

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of
Southern California Water Company (U
133 W) for an Order pursuant to Public
Utilities Code Section 851 Approving a
Settlement Agreement that will Convey
Water Rights in the Culver City
Customer Service Area.

Application 02-07-021

**COMMENTS OF THE OFFICE OF RATEPAYER ADVOCATES
ON THE PROPOSED DECISION OF ALJ WALKER**

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TABLE OF CONTENTS

I. RATEMAKING FOR THE GAIN ON SALE – P.U. CODE § 790	1
A. THE PD ERRS IN CONCLUDING WITHOUT SUFFICIENT ANALYSIS THAT P.U. CODE § 790 APPLIES TO ALL THE SETTLEMENT PROCEEDS	1
B. THE PD ERRS IN TREATING THE CITY’S DAMAGES PAYMENT FOR THE CHARNOCK BASIN PLANT AS A “SALE” UNDER P.U. CODE § 790	3
C. THE PD ERRS IN FAILING TO RECOGNIZE ISSUES ASSOCIATED WITH THE IMPLEMENTATION OF P.U. CODE § 790	5
II. RATEMAKING FOR THE PAYMENTS FROM THE POLLUTERS	9
III. VALUE OF CHARNOCK WELLFIELD ASSETS TO BE REMOVED FROM RATEBASE	9

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The Office of Ratepayer Advocates (ORA) files these comments on ALJ Walker's Proposed Decision (PD) pursuant to Rule 77.2.

This Proposed Decision addresses several issues in Phase II of this proceeding, in particular the ratemaking issues associated with the Commission's approval of the settlement between the Southern California Water Company (SCWC) and the City of Santa Monica (City) in D.03-05-001.

I. RATEMAKING FOR THE GAIN ON SALE – P.U. CODE § 790

A. The PD Errs In Concluding Without Sufficient Analysis That P.U. Code § 790 Applies To All The Settlement Proceeds

The PD wrongly concludes that if some assets that once were in rate base are transferred to a new owner who pays the utility money, then the entire transaction is governed by P.U. Code § 790. The statute is more restrictive than that, and requires an analysis by the Commission of the transaction. This is particularly true in the present case where it is not clear that the water rights sold were no longer used and useful, and over \$2.5 million of the proceeds received by SCWC are not associated with a sale at all.

P.U. Code § 790 applies only to the *sale* of real property that “is no longer, necessary or useful in the performance of the water corporation’s duties to the public.” The PD errs in concluding with almost no analysis that P.U. Code § 790 applies to all the proceeds from the settlement. The PD ignores the fact that part of the proceeds are not associated with the sale of any assets. The remainder of the settlement associated with the sale of SCWC’s water rights involves assets that are arguably necessary and useful to the ratepayers, and thus do not fit within the criteria of § 790.

In D.03-05-001 approving the settlement, the Commission made *no* finding as to whether SCWC’s *water rights* in the basin were still necessary and useful for SCWC’s utility operations. Nor did the Commission make a finding in that decision that SCWC’s Charnock Wellfield plant was no longer necessary or useful. (We address the Charnock Wellfield plant again later in these comments.) If the Commission finds here that SCWC’s *water rights* are necessary and useful, then P.U. Code § 790 does *not* apply, and all gain should go to the ratepayers as a rebate.

The PD states (at 8) that because of the MTBE pollution in the Basin, “it is clear that SCWC’s water rights and most of its facilities in the Basin are no longer necessary or useful in the provision of water service and have not as a practical matter been useful since 1996.” This conclusion is not supported by the facts.

In D.03-09-021, in discussing implementation of § 790 *et seq.*, the Commission that inclusion of plant in rate base is evidence that the associated assets are still used and useful. The presumption is that an asset remains used and useful until the Commission determines otherwise:

By authorizing the utility to earn a return in its rates on the value of the property [in rate base], the Commission expects the property to be used to serve the public. The contrary determination, namely, that the property is “no longer necessary or useful” and consequently should not earn a return for the utility, requires that the Commission review how the property

was employed in service to the public and how the need will be filled absent the property. (*mimeo* at 66)

The *only* evidence that the PD cites to support its conclusion that these water rights are no longer useful to ratepayers is the fact that SCWC has not pumped water from these wells since 1996. The most compelling evidence rebutting the PD's conclusion is the action of the City to pay millions of dollars for SCWC's water rights in this basin. The City and the EPA clearly plan to clean up this basin so the water will once more be usable. There may be good public policy reasons for the Commission to approve the transfer of SCWC's rights to the City to streamline such a cleanup, but that is different than saying the assets no longer have value to ratepayers in the provision of utility service. ORA witness Han's testified that the Charnock Basin was, and will be again, a valuable, low cost source of water, once the MTBE contamination is cleared up. In his judgment, this is an asset that should be considered necessary and useful for ratepayers of SCWC's district.¹

We note again that SCWC built a treatment plant for this water in the 1990s, and has kept the plant associated with the Charnock Wellfield in rate base up until the present time, certainly indicating SCWC's view that this asset has value to ratepayers.²

B. The PD Errs In Treating The City's Damages Payment For the Charnock Basin Plant As A "Sale" Under P.U. Code § 790

The PD errs in concluding that the approximately \$2.5 million that SCWC will receive associated with the Charnock Basin *plant* is a sale that falls under P.U. Code § 790. *There is no sale of these assets!* ORA raised this argument repeatedly

¹ Exh. 13 at 6-7.

