PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298

May 13, 2004

Agenda ID#3568
Alternate to Agenda ID# 3348
Ratesetting

TO: PARTIES OF RECORD IN APPLICATION 02-11-044

Enclosed is the Proposed Alternate Decision of Commissioner Brown to the Proposed Decision of Administrative Law Judge (ALJ) Patrick previously mailed to you.

When the Commission acts on the draft or alternate decision, it may adopt all or part of it as written, amend or modify it, or set aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Public Utilities Code Section 311(e) requires that an alternate to a draft decision be served on all parties, and be subject to public review and comment prior to a vote of the Commission. Rule 77.6(d) provides that comments on the alternate draft decision be filed at least seven days before the Commission meeting.

Comments on the alternate decision must be filed and served May 20, 2004. Reply comments are due May 25, 2004.

Pursuant to Rule 77.3 comments shall not exceed 15 pages. Finally, comments must be served separately on the ALJ and the assigned Commissioner, and for that purpose I suggest hand delivery, overnight mail, or other expeditious method of service.

/s/ ANGELA K. MINKIN
Angela K. Minkin, Chief
Administrative Law Judge

AKM:vfw

Attachment

Decision **ALTERNATE PROPOSED DECISION OF COMMISSIONER BROWN**
(Mailed 05/13/04)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SAN GABRIEL VALLEY WATER COMPANY (U337W) for Authority to Increase Rates Charged for Water Service in its Fontana Water Company Division to increase revenues by $11,573,200 or 39.1% in 2003, $3,078,400 or 7.3% in 2004, $3,078,400 or 6.8% in 2005, and $3,079,900 or 6.4% in 2006.	Application 02-11-044 (Filed November 25, 2002)

Timothy J. Ryan, Attorney at Law, Daniel A. Dell'Osa, Nossaman, Guthner, Knox & Elliott, LLP, by Martin A. Mattes, Attorney at Law, for San Gabriel Valley Water Company, applicant.
Keith Clements, for himself; Dennis R. Poulsen, for California Steel Industries, Inc.; Marvin T. Sawyer, General Counsel, and Endeman, Lincoln, Turek & Heater, LLP, by James C. Allen, for Fontana Unified School District; interested parties.
Best, Best & Krieger, LLP, by Kendall H. MacVey, Attorney at Law, for the City of Fontana, protestant.
Travis Foss, Attorney at Law, for the Office of Ratepayer Advocates.

OPINION AUTHORIZING INCREASE IN REVENUE

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OPINION AUTHORIZING INCREASE IN REVENUE

I. Summary

San Gabriel Valley Water Company (San Gabriel), Fontana Water Company Division (Fontana Division), is authorized to increase revenues by:

$5,705,100 (or 18.0%) for Test Year 2004[1]

$1,497,300 (or 4.0%) for Attrition Year 2005

$1,497,300 (or 3.8%) for Attrition Year 2006

We authorize rate of return on rate base of 9.40% for the years 2004, 2005, and 2006. The return on common equity (ROE) authorized by this decision is 10.10%. As a result of the revenue increase granted by this decision, the monthly bill for the average residential customer (23 hundred cubic feet (Ccf) of water with a 5/8 x 3/4-meter) would increase by $6.90 or 18% from $37.11 to $44.01 in the year 2004.

The major topic of inquiry in this proceeding was the adequacy of Fontana Division's current sources of supply and program to increase supply. The Fontana Division has met its existing water needs, although barely. The evidence shows that even on Fontana's hottest, driest days of the year, San Gabriel 's total water production capacity has matched its usage. Fontana Division is also experiencing ongoing customer growth of over 1,000 connections per year.

To address this situation, San Gabriel proposed a major construction program for plant additions through 2006. We find San Gabriel's proposed construction program to be overly ambitious. In this decision, we find a

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[1] This includes increased revenues of $4,207,800 (or 13.8%) for Test Year 2003.

reasonable amount for construction to be the 3 year average of recorded company funded plant additions for the period 2001-2003. This figure sets a realistic construction program that accounts for continuing infrastructure improvements and customer growth. This does not bar staff from challenging the inclusion of such investments in rate base in a later proceeding once the investments have been made.

Within this limitation, San Gabriel will be able to undertake needed replacement and additions of new mains and services, and to construct needed water production wells, booster pumping systems, and water storage reservoirs. The program would also provide for construction of needed wellhead treatment facilities at perchlorate-contaminated wells, and of the first 15 million gallons per day (mgd) increment of a conventional surface water treatment facility in the northwestern portion of the service area (Plant F 52). The proposed construction of a new office, garage, and warehouse is deferred because of the rate impact.

II. Background and Procedural History

San Gabriel is a Class A water company with two operating divisions – the Los Angeles Division serving 47,000 customers and the Fontana Division serving 37,000 customers. This proceeding involves the Fontana Division only. San Gabriel is also affiliated with the Arizona Water Company operating outside the Commission's jurisdiction.

On July 31, 2002, San Gabriel filed its Notice of Intention to File General Rate Increase Application (NOI). Customers were advised of the proposed rate increase through publication and bill inserts. On November 25, 2002, San Gabriel filed the above-captioned application seeking rate increases in its Fontana Division to produce an overall annual rate of return of 11.03% for the period 2002-2006.

San Gabriel stated that its revenue must be increased to enable it to meet expenses of furnishing water service to its customers, to maintain financial integrity and credit, to obtain and retain capital at reasonable costs, to continue compliance with all existing and emerging safe drinking water quality standards, and to provide a reasonable rate of return on investment. San Gabriel particularly emphasized the increasing costs of required water treatment to remove contaminants from groundwater supplies.

The assigned Administrative Law Judge (ALJ) held a prehearing conference (PHC) on May 5, 2003 in Fontana. Following the PHC, a Scoping Memo and Ruling of Assigned Commissioner and Administrative Law Judge was issued on May 20, 2003. The ruling confirmed the categorization of this proceeding as ratesetting pursuant to Pub. Util. Code § 1701.3, and Commissioner Peevey designated Administrative Law Judge (ALJ) Kathleen C. Maloney as the principal hearing officer. The proceeding was reassigned to ALJ Bertram D. Patrick in June 2003.

On July 31, 2003, the Commission's Office of Ratepayer Advocates (ORA) distributed its report. ORA recommended that rates in 2003 should be reduced by 7.35%. For 2004, ORA recommended an increase in rates of 2.2% above those authorized for 2003 and a decrease of 1% in each attrition year 2005 and 2006. ORA provided supporting analysis showing major adjustments to San Gabriel's proposal, including higher estimates of revenue, lower estimates of operating costs, lower forecasts of plant additions, and lower costs of capital. ORA also recommended that Fontana Division rate base be reduced by $15.1 million to account for condemnation proceeds received by San Gabriel, which ORA believes should be flowed through to ratepayers.

The City of Fontana (City) and the Fontana Unified School District (School District) actively participated in opposing San Gabriel's proposed rate increase. Both City and School District provided expert witnesses to rebut San Gabriel's showing.

Ten days of evidentiary hearings were held from September 15 through 18 in San Francisco, from September 29 through October 1 in Fontana, and on October 8, 2003 in San Francisco. The City, San Gabriel, School District and ORA filed concurrent opening briefs on November 21, and concurrent reply briefs on December 12, 2003, after which this matter was submitted for decision.

By ALJ ruling, the submission date of December 12, 2003, was set aside for purposes of addressing ORA's motion for sanctions for violation of the Commission's Rule 1. The new submission date for this proceeding is February 5, 2004. Oral argument was held before the Commission on April 14, 2004, in San Francisco.

III. Public Participation Hearing

A Public Participation Hearing (PPH) was held on May 5, 2003 in Fontana. Several speakers offered comments. All opposed the proposed rate increase as creating an excessive burden on residential customers, particularly those on fixed incomes. In addition to opposing the proposed rate increase, these speakers also emphasized the importance of taking action against the parties responsible for contaminating Fontana Division's ground water sources. The Commission also received 175 letters from customers. All opposed the proposed rate increase as being excessive, particularly given the current economic situation.

Mark Nuaimi, the Mayor of Fontana, spoke about the impact of San Gabriel's proposed rate increase on the City's budget for providing services. He believes that San Gabriel should be looking for alternative funding sources rather than expecting ratepayers to pay for the cleanup due to perchlorate contamination of the groundwater sources. He suggested that San Gabriel impose connection fees on developers to pay for needed facilities. He criticized San Gabriel's standby fee on residential fire sprinklers as being excessive compared with adjacent water districts. He believes that San Gabriel is not interested in promoting the use of recycled water to reduce the cost of service on all ratepayers because San Gabriel prefers to increase its investment in plant to generate high returns.

City criticizes San Gabriel for not working with city officials on matters of common interest. City says that San Gabriel made no effort to give advance warning to city officials of the proposed 77% increase in rates through 2006. According to City, the Mayor offered to pursue an interest-free loan from City to San Gabriel to address its expressed needs for water treatment plant, but San Gabriel's response was – no response. City states that it has 10,000 acre-feet per year of un-reclaimed water going to waste, but San Gabriel has no interest in a project to utilize this water.

School District points out that Fontana Division rates are already the highest in the area and San Gabriel's proposed increase will cause School District severe budgetary problems. School District argues that Fontana Division has sufficient capacity to handle the current drought situation, that San Gabriel is using the drought to justify unneeded capital projects for the sole purpose of increasing profits, and is proposing an unwarranted luxury of a new office building at a time when the State is in an economic slump.

IV. Capital Projects

The main issue in this proceeding is San Gabriel's proposed major increase in plant additions through 2006. As discussed below, we generally approve San Gabriel's construction program with some limitations to reduce rate impact.

