meter.....	\$93.13(I)
For 3/4-inch meter.....	139.70
For 1-inch meter.....	232.83
For 1-1/2-inch meter.....	465.65
For 2-inch meter.....	745.04 (I)

The Service Charge is a readiness-to-serve charge, which is applicable to all metered water service and to which is added to the charge for water used at the Quantity Rate.

SPECIAL CONDITIONS

1. All bills are subject to the reimbursement fee set forth in Schedule No. UF.

(END OF APPENDIX B)

APPENDIX C

UNION PACIFIC'S KEENE WATER SYSTEM

Schedule No. 1

GENERAL METERED SERVICE

Test Year 2005

COMPARISON OF RATES

A comparison of KWS' present rates and the adopted rates is shown below:

	<u>Present Rates</u>	<u>Recommended Rates</u>
<u>QUANTITY RATE</u>		
All water, per 1,000 gallons	\$ 4.00	\$ 8.86

SERVICE CHARGE

	<u>Per Meter Per Month</u>	
For 5/8x3/4-inch meter.....	0.00	93.13
For 3/4-inch meter.....	0.00	139.70
For 1-inch meter.....	0.00	232.83
For 1-1/2-inch meter.....	0.00	465.65
For 2-inch meter.....	0.00	745.04

A comparison of monthly bills for a 5/8 X 3/4-inch meter at various consumption rates is as follows:

Quantity Used <u>1,000 gallons</u>	<u>Current Rates</u>	<u>Adopted Rates</u>	<u>Amount Increase</u>	<u>Percent Increase</u>
3.0	\$12.00	\$119.71	\$107.71	897.58%
4.0	16.00	128.57	112.57	703.56
5.0	20.00	137.43	117.43	587.15
6.0	24.00	146.29	122.29	509.54

(END OF APPENDIX C)

APPENDIX D

UNION PACIFIC'S KEENE WATER SYSTEM

ADOPTED QUANTITIES

Test Year 2005

Service Connections

5/8x3/4-inch meter.....	33
3/4-inch meter.....	2
2-inch meter.....	<u>2</u>
Total	37

Meter Water Sales Used to Design Rates 7,000,000 gallons

(END OF APPENDIX D)