

WATER/RSK/JB5/AJT/ijj

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

DIVISION OF WATER AND AUDITS
Water and Sewer Advisory Branch

RESOLUTION NO. W-4824
April 8, 2010

R E S O L U T I O N

**(RES. W-4824), CALIFORNIA-AMERICAN WATER (CAL-AM).
ORDER AUTHORIZING A MEMORANDUM ACCOUNT TO
TRACK COSTS INCURRED TO ADDRESS THE STATE WATER
RESOURCES CONTROL BOARD (SWRCB) CEASE AND DESIST
ORDER (CDO) FOR UNAUTHORIZED DIVERSION OF WATER
FROM THE CARMEL RIVER IN THE MONTEREY DISTRICT.**

SUMMARY

By Advice Letter (AL) 805, filed on October 5, 2009, Cal-Am seeks authority to establish a Cease and Desist Order Memorandum Account to track the costs it incurs to address the SWRCB's CDO for unauthorized diversion of water from the Carmel River in the Monterey District and such other costs as arise with respect to this matter. Cal-Am requests the CDO Memorandum Account be made effective November 3, 2009.

Cal-Am asserts that if the SWRCB orders the utility to comply with new conditions in the CDO, the Monterey District will incur significant costs until the SWRCB deems it in compliance or some other resolution is achieved.

This resolution approves a memorandum account to track the costs Cal-Am incurs to address the SWRCB's CDO after the effective date of this resolution.

NOTICE AND PROTEST

In accordance with Section 4.3 of General Order (G.O.) 96-B, AL 805 was sent to Cal-Am's G.O. 96-B service list attached as Appendix A to AL 805. The Division of Ratepayer Advocates (DRA) was the only party filing a protest.

BACKGROUND

In its filing, Cal-Am summarized the background of this matter as follows:

The SWRCB Enforcement Division first proposed a Draft CDO on January 15, 2008. The Draft CDO primarily addressed proposed Cal-Am compliance with SWRCB Order 95-10 (Order 95-10). Order 95-10 impacts directly the Monterey District's right to use Carmel River water and currently restricts this critical source of supply for Cal-Am's Monterey service area.

The Enforcement Division of the SWRCB alleged that Cal-Am is in violation of condition No. 2 of Order 95-10 and is violating Water Code Section 1052. Cal-Am denied these allegations, and requested an evidentiary hearing before the SWRCB. The SWRCB issued a revised Draft CDO on September 16, 2009 adjusting the proposed enforcement and other conditions. The SWRCB issued its CDO (Order WR 2009-0060) on October 20, 2009 requiring Cal Am to terminate all unlawful diversions from the Carmel River no later than December 31, 2016. On November 3, 2009, the California Superior Court in Monterey County ordered the SWRCB to stay the operation of Order WR 2009-0060 pending the outcome in the mandamus proceeding before the Superior Court.

Cal-Am's Request

Cal-Am requests authorization to establish a Cease and Desist Order Memorandum Account to track costs it incurs to address the SWRCB's CDO. The requested costs that are expected to be captured in the Cease and Desist Order Memorandum Account include the following:

- Outside legal counsel;
- Experts needed to represent Cal-Am in administrative proceedings;
- Temporary legal measures regarding potential stays of the CDO;
- Court appeals related to any final CDO adopted by the SWRCB;
- Challenges, clarifications, and/or compliance with the CDO including any additional or more stringent conservation and reporting activities, the development and obtainment of water supply and water rights; and
- Any and all other immediate activities beyond those approved in the general rate case, D.09-07-021, related to the CDO.

Cal-Am is requesting to neither track nor seek recovery of fines in the memorandum account.

Cal-Am believes that the establishment of a memorandum account is justified on the basis that:

- 1) The costs are not under the utility's control;
- 2) The costs could not have been reasonably foreseen in the utility's last general rate case;
- 3) The costs will occur before the utility's next scheduled rate case;
- 4) The costs are of a substantial nature in that the amount of money involved is worth the effort of processing a memorandum account; and
- 5) The costs have ratepayer benefits.

Division of Ratepayer Advocates' Protest

The DRA filed a protest on October 23, 2009. Under the proposed memorandum account, Cal-Am would record and track for possible future rate recovery, legal and consulting costs as well as compliance costs. DRA did not oppose Cal-Am's requested effective date of November 3, 2009 for the memorandum account. However, DRA recommends that the memorandum account, if granted, allow only future *legal* costs relating to the CDO. DRA argues that Cal-Am should not be authorized to track CDO *compliance* costs in a memorandum account.

DRA argues that legal costs pertaining to the CDO may merit memorandum account treatment because they meet the test set forth by the Commission in Decision (D.) 02-08-054 and enumerated in AL 805¹ above. DRA recommends that the Commission should review the costs in the memorandum account in the next general rate case regardless of the balance in the account where the Commission can review the un-redacted legal invoices to determine which of the legal costs are reasonable for Cal-Am to recover from its ratepayers.