According to San Gabriel, perchlorate or nitrate contamination above current Action Levels has required it to shut-off seven Fontana wells amounting to a loss of capacity of 14,900 gallons per minute, equal to 30% of average daily production required to meet summer peak-day demand. Therefore, the centerpiece of San Gabriel's construction program is the installation of wellhead treatment plants at the seven contaminated wells to make these wells immediately available to meet summer peak-day and fire protection needs.

In opposing San Gabriel's request, ORA states that the three-year average for normal plant additions for 1998, 1999, and 2001 is approximately $8.0 million and the five-year average from 1998 to 2002 is $10.2 million. Both of these amounts are significantly lower than San Gabriel's request for Test Year 2003 of $18.5 million and $21.7 million for Test Year 2004, plus an additional $8.0 million for perchlorate treatment plants at issue in this proceeding.

Further, ORA contends that San Gabriel failed to adequately substantiate the need for such extraordinary plant increases, other than discussing the need for the perchlorate treatment plants. ORA argues that peak day consumption has remained relatively steady over the past 4 wells. ORA also argues that the company has been aware of contamination prior to 2002 and has since built 5 new wells to meet its increase in growth and to compensate for the loss of the contaminated wells.

ORA opposes construction of the proposed West Side Surface Water Treatment Plant, contending that it is not needed and, if so, it should be funded by developers through advances or contributions. Also, ORA opposes all but one of San Gabriel's proposed six reservoir projects, opposes all but two of the seven proposed booster stations, and opposes all but one of the seven proposed production wells. ORA opposes inclusion of the proposed seven wellhead treatment facilities in rates on the grounds that the parties responsible for the contamination should pay for these facilities. ORA also opposes San Gabriel's proposal for a new office building on the grounds that it is not needed.

City and School District oppose San Gabriel's wellhead treatment proposals on the grounds that San Gabriel was proposing the most expensive approach, and that San Gabriel's proposal for wellhead extraction and treatment could make the problem worse by spreading the groundwater contamination plume further. City witness Vitthal Hosangadi, a consulting engineer, faults San Gabriel for not making a systematic assessment of alternatives available to address the contamination situation and instead directly applying the approach it used in its Los Angeles Division. Hosangadi argues that site conditions and circumstances at Fontana are different; therefore, a site-specific analysis would be prudent. He recommends a "phased approach" in which strategically selected wells are equipped with treatment initially, followed by other wells to minimize "pulling" of the plume in the down-gradient direction. Hosangadi also recommends that San Gabriel obtain other supplies to minimize the amount of water requiring perchlorate treatment. He suggests State Water Project (SWP) water, and recycled or reclaimed water from the City for use by industrial customers who do not need treated water.

San Gabriel witness Mark Wildermuth, a consulting engineer, testified that he considered the alternative "dodge and drill" approach instead of wellhead treatment plants to be not a wise concept under circumstances where there is a significant probability of hitting perchlorate in a new well, or of avoiding perchlorate but ending up with high nitrate. He favored the alternative of "going after the contamination in place" rather than pumping at other locations to avoid creating a stress that would cause the contamination to migrate elsewhere.

Responding to ORA's general opposition to San Gabriel's proposed construction plan, Fontana Division Assistant General Manager Gerald J. Black contends that ORA has wrongly focused on annual production when what matters are peak-day and peak-hour water production needs. He stressed that all seven of the perchlorate-contaminated wells are needed to reliably meet customers' requirements and public fire protection demand, especially during the summer months. He calculated total well production capacity of all uncontaminated wells as 56.3 mgd, to which he added 3.6 mgd of surface water from Lytle Creek and the SWP, plus 2.9 mgd available from Cucamonga County Water District's (CCWD) two standby emergency interconnections. Not including the uncertain CCWD interconnections, witness Black estimated Fontana Division's current total daily production capacity at about 59.9 mgd – short of last year's peak day demand of 60.4 mgd and "leaving a possible shortage of production," especially in light of the continuing decline of Lytle Basin well production with continued drought. According to Black, there is absolutely no cushion for the loss of any well for any reason, such as power failure, starter failure, motor failure, vandalism, bacteriological contamination, industrial pollution, and a multitude of other unforeseen failures. He points out that in mid-August 2003, San Gabriel lost over 8.4 mgd of well capacity for most of one day due to two motor starter failures and one bacteriological flare-up.

Further, witness Black discounted ORA's suggestion that the production from the perchlorate-contaminated wells can be blended with SWP supplies. He pointed out that the wells are located many miles away from the SWP water source, and the SWP water itself would first have to be fully treated before blending would be feasible. He explained that blending with the production of other wells was not feasible, because, except for Well F4A, there are no uncontaminated wells in their vicinity that can be connected.

While noting San Gabriel's agreement with ORA that the polluters who contaminated the groundwater with perchlorate should bear the full cost of providing and operating wellhead treatment systems, Black stressed that San Gabriel cannot wait for all the polluters to be identified and made to pay, because "San Gabriel urgently needs the lost production restored now." According to Black, that is why San Gabriel has proposed a memorandum account to record all capital costs and related operating and maintenance expenses as well as any reimbursements received from third parties, polluters included.

School District argued during hearing that 78.2 mgd was available from current sources, comprising 56.3 mgd from uncontaminated wells, plus 5.0 mgd of blended Lytle Creek / SWP surface water, 2.9 mgd from CCWD and 14.0 mgd from five of the seven perchlorate contaminated wells.

San Gabriel witness Black rejected School District's 78.2 mgd estimate. Beginning with the 56.3 mgd estimate of the production from Fontana's uncontaminated wells, Black testified that "we have no guarantee that we can produce 56.3 [mgd] day in and day out," noting the example of a recent day on which three wells – totaling 7.5 mgd – went out of production. He concluded that "the 56.3 is not a solid number. It's the maximum number." He would reduce that number to 44 mgd.

Black considered the CCWD connection to be strictly an emergency connection, not available to meet an extended shortage of supply, and becoming less available in time as Cucamonga's own demand increases. He did not recognize the CCWD connection as providing any reliable source of supply at all. Likewise, Black completely discounted the perchlorate contaminated wells as providing any available supply, based on his expectation that the Department of Health Services (DHS) will soon set a Maximum Contaminant Level (MCL) for perchlorate that will prohibit Fontana Division from delivering water from those wells.[2] He also testified that another year of low rainfall and snowpack would deprive San Gabriel of at least 7.3 mgd from its Rialto Basin wells, and that, due to declining water levels, Fontana Division was already in peril of losing the use of its six Lytle Basin wells that were still producing at the time of his testimony. Summing up, witness Black found current reliable production capacity of just 46.7 mgd.

A. Discussion

Fontana Division expects to obtain 80% of its water supply from the Chino Basin; therefore, we find that cleanup of the basin is a matter of the highest priority for San Gabriel. The full extent of the perchlorate contamination plume

[2] DHS some years ago set a perchlorate Action Level of 18 ppb. In January 2002, DHS revised the Action Level for perchlorate downward to 4 ppb. Pursuant to Senate Bill 1822 (2202), DHS must adopt a primary drinking water standard or MCL for perchlorate. According to witness Black, that is likely to be set somewhere between 2 and 6 ppb, at which point San Gabriel will be prohibited from serving water exceeding the MCL.

has not yet been fully defined, and the Environmental Protection Agency (EPA) and other responsible agencies have yet to approve a comprehensive cleanup plan for the basin. In addition, DHS has yet to announce its latest drinking water standard or MCL for perchlorate levels. Notwithstanding ORA's arguments based on water supplies in 2001, the record fully supports San Gabriel's position that Fontana Division was barely able to meet peak-day demands in the summer of 2003, following closure of the seven wells in October 2002.[3] Furthermore, Fontana Division is adding over 1,000 connections per year.

Given the current situation, we agree with San Gabriel that doing nothing or waiting until some uncertain date for outside funding for perchlorate cleanup, are not realistic or responsible options. Therefore, we find that the current level of plant additions should be maintained, that San Gabriel be given some limited flexibility to deal with events as they unfold, and that San Gabriel be allowed to make its own decisions within that limitation.[4] San Gabriel should also open a memorandum account to record all capital costs, operating and maintenance expenses as well as reimbursements from third parties. San Gabriel should provide a full accounting of these proceeds for review in its next NOI for Fontana Division.

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[3] San Gabriel states that, contrary to ORA's repeated assertions, at no time did San Gabriel's witnesses testify that perchlorate in five connected wells (of the seven) was below the Action Level, or that DHS had given permission to operate these wells, or that any of these wells had been in operation during the summer of 2003.

[4] San Gabriel has previous experience in dealing with groundwater basin contamination. (See San Gabriel Los Angeles Division 1996 GRC decision regarding treatment of contamination throughout the Main San Gabriel Groundwater Basin (D.98-08-034).

In allowing San Gabriel needed flexibility to proceed with its plan for plant additions, we will set an upper limit. As ORA correctly points out, San Gabriel's proposals greatly exceed the $10.2 million per year five-year average for plant additions for the period 1998-2002. We also agree with City and School District that implementing San Gabriel's proposed plan for plant additions will cause undue hardship to ratepayers. Accordingly, for ratemaking purposes, we will spread the proposed plant additions over more years through the cap discussed below.