² The view that these assets continue to be used and useful is even supported by some of the testimony of SCWC witness Switzer who stated:

At this point, the Commission has never found those facilities [the Charnock Wellfield] not to be used and useful, so they're still in ratebase. Testimony of SCWC witness Switzer, 1 RT at 32.

in its pleadings, but it is addressed nowhere in the PD. Since the Charnock Basin plant assets are *not* being sold, P.U. Code § 790 does *not* apply.

The PD (at 4-5) correctly notes that a *separate* component of the settlement between SCWC and the City involves the City paying SCWC an “Assignment Payment” associated with its real and personal property at the Charnock Wellfield, excluding the land.³ SCWC’s Assignment Payment is agreed to be the fair market value of SCWC’s plant in the Charnock Wellfield.⁴ SCWC’s appraisal of these assets, *excluding* the underlying real property, suggests that the fair market value of these assets is \$2.75 million, significantly greater than the net book value.⁵

P.U. Code § 790 is not applicable here because *there is no sale of assets*. SCWC is *not selling* these assets. As the settlement makes clear:

Nothing in this Part is intended to transfer title from SCWC to the City of SCWC’s Charnock Wellfield.⁶

P.U. Code § 789.1 describes the Legislature’s intent in enacting the Water Utility Infrastructure Improvement Act of 1995. This section states in part:

It is the policy of the state that any net proceeds from *the sale* by a water corporation of real property that was at any time, but is no longer, necessary or useful in the provision of public utility service, shall be invested by a water corporation in infrastructure, plant, facilities, and properties that are necessary or useful in the performance of its duties to the public...(emphasis added)⁷

The requirement of a *sale* to trigger the statute is reiterated later in the statute at § 790(a):

³ SCWC would receive this Assignment Payment only if the City of Santa Monica prevailed in its litigation against the oil companies, and the amounts received exceeded the City’s litigation costs.

⁴ City-SCWC Settlement, Exh. 1 at 6 (para. 4.9).

⁵ SCWC June 6 report at 5.

⁶ Exhibit 1, Settlement, p.6, para. 4.9.1.

⁷ P.U. Code § 789.1(e).

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

As noted above, SCWC is retaining title to the land and physical assets in the Charnock Wellfield. There is nothing in the settlement that would prevent SCWC from using any of the equipment in the Charnock Wellfield elsewhere in their system. *There is nothing that would prevent SCWC from selling the Charnock Wellfield and its equipment again.* Indeed, under the logic of the PD, the company could keep “selling” these assets and reinvesting the gain on sale under P.U. Code § 790 over and over again!

The money that SCWC is receiving from the City for the Charnock Wellfield is not in consideration for its sale of its water rights. SCWC is already receiving the fair market value of a very generous assessment of its water rights. The payment for the Charnock Wellfield, is additional to payment for the water rights and does not come under § 790.

Ratepayers will be paying higher costs for purchased water in the future, certainly higher than what ratepayers were paying before MTBE contamination caused the shutdown. The difference between the value of the Assignment Payment and the net book value should be passed through to ratepayers. This can be done by adding this difference to the Purchased Water Balancing Account.

C. The PD Errs In Failing To Recognize Issues Associated With the Implementation of P.U. Code § 790

The PD erroneously interprets P.U. Code § 790 in a way that eliminates all Commission judgment associated with the ratemaking for sales of utility assets.

The PD errs in concluding that ratepayers will always be best served if all funds that could conceivably be described as a gain on sale are reinvested in new plant.

We have argued in our pleadings that the Commission should treat the gain on sale associated with SCWC's sale of its water *rights* as contributions in aid of construction if that money is going to be reinvested in new plant. Otherwise, this settlement will be a windfall to SCWC who would get to replace older, depreciated plant in rate base with more expensive plant that will earn a greater return *without any additional shareholder investment*. From the ratepayers' perspective, this churning of plant will lead to higher rates without any improvement in service.