DRA asserts that non-legal costs pertaining to the CDO should not be tracked in a memorandum account. Based on AL 805, DRA believes the non-legal costs fall into two categories: 1) plant costs, and 2) conservation and rationing costs.

Plant costs include costs to develop new water supply and reduce unaccounted for water. DRA provides the example in Cal-Am's most recent general rate case decision, D.09-07-021, where the Commission authorized substantial funding for a program to reduce system losses in the Monterey District. DRA states that these types of costs

¹ Although the factors enumerated in AL 805, listed above, and those set out in D.02-08-054 are similar, they are worded somewhat differently.

should be evaluated in a general rate case proceeding to determine whether these projects are cost-effective and prudent.

DRA contends that conservation expenses also do not belong in the proposed Cease and Desist Order Memorandum Account as the conservation matters were formally addressed in another recent Commission proceeding, D.09-05-029. There the Commission authorized Cal-Am \$2.4 million and the Monterey Peninsula Water Management District \$1.2 million in conservation spending through 2010. DRA also contends that Cal-Am has not demonstrated that the CDO will require additional reporting beyond what is already required by the Commission. Finally, DRA opposes including rationing costs in the Cease and Desist Order Memorandum Account. DRA points out that the Commission authorized a rationing memorandum account in D.03-02-030 and expanded the rationing memorandum account to include pre-rationing costs in D.08-07-010.

Cal-Am's Response to DRA's Protest

On November 2, 2009, Cal-Am filed a response to DRA's protest. Cal-Am responds to the four categories of the expected expenses related to the CDO (legal, plant improvements, conservation, and rationing) characterized by DRA. Cal-Am indicates it did not specifically use those categories in AL 805, but requests that the Commission should not limit any memorandum account it approves pursuant to these categories.

In summary, Cal-Am does not agree with DRA's arguments that all non-legal matters should be reserved for the GRC and requests that the memorandum account be broadened to include all other expenses related to the CDO. In addition, Cal-Am takes issue with requiring un-redacted invoices for legal costs arguing that this is premature. Cal-Am indicates that when it provides legal invoices for review, Cal-Am may redact information that would reveal substantive legal matters and litigation strategy, which may be privileged under the attorney-client privilege and work product doctrine.

DISCUSSION

This resolution approves a Cease and Desist Memorandum Account to track future expenses for:

- Outside legal counsel;
- Experts needed to represent Cal-Am in administrative proceedings;
- Temporary legal measures regarding stays of the CDO;
- Court appeals related to any final CDO adopted by the SWRCB;
- Challenges, clarifications, and/or compliance with the CDO including any additional or more stringent conservation and reporting activities, the development and obtainment of water supply and water rights; and

- Any and all other immediate activities beyond those approved in the general rate case, D.09-07-021, related to the CDO.

A memorandum account allows a utility to track costs arising from events that were not reasonably foreseen in the utility's last general rate case. By tracking these costs in a memorandum account, a utility preserves the opportunity to seek recovery of these costs at a later date without raising retroactive rate-making issues.

In this instance, we find that a memorandum account should be authorized to track these costs associated with the CDO. In reaching this determination, we consider the factors outlined in D.02-08-054 and Res. W-4276. In Res. W-4276, the Commission described that memorandum accounts are appropriate when the following conditions exist:

- The expense is caused by an event of an exceptional nature that is not under the utility's control,
- The expense cannot have been reasonably foreseen in the utility's last GRC and will occur before the utility's next scheduled rate case,
- The expense is of a substantial nature in the amount of money involved, and
- The ratepayers will benefit by the memorandum account treatment.

When the Commission has applied these factors, it has not always applied all of them or required that they all be met before authorizing a memorandum account. Thus, at different times, the Commission has considered all these factors, considered only some of these factors, or relied on other public policy considerations in determining whether to authorize a memorandum account. Regardless of the specific factors considered, the question presented to the Commission in all instances is whether a utility should be permitted to seek recovery of these costs at a later date without encountering retroactive rate-making issues.