B. The Rate Base Cap

Because of the controversy surrounding San Gabriel's proposed major plant addition plans, and the need to take into consideration the rate shock to customers that would result from San Gabriel's proposed construction program, the ALJ introduced an alternate approach, which would entail a Commission-approved cap on total rate base additions during the test years and attrition years. The ALJ suggested that adopting a rate base cap would allow San Gabriel to determine which projects to construct within the constraints of the Commission-approved cap, thereby eliminating a lot of the controversy on the ranking of different plant additions and the timing of the receipt of condemnation proceeds and related project work.

In response to the ALJ's direction, San Gabriel witness LoGuidice prepared and sponsored Exhibit 54, San Gabriel's Project Priority List of plant additions proposed to be implemented over the years 2003 through 2006. San Gabriel's position is that its plant forecasts should be adopted. In the alternative, San Gabriel agrees to a rate base cap which would allow rate base to increase by 10% annually during the test years and attrition years.

The School District argues that a rate base cap of 10% is too high and does not adequately reflect the annual consumer growth. The School District proposes a rate base cap that corresponds with the company's customer growth, which is 2.7%. We find that this cap would not enable the company to maintain its current level of plant additions, which must also account for water contamination.

Though we understand the ALJ's approach, we do not believe a 10% cap adequately reflects San Gabriel's current level of plant additions. We find a more reasonable amount for construction to be $7.6 million, which is the 3 year average of recorded company funded plant additions for the period 2001-2003. This figure sets a realistic construction program that accounts for necessary infrastructure improvements and customer growth.

As with previous rulings, we leave the fine-tuning of a utility's operation to the discretion of its management.[5] However, this determination does not allow San Gabriel "carte blanche" to construct whatever it wants without Commission review. This also does not bar staff from challenging the inclusion of such investments in rate base in a later proceeding once the investments have been made.

We note that the average recorded company funded plant additions for Fontana Division from 2001 through 2003 to be $7.6 million. We believe that given the customer growth being experienced and the perchlorate contamination issue, it is reasonable that the current rate of plant additions be maintained.

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[5] *Re California-American Water Company*, D.02-07-011, p. 6-7.

Therefore, as discussed above, rather than specifying which projects should be undertaken first, we will adopt the average recorded company funded plant additions for the most current 3 years for plant additions through 2006.

San Gabriel, in its application, proposed to seek Commission approval for construction of perchlorate removal facilities through advice letter filings. Advice letter filings are inappropriate for normal capital projects that should be handled on an estimated test year basis, such as the projects proposed here.[6] Rather than subject these projects to the proposed advice letter process, we will allow San Gabriel to make changes and substitutions for the projects show on Exhibit 54, limited to the cap as discussed above. Such a limitation would permit San Gabriel to make its own decision about the need for and timing of project on its Project Priority List and in turn be held accountable for its decisions. The individual projects are discussed later under the heading Rate Base Components.

V. Water Sales and Operating Revenues

A. Service Connections

San Gabriel forecasts an increase of 1,000 residential connections per year based on a seven-year average. ORA estimates increases of 1,410 and 1,336 connections for Test Year 2003 and 2004, respectively, based on a trending methodology. We find that San Gabriel's estimate is low because it gives too much weight to earlier lower growth years, and ORA's estimate is high given recent recorded growth rates. We adopt the five-year average of 1,298 new connections per year as fairly representing expected residential growth during the test years and attrition years.

[6] See D.04-03-039, p. 11.

San Gabriel's and ORA's estimates of service connections for all classes, other than residential, are essentially the same except for minor differences in the Public Authority classes. We adopt San Gabriel's estimates since, apparently, ORA double-counted two large customers.

B. Average Use Per Customer

San Gabriel's forecast of average residential customer usage is 321 Ccf / year based on the Modified Bean Method, a multiple regression analysis which eliminates variations due to time, rainfall and temperature. ORA's revised estimate, 336.5 Ccf / year, approximates the four-year recorded average. Fontana Division has experienced four drought years, and ORA's estimate is not "weather normalized" for test year ratemaking purposes. Therefore, we adopt San Gabriel's estimate of 321 Ccf / year for residential usage. Likewise, we will adopt San Gabriel's estimates for all other classes since these estimates are also weather normalized.

C. Miscellaneous and Construction Revenues

ORA's estimate of Miscellaneous Revenues is $531,751 for 2003 and $447,271 for 2004. San Gabriel's estimate is $106,881 for 2003 and 2004. ORA used a five-year average to estimate Account 611 (Miscellaneous Service Revenues) and included estimated revenues for reimbursement of operating costs of a contaminated well from the San Bernardino County Board of Supervisors. San Gabriel's estimate is based on recorded 2001. We adopt San Gabriel's estimate since ORA did not include the corresponding expenses for operating the contaminated well.

For Construction Revenues, ORA estimates revenues of $608,194, and San Gabriel estimates $326,008 for each test year. ORA's estimate is based on recorded 2002, which it contends more closely reflects the current level of construction activity in this region of continuing growth and development. San Gabriel used a five-year average from 1997 through 2001. We adopt ORA's estimate since San Gabriel's five-year average does not adequately reflect current construction levels.

VI. Operation and Maintenance Expenses

A. Supply Cost Expenses

1. Unmetered and Unaccounted for Water

Unmetered and unaccounted for water is a factor used to derive the total water supply needs from the sales forecast; thus, it also affects determination of both water costs and purchased power expense. San Gabriel forecasts 6.8%, based on a five-year average. ORA recommends 3.7% because it believes that a low level of water loss can be maintained by prudent management. We find that a drastic reduction of water losses, such as ORA recommends, is not reasonably feasible. For example, other than pipeline leaks which should be fixed, water is lost through flushing of mains and testing fire hydrants, and such losses vary from system to system. We adopt San Gabriel's forecast based on a five-year average of 6.8% since it is within a reasonable range for such losses.

2. Reclaimed Water

San Gabriel estimates no sales of reclaimed water during the test years. ORA estimates that 7,000 acre-feet of reclaimed water at $150 per acre-foot would be used in each of the test years. ORA's assumption is based on an e-mail from a City of Fontana employee that suggests reclaimed water is available but recognizes that facilities first must be built to transport the water. San Gabriel points out that not only are the needed transmission and distribution facilities not built or even planned yet, but there are no known customers who have expressed an interest in purchasing reclaimed water or who have on-site facilities available to receive reclaimed water. We adopt San Gabriel's estimate since it is unlikely that there will be facilities in place for distribution of reclaimed water during the test years. However, we expect San Gabriel to actively pursue this matter with City and provide the Commission with a report in its next NOI filing, detailing the effort it has made in this area.

3. Water Purchases from Cucamonga County Water District

ORA estimates the purchase of an additional 5,000 acre-feet of water from CCWD (beyond San Gabriel's forecasted 5,000 acre-feet) during the test years based on previous year purchases. According to San Gabriel, CCWD has stated by letter that it cannot guarantee San Gabriel the same amount of water will be available in the future. We adopt San Gabriel's estimate since there is no guarantee that the additional water will be available.

4. Water Costs

San Gabriel forecasts increases in water costs by applying non-labor escalation rates to current supplier prices. San Gabriel's forecasts are based on the availability of water from each individual source, using the most economical source first and using forecasts of the quantities that may reasonably be available from each source. ORA did not allow for any price increase and simply applied the year 2002 recorded expense. We find San Gabriel's estimating process more reasonable since it is based on usage of the most economical source first. However, we adjust San Gabriel's estimate to reflect current supplier prices without any escalation. As is customary, San Gabriel should recover additional costs due to price escalation through its Water Production Balancing Account.

5. Purchased Power Costs

San Gabriel forecasts its purchased power expense based on recorded 2002 billing information, site-specific energy forecasts, and the actual tariffs of Southern California Edison Company (Edison). As with its estimate of water costs, ORA used 2002 recorded (non-weather-normalized) expenses. ORA then applied ratios based on water consumption and Edison's average rate decrease effective August 1, 2003. We adopt San Gabriel's forecast since it is based on the pumping requirements at specific facilities and the applicable Edison tariffs.

6. Chemicals Expense

San Gabriel forecasts test year Chemicals Expense by starting with a five-year average of recorded expenses and applying non-labor escalation rates. In addition, San Gabriel made separate adjustments for: (1) forecasted water supply, (2) the additional flow of SWP water through the Sandhill Treatment Plant, and (3) chemicals needed for new wellhead treatment facilities. ORA averaged three of five recorded years and did not adjust for identifiable increases in chemicals usage. We adopt San Gabriel's estimate since it better reflects expected usage during the test years.

7. Plant F10 Treatment Plant Reimbursements

Fontana customers directly benefit from the Mid-Valley Settlement Agreement, under which San Bernardino County must reimburse San Gabriel for all ongoing Operation and Maintenance (O&M) expenses for operating the F10 Treatment Plant to remove volatile organic compounds from the groundwater produced at that site and Plant F49. San Gabriel bills the County monthly for those expenses, and the reimbursements are recorded in Account 614, Other Water Revenues. San Gabriel updated its test year estimates for Plant F10 treatment O&M expenses and made corresponding estimates of Other Water Revenues in the same amounts so that treatment expenses are revenue-neutral for ratemaking purposes. ORA adopted the County's projected annual reimbursements to San Gabriel of $531,800 and $447,300 for Test Years 2003 and 2004 as Other Water Revenue but failed to include corresponding amounts in O&M expenses. Though we adopt San Gabriel's estimates here, we will include the reimbursement for ongoing Operation and Maintenance expenses in the audit of proceeds from the County. Any discrepancies in the company's accounting of these expenses will be subject to refunds.