The PD cites the Commission's statement in *Re Southern California Water Company (1992)* 43 CPUC2d 596 which recognizes the value of Commission discretion in ratemaking and appears inconsistent with the outcome in the PD. In that decision, the Commission directed SCWC to use the gain on sale to reduce the utility's rate base, rather than reinvesting the gain to increase the rate base. The Commission stated:

Ratepayers will benefit over the long term through a reduction in rate base by the amount of the gain-on-sale and the consequent reduction in the return on the reduced rate base. *Id.* at 604.

In that case, SCWC could reinvest the net proceeds from the sale in new plant for the district. However, that reinvestment would be reflected in SCWC's rate base at the value of any *new* incremental investment made by shareholders. The net proceeds from the sale of these water rights would be booked at zero dollars for ratemaking purposes.

Very recently, in D.03-09-021, the Commission reviewed the new, and sometimes troubling, incentives created by § 790 *et seq.* There, the Commission noted that:

The Commission must also determine the ratemaking treatment for assets and expenses associated with the

sale of unneeded real property and reinvestment of the net proceeds from the sale.

...[W]e note that the result of allocating all net proceeds to shareholders creates a powerful financial incentive for water utilities to sell real property. Our research indicates that this purported statutory right to allocate all gain on sale to shareholders is unprecedented in all regulatory jurisdictions in this country. Such a right could encourage water utilities to sell real property without regard to long-term customer service needs, and may even lead to real property speculation by water utilities, relying on rate base treatment to protect shareholders from losses but using § 790 to reap all gains. *In short, the interpretation of this statute, and the potential consequences, will need to be fully analyzed and briefed when we address the ratemaking and rate base issues raised by the Infrastructure Act.*

For now, however, we note that the Infrastructure Act creates new incentives and that those incentives *require even greater regulatory scrutiny of real estate transactions to ensure that the intended benefits to ratepayers materialize.* Accordingly, the Commission must carefully review the details of each real property parcel that a water utility proposes to sell pursuant to § 790. *The Commission must consider both the history of the property proposed to be sold, its use to provide service to customers, its historic ratemaking treatment, as well as any potential future use to serve customers, whether any replacement property is needed, and such issues as may be specific to each proposed transaction. (id. at 66, 67)*

The Commission went on to discuss the importance of Commission consideration of what constitute the *net* proceeds that might be subject to § 790. Whereas the PD in the present case *assumes* that all of the gross revenues from the settlement can be treated as new investment under § 790, the Commission made it clear that it, not the utility, determines what constitutes the net gain that is subject to § 790.

We observe that, as a threshold matter, § 790 may not even apply to this transaction. Here, Cal Water proposes to charge customers at least \$1.4 million to build a new customer center, declare the old one “no longer necessary or useful in the performance of [its] duties to the public,” and give shareholders all the proceeds from the sale of the old center. Cal Water’s proposal fails to recognize *that but for the construction of the new center, the old center would be needed to serve customers*. Thus, in looking at the entire project, the amount Cal Water expects to realize from the sale of the old center, \$455,000, is more than offset by the cost of the new center.⁸ Consequently, after detailed review of the facts, *the Commission could conclude that there are no net proceeds from this transaction to consider allocating to shareholders*. (emphasis added) *Id* at 69.

In the current case, it is clear that SCWC will have to (continue) to replace the water it had previously been pumping from the Charnock Basin. Yet the PD makes no attempt to reflect those continuing higher costs for replacement water in its ratemaking treatment of the sale of water rights. This is error.

ORA has contended in previous filings that one way to mitigate the harm to ratepayers from these kind of sales is to treat any reinvestment of proceeds from this settlement as Contributions in Aid of Construction rather than new shareholder investments. Shareholders would be allowed to retain in rate base the same amount they had prior to sale of the old assets. This is similar to the ratemaking the Commission used in *Great Oaks Water Company* (D.93-09-077, 51 CPUC 2d 366)

ORA understands that the Commission will soon issue an OIR on how it should deal with ratemaking issues associated with P.U. Code § 790. Rather than set any precedent in this case, the Commission may wish to consider the issues raised in this case in that Rulemaking.

⁸ This is consistent with the accounting treatment of “trade-ins,” where any revenue from sale of the old asset offsets the cost of acquiring the replacement asset.

II. RATEMAKING FOR THE PAYMENTS FROM THE POLLUTERS

The PD correctly directs SCWC to refund to ratepayers the approximately \$4.2 million it has already collected from the “Potentially Responsible Parties” identified in SCWC’s lawsuit and the EPA order (*aka* “the polluters”). The PD states that the Commission has reviewed such payments by polluters on a case by case basis, first seeking “to make ratepayers whole for amounts that they have paid in rates because of contamination.” *Re Del Este Water Company*. (1995) 60 CPUC2d 418 at 423. As the PD correctly notes, SCWC faces no further costs of cleanup of the Basin supply, and the settlement with the City removes any risk that SCWC will have to repay the polluters the \$4.2 million it has received even if a court later determines that SCWC was not entitled to that money.