The CDO was issued by the SWCRB Enforcement Division and contains multiple requirements and mandates that Cal-Am would need to comply with by 2016. Thus, the costs associated with the CDO are the result of an event that is not under Cal-Am's control and is of an exceptional nature. These costs also could not have been reasonably foreseen when Cal-Am filed its last general rate case soon after the issuance of the draft CDO on January 15, 2008 and at least some of them will be incurred prior to the effective date of Cal-Am's next scheduled general rate case. Cal-Am indicates that the legal-related costs could exceed \$1 million based on its costs to defend the first draft CDO, and that the development of water projects would cost several more million dollars. Furthermore, we believe that ratepayers would benefit from memorandum

account treatment of both legal and non-legal expenses. With regard to the legal expenses related to the CDO, we find that incurring these expenses will benefit ratepayers by helping to ensure that ratepayers do not have to bear any unnecessary expenses in obtaining an adequate water supply to serve the public health and safety needs of residential and commercial customers in the Monterey District. The non-legal related expenses are associated with conservation and compliance requirements beyond what the Commission has previously authorized in prior decisions. While the Commission has recently authorized significant ratepayer funding of investments to develop new water supply for customers (e.g. funding to reduce system loss and unaccounted for water) and conservation efforts in decisions, D.09-07-021 and D.09-05-029, the authorized funding does not address the specific CDO requirements. The CDO contains eleven ordering paragraphs, several containing multiple requirements and mandates. The CDO goes beyond what previously adopted Commission decisions authorized with regards to plant additions and conservation expenditures. The compliance requirements direct Cal-Am to undertake measures to offset any reductions in water quality diverted from the Carmel River without threatening the public health and safety of its customers. Although we reach no conclusion as to whether these costs are “substantial in nature”, there is a potential for cost savings to ratepayers to the extent that some of these requirements are complementary to the measures ordered by the Commission and cost savings could be achieved by having them implemented at the same time. Thus, ratepayers could potentially benefit if Cal-Am is authorized to track the non-legal expenses at this time. Most importantly, the public policy considerations of ensuring that ratepayers in the Monterey District have an adequate water supply support authorizing Cal-Am to establish a CDO Memorandum Account to track those legal and non-legal expenses related to the CDO that are above and beyond those approved in other decisions including D.09-07-021.

Authorization of a memorandum account does not mean that the Commission has decided that the types of costs to be recorded in the account should be recoverable in addition to rates that have been otherwise authorized, e.g., in a general rate case. Instead, the utility shall bear the burden when it requests recovery of the recorded costs, to show that additional recovery of the types of costs recorded in the account is appropriate, that the utility acted prudently when it incurred these costs and that the level of costs is reasonable. Thus, Cal-Am is reminded that just because the Commission has authorized a memorandum account does not mean that recovery of costs in the memorandum account from ratepayers is appropriate. As such, Cal-Am will bear the burden of showing that the costs it has incurred are reasonable when seeking to amortize the balance in this account. Cal-Am should seek to amortize the balance in the Cease and Desist Order Memorandum Account at the time of its next general rate case. This will ensure that DRA will have an opportunity to vet Cal-Am’s recorded CDO memorandum account expenses.

In the Southern California Water Co. Headquarters case, D.92-03-094 (March 31, 1992) 43 Cal. P.U.C. 2d 596, 600, the Commission said:

“It is a well established tenet of the 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. This practice is consistent with the rule against retroactive ratemaking. (Emphasis in original.)”

Consistent with this practice we will authorize the CDO memorandum account to only track costs incurred after the date of this resolution.

COMMENTS

Public Utilities Code § 311(g)(1) provides that resolutions must generally be served on all parties and subject to at least 30 days public review and comment prior to a vote of the Commission. This resolution was mailed on December 22, 2009 to the parties on the service list attached to AL 805. Comments were received from Cal-Am on January 11, 2010. No other comments were received.

Cal-Am objected to the draft resolution’s exclusion of non-legal compliance costs in the CDO memorandum account. Cal-Am argued that there are compliance costs related to the CDO that have not been previously approved by the Commission. In response to Cal-Am’s comments, we have decided to include non-legal expenses as part of the CDO memorandum account. To the extent that changes were necessary to this resolution, they have been incorporated herein.

FINDINGS AND CONCLUSIONS

1. California-American Water seeks authority to establish a Cease and Desist Order Memorandum Account to track the costs it incurs to address the State Water Resources Control Board’s Cease and Desist Order for unauthorized diversion of water from the Carmel River in the Monterey District and such other costs as arise with respect to this matter.
2. The State Water Resources Control Board’s Enforcement Division first proposed a Draft Cease Desist Order on January 15, 2008.
3. The State Water Resources Control Board issued its Final CDO, Order WR 2009-0060, on October 20, 2009.