8. Labor Costs – New O&M Positions

San Gabriel requests authorization of 13 new positions in its Fontana Division over the three-year period covered by its application. Nine positions are classified as O&M, and four positions (discussed later) are classified as Administrative and General (A&G). The nine O&M positions, fully described in Exhibit 10, comprise two customer servicemen, one field meter repairman, five water treatment operators, and one plant maintenance man "B." San Gabriel states that the two customer servicemen are needed to maintain a high level of customer service; the field meter repairman is needed to assist the existing one repairman; and the five water treatment operators are needed for the extensive monitoring and water quality sampling now required and for operating the Sandhill Treatment Plant, which will be upgraded. ORA opposes San Gabriel's request on the grounds that existing staff is sufficient and San Gabriel has yet to build the new facilities for which it has requested additional personnel.

We approve San Gabriel's request for nine new O&M positions subject to certain conditions. San Gabriel's request is reasonable considering the growth (over 1,000 connections per year) the Fontana Division is experiencing, its complex system of 34 wells and five pressure zones that require careful management, its perchlorate and nitrate contamination problem, and the proposed new wellhead and surface water treatment plant upgrades it expects to construct. However, ORA has valid concerns that in the past San Gabriel has not filled positions allowed in rates, and the plant for which additional personnel has been requested, is not yet built. Therefore, we will not allow these positions in rates at this time, but will require San Gabriel to file an advice letter to include the expenses for these positions in rates after San Gabriel has hired these personnel. The advice letter filing will be allowed only once a year.

B. Other O&M and A&G Expenses

1. Materials & Supplies (M&S) Expense

M&S expense is a subaccount within various O&M and A&G accounts. San Gabriel uses a five-year average escalated by non-labor escalation rates. ORA's estimates are based on recorded amounts for the past five years after dropping the lowest and highest recorded figures, increased by ORA's inflation factors. ORA provides no justification for dropping the highest and lowest recorded five-year figures. We adopt San Gabriel's estimate because its method of estimating test year expense is more reasonable.

2. Transportation Expense

San Gabriel uses a five-year recorded average of transportation expense escalated by non-labor escalation rates. ORA's estimate is based on the average amounts recorded for this account for the past five years, after dropping the lowest and the highest recorded figures, increased by ORA's factors of inflation. ORA provides no justification for dropping the lowest and highest recorded five-year figures. We adopt San Gabriel's estimate because its method of estimating test year expense is more reasonable.

3. Outside Services Expense – Other Than Legal Expenses

ORA's estimates are $163,900 and $166,000 and San Gabriel's estimates are $210,300 and $232,000, for Test Years 2003 and 2004, respectively. ORA's estimates are based on the average amounts recorded for the past five years, after dropping the lowest and the highest figures, increased by ORA's factors of inflation. ORA provides no justification for dropping the lowest and highest figures. San Gabriel's estimates are based on a combination of five-year average, recorded 2001 and a special forecast. Because the expense levels in certain accounts vary with the amount of physical plant, San Gabriel forecasted these expenses using 2001 recorded information and adjusted for the forecast amounts of plant as well as inflation. We adopt San Gabriel's estimate because its method of estimating test year expense is more reasonable.

4. Outside Services – Legal Expenses

Outside Legal Expense consists of two components: litigation issues not related to perchlorate contamination and perchlorate contamination-related litigation issues. These two categories of expense typically receive different ratemaking treatment.

a) Non-Perchlorate-Related Legal Expenses

San Gabriel estimates $479,644.23, $495,952,15, and $515,294.28, for Estimated Year 2002 and Test Years 2003 and 2004, respectively, for outside legal expenses unrelated to perchlorate groundwater contamination. San Gabriel analyzed its outside legal costs over a 10-year period to develop an average, normalized estimate applicable to Fontana Division. ORA estimates the non-perchlorate-related test year expense by averaging the two years of lowest recorded expense. ORA offers no explanation for selectively averaging the two lowest years of recorded expense. We adopt San Gabriel's estimate because San Gabriel's estimating procedure is more reasonable.

b) Perchlorate-Related Legal Expenses

San Gabriel estimates expenditures for outside legal costs for perchlorate contamination-related issues based on a forecast of its share of the Perchlorate Task Force legal fees and costs. ORA excludes all perchlorate contamination-related expense in the test years because it believes such expenses should be dealt with separately in a memorandum account.

The issue here is whether test year ratemaking or memorandum account treatment should be applied. We conclude that, as recommended by ORA, costs of outside legal services related to perchlorate contamination should be excluded from test year expense and be recorded in a memorandum account. A final accounting is necessary after payments are received from condemnation suits to determine the proper allocation of these payments between ratepayers and shareholders. San Gabriel should provide such an accounting so that this issue may be reviewed in the next Fontana GRC proceeding. We adopt ORA's recommendation of memorandum account treatment of perchlorate-related legal expenses.

5. Utilities and Rents Expense

This sub-account consists primarily of purchased power expense for the lighting, cooling, and heating of office buildings and service facilities. Because of significant changes in Edison tariffs in 2001, San Gabriel based its forecast on 2001 recorded information and non-labor escalation rates. ORA accepts San Gabriel's forecast but such acceptance was apparently limited only to Operations Expense. We likewise adopt San Gabriel's forecast of Utilities and

Rents Expense since San Gabriel derived its forecast using the same methodology that ORA accepted for Operations Expense.

6. Employee Pensions & Benefits

Account 795, Pensions & Benefits, consists chiefly of Vacations, Holidays, Sick Leave, Pensions, insurance, and other minor expenses. We will adopt San Gabriel's estimates for uniforms and for life and long-term disability insurance, as those estimates are undisputed. The other items are discussed below.

a) Vacation, Holidays, Sick Leave, and Pensions

Differences between forecasts by San Gabriel and ORA are due to payroll and escalation rate issues discussed in other sections of this decision. We adopt San Gabriel's estimate since we are adopting its estimate of employees.

b) Health Insurance

San Gabriel's forecast is based on known premium increases through June 2002, projected employment levels through the test years, and estimated 15.37% and 22.34% increases in 2003 and 2004, respectively. San Gabriel's witness provided documentation to support these forecasted increases. ORA accepted that premiums increased by 14.02% in 2002, but applied non-labor escalation rates of 1.80% and 1.81% to arrive at test year estimates. ORA's estimate of $189,486 for Test Year 2003 is far less than the recorded $306,241. San Gabriel's estimates are $383,781 and $442,500 for the test years. We adopt San Gabriel's estimates since they appear to be more reasonable than ORA's.

c) Dental Insurance

San Gabriel's forecast is based on recorded 2002 expense and estimated 14.97% and 16.33% increases in 2003 and 2004, respectively. ORA estimates a Test Year 2003 expense of $23,420, which is about 30% lower than recorded 2002 expense of $34,485. We adopt San Gabriel's estimates since they appear to be more reasonable than ORA's.

d) d) Business, Property and Umbrella Liability Insurance

San Gabriel's business, property, and umbrella liability premium for 2002 ($243,263) was known at the time the application was prepared. Based on discussions with its insurance brokers, San Gabriel projected a 38% increase for 2003 and a 10% increase for 2004. These estimates were updated in San Gabriel's rebuttal testimony to reflect the actual 2003 premium ($436,916 – an 80% increase over 2002) and an additional 20% increase for 2004. San Gabriel witness Nicholson explained how the expiration of a three-year rate guarantee, starting in 2000 at a very favorable premium, along with subsequent events such as the September 11 attack that caused insurance rates to "skyrocket," contributed to a substantial premium increase experience for Test Year 2003. According to Nicholson, the insurance broker now estimates a further 20% increase in 2004.

ORA's estimate is significantly lower. ORA started with the same $243,263 premium in 2002 but escalated this premium by 1.80% for Test Year 2003 and 0.40% for Test Year 2004. ORA used non-labor escalation rates to estimate the test year expense even though ORA's escalation memorandum explicitly states that non-labor rates should not be applied to insurance.

An issue specific to umbrella insurance is the allocation of the premium among San Gabriel and its non-utility affiliates. San Gabriel negotiates a single umbrella policy covering the water utility and its affiliated companies in order to achieve greater buying power and lower overall premium cost for San

Gabriel and each of its affiliates. However, each affiliate, including San Gabriel, is separately billed by the insurance broker. ORA, alleging that San Gabriel has some control over the allocation of the total premium to each affiliate because the invoices are issued by the insurance broker rather than by the insurance company, allocated 45% of San Gabriel's premium expense to the affiliates. We adopt San Gabriel's estimate since it more reasonably reflects actual increases in insurance costs, and there is no evidence of wrongdoing by the insurance broker.

e) Workers' Compensation Insurance

San Gabriel based its forecast of Workers' Compensation insurance premium on rates in effect on July 31, 2002, ($292,686) and estimated mid-year increases of 30% in 2003 and again in 2004. However, the actual increase in San Gabriel's premium effective July 1, 2003, was significantly higher than forecast. San Gabriel also had not made any upward adjustment to its forecast for growth in the number of employees. ORA adjusted San Gabriel's original forecast downward to reflect ORA's proposed 13.62% decrease in overall payroll for year 2002, and allowed only the non-labor escalation factor of 1.8% for Test Year 2003 and 0.4% for Test Year 2004. We adopt San Gabriel's estimate because it is more consistent with actual premiums that have to be paid.

7. Regulatory Commission Expense

San Gabriel's estimate of $70,050 is based on a recorded five-year average (approximately $2,500 / year) plus the estimated cost of retaining Dr. Zepp and consulting engineer Wildermuth to provide expert testimony.
San Gabriel requests amortization of these costs over the three-year term of this rate case. San Gabriel did not include its legal fees for this proceeding, which at the conclusion of hearings exceeded $100,000, because it did not anticipate the complexity of this case (e.g., an unprecedented number of contested issues,

motions, depositions, and hearings over three weeks in two cities). ORA recommends disallowing 50% of San Gabriel's requested allowance for outside expert costs because it considers San Gabriel's request to be an enormous burden on Fontana ratepayers. We find San Gabriel's request reasonable given its recent experience. We adopt San Gabriel's estimate of $70,050 amortized over three years.