Finally, ORA supports the PD’s directive to SCWC to transfer the funds received from the polluters from its Account 704 to the purchased water balancing Account 704.02. The “rules” referred to in the PD perhaps would be more accurately described as an internal CPUC memo drafted decades ago, long before MTBE or other pollutants were an issue in purchased water expenses. We agree with the PD that the Commission is free to direct the utility to refund these payments to ratepayers, and is in no way barred by that decades old memo.

III. VALUE OF CHARNOCK WELLFIELD ASSETS TO BE REMOVED FROM RATEBASE

The PD directs SCWC to remove the assets no longer necessary and useful in the Charnock Wellfield from its ratebase. The PD notes (at 17) that SCWC has taken steps in its current GRC (A.03-10-006) to remove these items from rate base. Although ORA would like these assets removed as quickly as possible, the GRC may be an appropriate docket in which to address this issue.

The PD notes (at 5) that in a March 2003 late-filed exhibit SCWC had listed the net book value of the Charnock Basin facilities as \$523,671. This is a substantially lower value than SCWC had presented during the course of the hearings in Phase I. It appears that SCWC now considers certain specific assets no

longer to be associated with the Charnock Basin. ORA does not suggest that that this dispute be resolved in this proceeding. Instead ORA recommends the Commission explicitly delegate to the SCWC GRC the task of determining the correct amount to be removed from SCWC's ratebase associated with the Charnock Wellfield assets. Thus, the language in footnote 2 on page 5 of the PD would not be deemed as controlling as to the proper amount to be removed from rate base.

Respectfully submitted,

/s/ JAMES E. SCARFF

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January 8, 2004

Proposed Findings of Fact

Modify or Add the Findings of Fact as follows:

Add: *Under the settlement, the City will pay SCWC an Assignment Payment estimated as being worth between \$2.75 million, based on the fair market value of plant in the Charnock Wellfield, if the City's ultimate net recovery from the polluters is greater than such a fair market value of this plant. Under this provision, the plant would not be sold to the City, and would remain the property of SCWC*

Modify finding #12 as follows.:

~~In its last two general rate cases for the Culver City service area, SCWC has provided only for water purchased from MWD and has included no groundwater in its supply. In SCWC's 1995 GRC decision, we assumed that SCWC would obtain no groundwater from the Charnock Basin during the test year or subsequent years, and accordingly provided SCWC with a revenue requirement designed to fully compensate for the additional purchased water SCWC would have to acquire given SCWC's inability to pump water from the Charnock Basin.~~

Add the following findings:

In SCWC's 1998 GRC decision, D.98-12-070, we adopted a settlement that assumed that SCWC would obtain no groundwater from the Charnock Basin during the test year or subsequent years, and accordingly provided SCWC with a revenue requirement designed to fully compensate for the additional purchased water SCWC would have to acquire given SCWC's inability to pump water from the Charnock Basin.

In both SCWC's 1995 and 1998 GRC decisions, we allowed SCWC to keep its Charnock Wellfield in rate base as plant in service, and included in

SCWC's revenue requirement both depreciation and a return on equity associated with the Charnock Wellfield.

Proposed Conclusions of Law

Modify

3. Pub. Util. Code § 790 applies to the sale by SCWC of its water rights ~~and related facilities~~ in Charnock Basin *if the Commission finds that those water rights were no longer necessary and useful.*

Add:

SCWC's keeping the Charnock Wellfield as plant in service in rate base shows that this property was at the time of sale still necessary or useful in the performance of SCWC's duties to the public.

Public Utilities Code §790 does not apply to that portion of a settlement wherein the corporation receives money not directly connected to a sale of real property.

The Assignment Payment in the City-SCWC settlement wherein SCWC will receive the fair market value of its wells, distribution piping, treatment facilities and reservoir at fair market value is not a sale of that property within the meaning of P.U. Code § 790(a).

Proposed Ordering Paragraphs

1. Southern California Water Company (SCWC) is directed to deal with settlement payments received from the City of Santa Monica (City), for conveyance of SCWC's Charnock Groundwater Basin assets, in a manner *as set forth in ~~Pub. Util. Code § 790~~ in the decision above.*

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the foregoing document
**“COMMENTS OF THE OFFICE OF RATEPAYER ADVOCATES ON THE
PROPOSED DECISION OF ALJ WALKER”** in A.02-07-021.

A copy has been e-mailed to all known parties of record who have provided e-mail addresses. In addition, all parties have been served by first-class mail.

Executed in San Francisco, California, on the **8th** day of **January, 2004**.

/s/ Joanne Lark

Joanne Lark