4. On November 3, 2009, the California Superior Court in Monterey County ordered the State Water Resources Control Board to stay the operation of Order WR 2009-0060 pending the outcome in the mandamus proceeding before the Superior Court.
5. The Division of Ratepayer Advocates (DRA) filed a protest to Advice Letter 805 on October 23, 2009.
6. Cal-Am requests authorization to track in a Cease and Desist Order Memorandum Account outside legal counsel, experts needed to represent Cal-Am in administrative proceedings, temporary legal measures regarding potential stays of the CDO, court appeals related to any final CDO adopted by the SWRCB, challenges, clarifications, and/or compliance with the CDO including any additional or more stringent conservation and reporting activities, the development and obtainment of water supply and water rights, and any and all other immediate activities beyond those approved in the general rate case, D.09-07-021, related to the CDO.
7. The CDO costs are the result of an event that is not under the utility's control and exceptional in nature.
8. The CDO costs could not have been reasonably foreseen in the utility's last general rate case and at least some of them will be incurred prior to Cal-Am's next scheduled general rate case.
9. The public policy considerations of ensuring that ratepayers in the Monterey District have an adequate water supply at a reasonable cost support authorizing Cal-Am to establish a CDO Memorandum Account to track those legal and non-legal expenses related to the CDO that are above and beyond those approved in D.09-07-021.
10. The compliance requirements direct Cal-Am to undertake measures to offset any reductions in water quantity diverted from the Carmel River without threatening the public health and safety of its customers. These requirements ensure that ratepayers in the Monterey District have an adequate water supply.
11. The Commission's practice, consistent with the rule against retroactive ratemaking, is to authorize memorandum accounts to track costs incurred only after the date of the Commission's authorization of the account.
12. The costs related to the Cease and Desist Order incurred after the date of this resolution should be tracked in the Cease and Desist Order Memorandum Account.

13. The Commission has recently authorized significant ratepayer funding of investments to develop new water supply (e.g. funding to reduce system loss and unaccounted for water) and conservation efforts in Decisions 09-07-021 and 09-05-029.
14. The authorized funding in Decisions 09-07-021 and 09-05-029 does not address specific CDO requirements.
15. The CDO contains eleven ordering paragraphs, several containing multiple requirements and mandates.
16. The CDO goes beyond what previously adopted Commission decisions authorized with regards to plant additions and conservation expenditures.
17. California-American Water Company may track those expenditures related to the CDO, above and beyond the expenses already approved in other decisions including Decision 09-07-021, in the CDO memorandum account.
18. The creation and use of a memorandum account preserves an opportunity for the utility to seek recovery of the booked costs at a later date, without raising retroactive rate-making issues.
19. Authorization of a memorandum account does not mean that the Commission has decided that the types of costs to be recorded in the account should be recoverable in addition to rates that have been otherwise authorized, e.g., in a general rate case.
20. California-American Water Company should seek authorization to amortize the balance in the Cease and Desist Order Memorandum Account in its next general rate case.
21. California-American Water Company shall bear the burden when it requests recovery of the recorded costs, to show that they are not costs covered by other authorized rates, it is appropriate for ratepayers to pay for these categories of costs in addition to otherwise authorized rates, the utility acted prudently when it incurred these costs and that the level of booked costs is reasonable.
22. This is a contested matter subject to public comment pursuant to Public Utilities Code Section 311(g) (1).
23. California-American Water Company should establish a Cease and Desist Order Memorandum Account to track legal and non-legal costs associated with the Cease and Desist Order.

THEREFORE IT IS ORDERED THAT:

1. Within thirty days of the effective date of this Order, California-American Water Company shall supplement Advice Letter 805 so that the Purpose Section of Preliminary Statement for the Cease and Desist Order Memorandum Account shall read substantially as follows:

The purpose of the Cease and Desist Order Memorandum Account ("CDOMA") is to track Outside legal counsel; Experts needed to represent Cal-Am in administrative proceedings; Temporary legal measures regarding stays of the CDO; Court appeals related to any final CDO adopted by the SWRCB; Challenges, clarifications, and/or compliance with the CDO including any additional or more stringent conservation and reporting activities, the development and obtainment of water supply and water rights; and Any and all other immediate activities beyond those approved in the general rate case, D.09-07-021, related to the CDO to address the State Water Resources Control Board ("SWRCB") Cease and Desist Order ("CDO") for unauthorized diversion of water from the Carmel River in the Monterey District .

2. As revised by Ordering Paragraph 1, California-American Water Company is authorized to establish a Cease and Desist Order Memorandum Account.
3. This Cease and Desist Order Memorandum Account is effective as of the date of this resolution and shall only include costs incurred from and after the date of this Resolution.
4. Recovery of amounts recorded in the Cease and Desist Order Memorandum Account shall be reviewed in California-American Water Company's next general rate case for its Monterey District.
5. California-American Water Company shall bear the burden when it requests recovery of the recorded costs, to show that they are not costs covered by other authorized rates, it is appropriate for ratepayers to pay for these categories of costs in addition to otherwise authorized rates, the utility acted prudently when it incurred these costs and the level of booked costs is reasonable.

6. This Resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed, and adopted at a conference of the Public Utilities Commission of the State of California held on April 8, 2010; the following Commissioners voting favorably thereon:

/s/ PAUL CLANON

Paul Clanon
Executive Director

MICHAEL R. PEEVEY
President

DIAN M. GRUENEICH

JOHN A. BOHN

TIMOTHY ALAN SIMON

NANCY E. RYAN

Commissioners