8. Labor Costs – New A&G Positions

San Gabriel seeks approval of four new A&G positions, namely, Assistant General Manager, Engineer / Draftsman, Water Quality Specialist, and Human Resources Clerk. San Gabriel justifies the positions as follows. The Assistant General Manager is needed to help with the workload because the General Manager devotes a great amount of time dealing with the groundwater contamination problem. The Engineer / Draftsman is needed to deal with the backlog and to work with developers and regulatory agencies regarding construction projects. The Water Quality Specialist is needed to review all laboratory results for compliance with safe water record keeping for the appropriate regulatory agencies. The Human Resources Clerk is needed in Fontana Division because the two current employees in the Los Angeles Human Resources Department cannot cope with the Fontana Division workload.

ORA opposes these four new positions on the grounds that the General Manager has sufficient numbers of staff, the General Engineering Department can provide sufficient engineering and drafting services, and the Water Quality Superintendent should coordinate with the Production Superintendent and the Production Foreman at Fontana Division. Similarly, ORA faults San Gabriel for not providing a study showing the need for the requested Human Resources position.

We authorize the four new positions since Fontana Division has had to cope with significant growth in the last several years and the growth is expected to continue. However, as pointed out by ORA, in the past San Gabriel has taken its time to fill authorized new positions. Therefore, after San Gabriel has filled an authorized position, it may file an advice letter to include in rates the cost related to the filled position. Such advice letters will be allowed only once a year.

VII. General Office

General Office expenses are apportioned between Fontana and Los Angeles Divisions.

A. Officers' Salaries

The issue here is ORA's recommendation that San Gabriel's officer's salaries be cut. We do not adopt ORA's recommendation for the reasons discussed below.

ORA contends that San Gabriel's executive salaries have increased higher than necessary to account for inflation, and it recommends reductions in estimated Common Payroll Expense of 21.2% and 24.2% for A&G; 12.2% and 15.8% for O&M; and, 7.6% and 11.2% for Customer Accounts, for Test Years 2003 and 2004, respectively. ORA's recommendation is based on an American Water Works Association (AWWA) Compensation Survey for the year 2001. First, ORA calculated an average for the AWWA categories of "Board Operated," "Private," and "State of California" systems. Next, ORA used salary data for Commission regulated Class A water companies, applied ratios for "Number of Connections" and "Total Utility Plant" to that data, and derived an average of those figures. Then, ORA determined its overall salary adjustment by calculating the average of its AWWA Survey averages and the Class A Water Company salary averages.

San Gabriel uses the Employers Group[6] Executive Compensation Survey as a benchmark for determining the adequacy of its salaries for executives and positions such as accounting, legal, drafting, and other position types that cross industry boundaries. San Gabriel believes that the Employers Group survey is more reflective of the overall job market in which San Gabriel must compete than other available surveys. According to San Gabriel, the 2001 Employers Group Executive Compensation Survey shows that executive salaries increased at substantially above the general rate of inflation in 2001. For example, the average Chief Executive Officer's base salary increase for non-manufacturing firms was 8.59% and for other executives was 7.95%, reflective of the market factors that San Gabriel believes it must consider to attract and retain qualified executives.

We do not agree with ORA's proposed executive payroll reductions because it is not reasonable to use averages from a national survey, such as the 2001 AWWA survey, to assess the reasonableness of salaries in the Southern California job market. Also, the AWWA survey does not adjust its compensation figures for pensions and benefits normally provided by governmental agencies, which comprise the majority of respondents in that survey. Furthermore, applying ratios based on Number of Customers and Plant in Service to make comparisons with salaries paid by other Class A water companies makes little sense since salaries are not directly proportional to these numbers. For these

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[6] The Employers Group is an association of businesses that provides human resources information, including comprehensive salary surveys and benefit information, to more than 4,000 members in Southern California.

reasons, we adopt San Gabriel's estimate since its method of setting executive salaries is more reasonable.

B. Disallowance of Chairman's Salary

ORA recommends disallowance of 100% of the Chairman's salary. ORA believes that 50% of the salary should be allocated to Arizona Water Company and that the remaining 50% should be disallowed because there are similarities between the responsibilities of the Chairman and the President of San Gabriel.

San Gabriel responds that the Chairman, President, and other executives and employees, who devote time to Arizona Water Company or other affiliates, maintain daily records tracking the direct amount of time they devote to those affiliates. According to San Gabriel, those daily time records are kept in accordance with agreed-upon procedures established and adopted by the Commission in D.93-09-036. Those daily time records and associated charges were admitted as evidence in this case. (Exhibit 8, Attachments F and H.) We will not disallow any portion of the Chairman's salary since San Gabriel appears to be in compliance with D.93-09-036, and we find nothing else in the record that might support the recommended disallowance.

C. Allocation of Chairman's and President's Salaries

Apart from its disallowance recommendation discussed above, ORA opposes allocating to San Gabriel ratepayers part of the salaries paid to San Gabriel's officers. Specifically, ORA states that San Gabriel provided conflicting and incomplete information regarding the time and salary amounts of San Gabriel's officers charged to its affiliates. Thus, until a time and motion study or audit is performed and verifiable accurate records of the President's time are provided, ORA contends that at a minimum, 10% of the President's salary and salaries of other key executives should be allocated to Arizona Water Company and other affiliates.

San Gabriel responds that the Chairman and President receive salaries directly from Arizona Water Company, compensating them based on the amount of time they devote to that company's matters.[7] According to San Gabriel, the amounts shown in the monthly summaries of San Gabriel's inter-company charges for services to affiliates do not include those salaries because they are paid directly by Arizona Water Company. The monthly summaries of charges reflect only the time the Chairman and President devoted to the affiliates other than Arizona Water Company. (Exhibit 8, at 27.) Further, San Gabriel states that information on the salaries Arizona Water Company paid directly to the Chairman and President was provided to ORA and are shown in witness Batt's rebuttal testimony (Attachment K to Exhibit 8).

We reject ORA's proposed adjustments for the same reasons we rejected the disallowance discussed above. As far as the record discloses, San Gabriel executives' daily time records are kept in accordance with the procedures established in D.93-09-036.

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[7] San Gabriel witness Batt provided a monthly summary of the actual time the Chairman and President devote to Arizona Water Company matters. (Exhibit 8, Attachment F.) San Gabriel's President Michael Whitehead testified that he maintains daily time records of the hours devoted to Arizona Water Company matters. Witness Batt testified to the same effect regarding San Gabriel's Chairman.

D. New Positions in General Office

We approve San Gabriel's request for three new positions in its General Office needed to respond to the increasing complexity of regulatory requirements affecting water utilities. These new positions are discussed below.

1. Property Manager

San Gabriel states that the property manager will determine the fair value of property; negotiate agreements; work with escrow, environmental survey and title companies; oversee licenses, easements, leases, and rights-of-way; and, monitor property tax assessments, zoning changes and public works projects. ORA is concerned that a property manager would provide services for some of San Gabriel's affiliates such as Rosemead Properties. San Gabriel responds that even if services are provided for an affiliate, that time would be tracked and the affiliate would be charged for the actual costs associated with the services. Further, San Gabriel disputes ORA's assertions that the duties of the property manager are well suited for consultants to perform. San Gabriel states that especially in Fontana, because of the growing system, hiring a consultant to handle property acquisitions would be expensive and would still require one or more San Gabriel officials to direct and oversee that process. We approve San Gabriel's request because the growth in Fontana Division justifies the new position.

2. Accountant

San Gabriel states that the accountant will assist the chief accountant, who is currently the only employee in the Accounting Department with training and work experience regarding utility accounting methods including the Uniform System of Accounts. ORA opposes San Gabriel's request on the grounds that existing staff is adequate to handle San Gabriel's accounting requirements. We approve San Gabriel's request because it is reasonable that the chief accountant have someone to assist him in utility accounting matters, and to provide back-up when he is not available.

3. Rate Analyst

San Gabriel states that the rate analyst will assist and support the preparation of general rate cases, other Commission applications and advice letters; assist in maintaining balancing and memorandum accounts; respond to data requests; and prepare pro formas and various rate analyses. According to San Gabriel, its Rate Department presently consists only of the Director—Rates and Revenue and an auditing clerk who focuses on accounting activities. ORA opposes the request on the grounds that San Gabriel currently has sufficient work force to prepare rate cases and thus the additional position is not required. We approve San Gabriel's request because it needs to be in a position to better respond to the increasing complexity of its rate proceedings.

4. Discussion

As discussed above, we approve the three new General Office positions. San Gabriel has adequately demonstrated the need for these positions. However, in the past, San Gabriel has taken its time to fill authorized new positions. Therefore, after San Gabriel has filled an authorized position, it may file an advice letter for inclusion in rates of the costs related to the filled position. Such advice letter filings will be allowed only once a year.

E. Exclusion of Existing Management Positions

ORA recommends that the four existing positions of Director of Tax Accounting, Financial Analyst, Senior Engineer and Vice President be excluded for ratemaking purposes. The record does not support ORA's recommendation, and we reject it, as discussed below. Briefly, the weight of evidence is that the positions are needed and should be reflected for ratemaking purposes.

1. Director of Tax Accounting

ORA recommends disallowance of this position, claiming that the Director of Tax Accounting prepares Internal Revenue Services Form 5500 filings for Arizona Water Company. According to San Gabriel, however, the only Form 5500 filings the Director of Tax Accounting prepares are San Gabriel Valley Water Company's. Further, San Gabriel states that the majority of the work of the Director of Tax Accounting is on San Gabriel matters. Only 42.6 hours of her time were spent on affiliate matters in 2002, and all of that time was paid for by the affiliates. San Gabriel points out that the Commission specifically evaluated the need for and approved the position in D.92-04-032. We reject ORA's recommendation. The weight of the evidence is that almost all the work of this position is performed for the California utilities and the small amount that is not is properly accounted for and charged to the affiliates.

2. Financial Analyst

According to San Gabriel, the financial analyst prepares various reports on such items as pro forma bank balances and short-term borrowing for use by management; monitors and initiates long-term debt payments; and acts as liaison with Bank of America to resolve problems. ORA asserts that these functions could be performed by other personnel such as the Chief Accountant, the General Accountant, or Treasurer. San Gabriel responds that each of these positions has a full slate of duties currently. We find that San Gabriel has justified this position.

3. Senior Engineer

ORA asserts that a vacant Senior Engineer position should be eliminated because San Gabriel's engineering needs are covered by other engineering positions. San Gabriel's Engineering Department currently has only two registered engineers—the Chief Engineer and the Senior Engineer. San Gabriel states that in its most recent Los Angeles County Division rate case (which covers part of the period of this rate case), the Commission approved a third engineering position in the General Office. San Gabriel says that the engineer is needed to work with developers, and it has advertised and interviewed applicants for this position. According to San Gabriel, it has not been able to hire anyone due to the scarcity of qualified engineers and the intense competition for water system engineers among water companies and water agencies. We find that San Gabriel has justified this position.

4. Vice President

ORA argues that since San Gabriel has a Human Resources Manager and a Manager of Customer Services, the position of the Vice President is redundant. San Gabriel's Vice President Robert W. Nicholson described his own duties as follows: Overseeing the Human Resources Department and the Los Angeles Division Customer Service Department; representing San Gabriel as a board member on the Main San Gabriel Basin Watermaster and as an alternate board member on the Chino Basin Watermaster; procuring and administering all of San Gabriel's business, property, and umbrella liability insurance policies, workers' compensation insurance policies, and employee pensions and benefits policies; in the absence of a Property Manager, handling all San Gabriel's property matters; and being responsible for strategic planning. According to San Gabriel, the Vice President has general oversight responsibilities, whereas the managers are responsible for day-to-day operations of the departments. We find that San Gabriel has justified this position.

VIII. Components of Rate Base

A. Plant Additions—Overview

As discussed earlier, we find San Gabriel's construction plan to be overly ambitious and limit construction to the 3-year average of the recorded company funded plant additions for the period 2001 through 2003. We generally approve San Gabriel's construction plan subject to this cap and expect the utility to prudently manage its funds and prioritize its needs. Below, we discuss the key features of San Gabriel's plan.

1. Wellhead Treatment Facilities and Surface Water Treatment

In its Priority List of capital projects (Exhibit 54), San Gabriel substituted upgrades to the Sandhill Treatment Plant (estimated to cost $3.0 million), which will allow full use of its 20 mgd capacity, in place of the near-term development of the new west-side treatment plant (estimated to cost $17.0 million). All parties appear supportive of the proposed upgrades to the existing Sandhill Treatment Plant.

All parties agree the costs of perchlorate removal treatment ought to be borne by the polluters. San Gabriel states that as directed by the Commission in Resolution W-4089 (January 21, 1998) and Resolution W-4094 (March 26, 1998), San Gabriel is actively pursuing those polluters.

Contending that less expensive alternatives are available, City, School District and ORA oppose San Gabriel's plan to install wellhead treatment plants. However, San Gabriel argues that construction of seven wellhead treatment plants (each costing about $1.75 million) cannot be put on hold awaiting the outcome of litigation and receipt of funds from third-party sources, which may take many years to achieve. According to San Gabriel, it urgently needs the restoration of lost production capacity now, so the treatment systems must be built now even though the costs have not yet been recovered from the polluters. Therefore, the tasks of cleaning up the contaminated ground water and pursuing the polluters for reimbursement are being conducted concurrently. As it has already done in its Los Angeles County Division, San Gabriel proposes maintaining a memorandum account to record the proceeds already received and future possible recoveries of treatment plant costs and operating expenses from polluters and possible grants from state or federal sources so the cost borne by the customers can be mitigated. We agree with San Gabriel's plan to construct wellhead treatment plants and to implement a memorandum account since the record supports such a course of action.[7]

2. Wells

The Chino Basin is the only reliable source of water currently available to Fontana Division. Accordingly, San Gabriel proposes to drill three new wells (F51A, F51B, and F51C) in Test Year 2003 and one new well (F7B) in Test Year 2004. San Gabriel witness Black testified that without restoring contaminated wells and drilling new wells, Fontana Division would likely not be able to meet peak summertime demands. We agree with San Gabriel's plan to drill new wells to meet peak summer time demands since the record shows that Fontana Division had difficulty meeting those needs in the summer of 2003.

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[7] See Exhibit 96 – Statement of California Regional Water Quality Control Board.

3. Reservoirs

San Gabriel plans to construct six reservoirs in Test Years 2003 and 2004 at a cost of $4.55 million. ORA acknowledges that one reservoir is necessary but proposes that the other five reservoirs be disallowed. ORA argues that the proposed increase in storage capacity far exceeds the increments in such additions during the prior 15 years, and that compared to another [unspecified] Class A water company, Fontana Division has enough storage capacity.

We reject ORA's recommendation because there is no logical relationship between historical increases to capacity and the additions to storage capacity that are presently needed. ORA also fails to explain why the water storage capacity of another water utility is relevant to Fontana Division's water storage needs. Accordingly, we adopt San Gabriel's plan for new reservoirs since the current rate of growth supports such additions.

4. Booster Stations

San Gabriel plans booster stations at five sites to deliver water produced from lower elevations in the Chino Basin to higher pressure zones within the system. ORA agrees that a new booster station should be built for plant F-16 at a cost of $395,000, but believes additional details need to be provided to the Commission before this item is included in rates. ORA does not state what additional information is needed. We adopt San Gabriel's plan for booster stations since the record supports San Gabriel's need for flexibility to pump water to its five pressure zones.

5. SCADA System

San Gabriel budgeted $1.2 million to design and construct a new SCADA system to control and monitor wells, booster pumps, reservoirs, treatment plants, and disinfection facilities, as well as gather and store production data, system pressures, and flows. Fontana Division's existing telemetering system is not computerized, cannot be expanded, and is more than 35 years old. According to San Gabriel, the new SCADA system will allow continuous monitoring of all facilities and promote more efficient operations. ORA recommends exclusion of this investment on the basis that San Gabriel has not made an adequate showing and there is no urgent need for a SCADA system.

We approve San Gabriel's plan to install a computerized control system. We find that Fontana Division needs to be better able to manage its complicated system of 34 wells and five pressure zones, and the existing system has outlived its useful life.

6. Security Equipment

San Gabriel budgeted $1 million for security equipment to be installed at 20 sites. ORA recommends that no expenditure be approved. San Gabriel provided justification of the need for this equipment to prevent unauthorized tampering with or disruption of the water system.

We adopt San Gabriel's plan for installing security equipment. Following the events of September 11, 2001, and the recently enacted Public Health and Bio-Terrorism Act signed by President Bush into law in June 2002, it is necessary that San Gabriel develop a security plan in conformance with industry guidelines.

7. Emergency Generators

San Gabriel proposes to install four emergency generators at a cost of $400,000 to operate its wells, booster pumps, and treatment plants when electrical outages occur. ORA opposes the installations on the premise that the existing emergency generators have not been used. San Gabriel responds that the emergency generators were used during the recent fires in the Fontana area when electrical power was interrupted. We approve San Gabriel's request. The recent fires underscore the need for emergency power. Sound water system operations and planning, particularly in Fontana Division with its five different pressure zones and high-fire risk, requires that it be prepared for severe, if infrequent, outages.

8. Water Treatment and Distribution Mains

ORA agrees with San Gabriel's 2003 capital budget for water transmission and distribution mains, but contends that the $7.47 million required for Test Year 2004 is excessive and unsupported. We adopt San Gabriel's plan for additional mains because the system growth being experienced in Fontana Division justifies such expenditures.

9. Vehicles

San Gabriel budgeted $270,000 in each of the test years for transportation equipment. ORA used an average of 2000 and 2002 recorded expenditures for its $69,107 estimate, dropping the much higher level of expense San Gabriel incurred for such equipment in 2001. San Gabriel states that it replaces vehicles at the earlier of 120,000 miles or 10 years of age, and that it adds vehicles required for certain new employees or for replacing vehicles damaged beyond repair. The record supports San Gabriel's plan for new vehicles, and we approve its budget request.

10. Tools & Equipment

San Gabriel budgeted $125,000 for Test Year 2003 and $5,000 for Test Year 2004. ORA recommends the recorded 1999-2001 average of $10,771, leaving out the substantially higher expense incurred for these items in 2002, amounting to $56,900. We adopt San Gabriel's estimate since it is based on actual expected needs.

11. New Building

San Gabriel initially budgeted $3 million to replace Fontana Division's administrative and operations offices. San Gabriel states that these facilities are now housed in seven old, overcrowded, and unsafe structures. During the course of these proceedings, San Gabriel revised the estimated cost to $6 million. San Gabriel submits that a new building will provide a safer and more efficient working environment than the existing array of very old facilities, and therefore should be approved. City, School District and ORA oppose this new facility on the basis that it is not needed or that it is a luxury the ratepayers cannot afford.

A new office building may enable Fontana Division to operate more efficiently, but it should be deferred to the next GRC filing, given the rate impact of the other plant additions we are authorizing in today's decision. However, we will allow San Gabriel to purchase the land for a new office building and include the cost in rate base, since land for such a facility in a suitable location may not be available later. If in its next NOI filing, San Gabriel requests authorization to proceed with the new building, it should provide a complete justification and address the ratemaking treatment of the proceeds from the sale of the existing facility.

B. Materials & Supplies (M&S)

San Gabriel's M&S balances are primarily determined by the level of its construction activities. For its test year forecasts, San Gabriel escalated the most recent recorded average M&S balance by both the forecasted increase in average plant and by non-labor escalation factors. ORA based its estimate on a comparison with other water utilities that are not experiencing a level of development and construction activity comparable to Fontana Division's current situation. We adopt San Gabriel's estimate of M&S because it better reflects the current level of construction activity in Fontana Division.

C. Construction Work in Progress (CWIP)

ORA incorporated recorded December 2002 Plant into its test year estimates but, without explanation, applied the recorded December 2001 balances of CWIP as a deduction from that account. Amounts recorded as CWIP ultimately are transferred to Plant, and it is inappropriate to mix recorded data as ORA has done, to calculate test year rate base. Therefore, we adopt San Gabriel's estimate of CWIP.

D. Contributions in Aid of Construction (CIAC)

CIAC recognizes amounts contributed by developers and customers for plant needed solely for their projects. The utility does not earn on contributed plant. ORA excluded from Plant the cost of treatment facilities reimbursed from polluters and government agencies but retained as CIAC the funds provided by those third parties. We adopt San Gabriel's estimate since the mismatch in ORA's estimate is inappropriate for purposes of calculating test year rate base.

E. Fontana Union Water Company Stock

San Gabriel's proposed rate base includes $747,800, which represents its investment in Fontana Union Water Company (Fontana Union), the primary source of its water supply. ORA excluded this investment from its calculation of rate base claiming that Fontana Union had paid dividends to San Gabriel. San Gabriel witness Michael L. Whitehead, an officer and director of Fontana Union for more than 20 years, testified that Fontana Union does not pay dividends, and the only occasion on which Fontana Union ever made a distribution to shareholders occurred in 1989 over San Gabriel's objection and with full disclosure to the Commission. He further testified that the distribution was accounted for in Account 523 and, in the next rate case, applied as a credit to the purchased water balancing account. We find no justification for reversing the historical rate base allowance for San Gabriel's investment in Fontana Union Water Company. Accordingly, ORA's proposed rate base adjustment is rejected.

F. Working Cash

The function of working cash as a component of rate base is to compensate San Gabriel's shareholders for funds provided by them which are permanently committed to the business for the purpose of paying operating expenses in advance of receipt of revenues from customers and to maintain minimum bank balances. Taking into consideration certain proposed ratemaking adjustments that are unrelated to the function of working cash, ORA estimates of negative working cash needs are (-$20.99 million and -$21.852 million). San Gabriel's estimates are positive $0.631 million and positive $0.739 million for the Test Years 2003 and 2004, respectively. San Gabriel's working cash estimate is consistent with the method adopted by the Commission in its prior rate cases. San Gabriel disputes ORA's reduction of San Gabriel's working cash estimate by certain liability accounts, contending that ORA has applied only reductions, but failed to apply all additions to working cash required by Standard Practice U-16. We find that, even after adjusting ORA's estimate by the proposed negative $15.1 million disallowance discussed below, San Gabriel's estimate appears more reasonable. We adopt San Gabriel's estimate of working cash since it has better supported its estimate.

G. Plant Sales/Condemnation Proceeds

The issue of "proceeds from sales and condemnations" was the most hotly contested issue in this proceeding. ORA proposed a $15.1 million reduction to Fontana Division rate base through a reduction in working cash allowance "pending the resolution of these missing or unaccounted proceeds." ORA states that between 1996 and 2001, San Gabriel had a significant amount of utility plant sales and received proceeds from utility plant abandoned because of contamination. According to ORA, for plant sales and condemnations, San Gabriel was paid about $17,430,754, but only accounted for $2,320,909 leaving a balance of $15,109,845 that is "not accounted for." ORA contends that most of the utility plant was still used and useful at the time of condemnation or sale;

therefore, Pub. Util. Code § 790[8] is not applicable. Further, ORA argues that D.93-01-025 requires San Gabriel to have disclosed proceeds from sales and condemnation in its Application, but that it failed to do so.

San Gabriel responds that D.93-01-025, which applied to California Water Service's sale of a system, does not apply here. San Gabriel points out that in this case, San Gabriel has not sold its system, nor has it been relieved of its public utility obligations to its customers (see D.93-01-025, 47 CPUC2d at 599). San Gabriel submits that even if the Commission had such criteria back in 1993, Section 790, which became effective in 1996, controls the property sales at issue here, and supersedes any inconsistent prior Commission policy. San Gabriel submits that it already has provided evidence that it complied with the requirements of Section 790.

San Gabriel's position is that all the sales and condemnation proceeds at issue here are subject to Section 790, because at the time of sale, condemnation, or involuntary conversion, the properties were no longer necessary or useful in the performance of its obligations as a public utility.

San Gabriel explains that the $15,109,845 amount is comprised of four categories of transactions: (1) funds for facilities sold to governmental agencies

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[8] Section 790 provides:

> 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. . . . . (Pub. Util. Code § 790(a), emphasis added.)

under threat or imminence of condemnation ($547,785); (2) plus funds for inverse condemnation from service duplication ($3,814,528); (3) plus funds for involuntary conversion relating to groundwater contamination ($11,071,396); and, (4) minus the amount of facilities reported in data requests but not eligible for tax deferral in the tax return schedules ($323,874). According to San Gabriel, its rebuttal testimony (Exhibit 8) shows that all property sales and condemnation proceeds were properly accounted for as prescribed by the Uniform System of Accounts (Utility Plant Accounts, Instruction 12F, Utility Plant Sold), by precedent set in previous general rate case decisions, and by Section 790.

ORA also contends that San Gabriel did not account for several thousand dollars of interest income from the condemnation proceeds. San Gabriel responds that any interest would be *de minimis* since the proceeds were invested in utility plant in the same year that they were received. San Gabriel refers to Attachment D of ORA's Report (provided by San Gabriel to ORA) which shows investment in utility plant far exceeding the net proceeds received by San Gabriel; thus, San Gabriel claims that any interest was invested in the specified assets.

Further, San Gabriel states that contrary to ORA's assertions that Section 851 requires San Gabriel to obtain Commission approval for sales or transfers of utility plant, a large portion of the proceeds received by San Gabriel relate to inverse condemnation claims or service duplication damages caused by third parties that did not involve the physical taking or selling of utility plant facilities. According to San Gabriel, these are involuntary conversions of its property rights and, thus, San Gabriel would not have occasion to request Commission approval for a taking or damaging of its property or rights that has already occurred.

We are not persuaded that the condemnation proceeds from the County of San Bernardino are subject to Section 790. As San Gabriel points out, no property was ever sold and therefore not subject Section 851, but with that same consideration, Section 790 specifically states, "whenever a water corporation sells any real property." We can then logically conclude that the condemnation proceeds invested in plant additions should be treated as contributions and not included in ratebase. We find enough confusion on this issue to grant the City's motion for an audit of San Gabriel's condemnation proceeds. We will in this decision order Water Division staff to perform an audit prior to Fontana's next GRC of any proceeds San Gabriel received from the County of San Bernardino and will be addressed with Fontana's next GRC. Any proceeds from the County will be removed from rate base and is to be held in a memorandum account until the Commission may fully address the disposition of the condemnation proceeds.

As previously discussed in Section VI.A.7 Plant F10 Treatment Plant Reimbursements, the ongoing Operation and Maintenance expenses from the San Bernardino County for the operation of the F10 Treatment Plant will also be subject to this audit. This is to ensure that San Gabriel is not receiving reimbursement for these expenses from both ratepayers and the County. Any discrepancies on this issue will be subject to refund.

The subject of the condemnation proceeds from the County were not included in the utility's initial filing. The proceeds were uncovered as a result of ORA's discovery in this proceeding. Consequently, we cannot be sure if the company has received any additional proceeds as a result of contamination litigation which has not been disclosed. Though we trust that the condemnation proceeds from San Bernardino County were inadvertently withheld from this proceeding, if Water Division staff should find any other proceeds as a result of other contamination litigation during the audit, we will address those potential funds in the next GRC as well.

IX. Cost of Capital

A. Capital Structure

San Gabriel projects common equity ratios averaging 67.3% for the years 2003-2006. ORA recommends a common equity ratio of 55% for all years. As discussed below, we conclude that for ratemaking purposes, a capital structure with an imputed common equity ratio of 60% is reasonable for San Gabriel.

San Gabriel argues that before adopting a hypothetical capital structure that contains less common equity than San Gabriel actually employs to provide service, there should be compelling evidence that San Gabriel's actual capital structure is inefficient, i.e., not least cost. According to San Gabriel, ratepayers have already received benefits from that actual capital structure in the form of lower costs of debt than otherwise could have been obtained – if debt could have been obtained at all – with the highly leveraged capital structure proposed by ORA for ratemaking purposes. San Gabriel contends that as a relatively small, privately held water utility facing substantial capital needs, it requires a strong equity position to be able to sell bonds on reasonable terms and to finance expected and unexpected investments in a timely manner.

ORA argues that the adopted common equity ratio in past San Gabriel rate cases has been 55%. ORA points out that in D.96-07-057, the Commission concluded that "Rather, we will adopt an imputed equity ratio of 55%, which we believe is a more reasonable and fair ratemaking approach that balances both shareholder and ratepayer interest." Further, ORA contends that a higher equity ratio is inefficient and burdensome to the ratepayers (51 CPUC2d at p. 625). ORA also refers to a decision regarding San Jose Water Company where the Commission stated: "Excess levels of common equity burden the ratepayer with excessive rates. Ratepayers do not receive a tax benefit for paying this revenue requirement on equity as they do from the tax deduction allowed for debt interest payments." (33 CPUC2d at p. 312.)

We believe that since San Gabriel is a relatively small Class A utility, an imputed equity ratio of 60% is reasonable for ratemaking purposes. A strong equity position allows San Gabriel to issue bonds when needed at reasonable terms, and ratepayers have benefited accordingly. Notwithstanding ORA's argument about the need for an efficient capital structure, there is also a tradeoff between high capital costs (high costs for both equity and debt) and tax benefits of debt. As the debt ratio is increased, both debt and equity costs increase and offset the tax benefits of debt. We also note that the Commission has found that an equity ratio of approximately 60% is reasonable and appropriate for small Class A water utilities.[9] Accordingly, we adopt a common equity ratio of 60% for San Gabriel, for purposes of this proceeding.

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[9] For example, the Commission stated in its recent decision in Park Water Company's GRC decision for Apple Valley Ranchos:

"Although Park's approximate 60% equity ratio is slightly higher than the average of AVR's proxy groups and the 48% average of ORA's proxy group, AVR still has a limited source of external financing and its stock is still not publicly traded, justifying a premium ROE. …" (D.03-08-069, mimeo., p. 40.)

B. Effective Cost of Long-Term Debt

ORA agreed with the timing and amount of long-term debt issues in San Gabriel's application. San Gabriel determined the interest rate for new long-term debt issues by adding 246 basis points to the 30-year Treasury bond rate forecast by Value Line. ORA independently verified and agreed with San Gabriel's 246 basis point figure. However, ORA used the forecasted 30-year Treasury Bond rate projected by Data Resource Inc. (DRI) for each year, plus the 246 basis points, to approximate San Gabriel's cost of new long-term debt. ORA's and San Gabriel's computation of the effective cost of long-term debt matched for years 2002 and 2003 while differing slightly in years 2004 through 2006.

Since the Commission regularly uses the DRI forecast, as opposed to Value Line, we will continue to use DRI. On this basis, the adopted costs of new long-term debt issues for San Gabriel are 8.04% for 2004 and 8.82% for 2006. Based on this, the adopted average embedded costs of debt are 8.38%, 8.36%, and 8.35% for 2003, 2004 and 2005, respectively.

C. Equity Cost

Equity cost is a direct measure of the utility's after-tax Return on Equity (ROE) investment. Its determination is based on subjective measurement, and not susceptible to direct measurement in the same way capital structure and embedded long-term debt costs are.

Both San Gabriel and ORA acknowledged the well-established legal standard for determining a fair ROE, and we have many times cited that same legal standard. In the Bluefield Water Works case, the Supreme Court stated that a public utility is entitled to earn a return on the value of its property employed for the convenience of the public, and set forth parameters to assess a reasonable return.[10] That return should be "…reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economic management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."

As the Supreme Court also noted in that case, a utility has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. In 1944, the Court again considered the rate of return issue in the Hope Natural Gas Company case, stating, "[T] he return to the equity owner should be commensurate with returns on investments in other enterprises sharing corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[11]

Hence, we set the ROE at a level of return commensurate with market returns on investments having corresponding risks, and adequate to enable a utility to attract investors to finance the replacement and expansion of a utility's facilities to fulfill its public utility service obligation. To accomplish this objective, we have consistently evaluated quantitative financial models and risk factors prior to exercising informed judgment to arrive at a fair ROE.

1. Financial Models

The quantitative models commonly used in ROE proceedings as a starting point to estimate investors' expectations for ROE are the Discounted

[10] Re: *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virgina* (1923) 262 US 679.

[11] Re: *Federal Power Commission v. Hope Natural Gas Company* (1944) 320 US 591.

Cash Flow (DCF) and Risk Premium (RP). Although the parties agreed that the financial models are objective, the results are dependent on subjective inputs. Detailed description of the DCF and RP models are contained in the record and are not repeated here.

Although the parties agree that the models are objective, the results are dependent on subjective inputs. For example, each party used different proxy groups, betas, growth rates, and calculations of market returns. It is the application of these subjective inputs that resulted in a wide range of ROEs being recommended by the parties as shown by the results of their individual models. From these subjective inputs, the parties advance arguments in support of their respective analyses and in criticism of the input assumptions used by the other party. These arguments will not be addressed extensively in this opinion, since they do not materially alter the model results. In the final analysis, it is the application of judgment, not the precision of these models, which is the key to selecting a specific ROE estimate within the range predicted by analysis.

a) San Gabriel's Financial Models

San Gabriel estimated the ROE investors expected to earn by applying the DCF and the RP models to a selected group of three water utilities. The criteria it used to select this proxy group were that the water utilities have at least one bond rating of A or better from Moody or Standard & Poor (S&P); that are not being acquired and are not likely acquisition candidates; and that there be analyst's forecasts of future earnings, dividends and returns on equity.

San Gabriel supplemented its small sample of water utilities with a separate proxy group of eight gas distribution utilities to which it applied the DCF and RP models. The criteria used by San Gabriel to select this proxy group were that the gas utilities paid dividends; have at least one bond rating from

Moody or S&P that is single A or higher; and, have at least 60% of revenues derived from gas distribution utilities.

San Gabriel derived an overall ROE range from the results of its DCF and RP models as summarized in the following table:

	San Gabriel's Estimated Ranges of Equity Costs
Discounted Cash Flow Estimates	
Based on Water Utilities	12.2% to 12.3%
Based on Gas Utilities *	11.9% to 12.2%
Risk Premium Analyses Estimates	
Based on Water Utilities	12.4% 12.4%
Based on Gas Utilities * Authorized ROEs	11.9% 12.0%
Based on Moody's Gas * Utilities Index	12.3% 12.4%
Estimated Equity Cost Range	11.9% 12.4%
San Gabriel requested ROE	12.25%

- San Gabriel reduced each of these gas proxy results by 50 basis points to make its gas proxy group comparable to water utilities.

b) ORA's Financial Models

ORA estimated the ROE that investors expect to earn from San Gabriel by applying a selected proxy group of six water utilities to the DCF and RP model. The criteria used by ORA to select this proxy group were that water operations accounted for at least 70% of the utility's revenues and that the utility's stock is publicly traded.

ORA applied three variations of the DCF model to mitigate period specific biases and to consider both current and long-term trends. It also applied two variations of the RP model to its same proxy group. ORA derived an overall simplified 8.61% to 10.24% average ROE range from the results of its

DCF and RP models applied to its water utilities' proxy group, as summarized in the following table:

Model	Proxy		
DCF Growth Rates			
3-Month ROE	8.63%		
6-Month ROE	8.63%		
12-Month ROE	8.56%		
DCF AVERAGE			8.61%
RP Period	Five Year	10 Year	
30-Year Treasury Bond	10.49%	10.45%	
10-Year Treasury Bond	10.03%	9.99%	
RP AVERAGE			10.24%
ORA Recommended ROE			9.43%

2. Risk Factors

Risk factors consist of financial, business and regulatory risk. Financial risk is tied to the utility's capital structure. The proportion of its debt to permanent capital determinates the level of financial risk that a utility faces. As a utility's debt ratio increases, a higher return on equity may be needed to compensate for that increased risk.

Business risk pertains to uncertainties resulting from competition and the economy. That is, a utility that has the most variability in operating results has the most business risk. An increase in business risk can be caused by a variety of events that include poor management, and greater fixed costs in relationship to sales volume.

Regulatory risks pertain to the impact on risks that investors may face from future regulatory actions that we, and other regulatory agencies, might take. These risks are assessed to determine whether there is a need to increase or decrease a ROE to compensate investors for added or reduced risks.

San Gabriel witness Dr. Thomas M. Zepp testified that San Gabriel faces far greater operating and business risks than most other water companies. He concluded that just its smaller relative size justifies a 99 basis point risk premium for San Gabriel. Dr. Zepp further testified that other risk factors include the very substantial risk San Gabriel faces related to contamination of its water supplies, including uncertainty as to the availability of its wells, increased investment needs, ongoing and future costs of defending lawsuits alleging tort liability, and the risk of such liability, as well as further risks to San Gabriel's earnings due to the erratic availability of surface water supplies, the lack of financing flexibility for a closely held company like San Gabriel, and the asymmetric treatment of water supply costs under the new balancing account rules adopted by the Commission in D.03-06-072.

ORA's witness Seaneen M. Wilson disagrees with San Gabriel's risk assessment and concludes that no addition to the ROE is necessary. ORA responds that if new investment in water treatment facilities to treat groundwater contamination is required, and if investment in these facilities is determined to be reasonable, the capital projects will be included in rate base and San Gabriel will receive a return on its investment. ORA points out that if San Gabriel faces lawsuits regarding alleged contaminated water, a number of options are available to reduce risk, including a memorandum account to record costs associated with litigation, which will be allowed in rates if found reasonable. Further, ORA argues that San Gabriel's argument for a 99 basis points "small size" premium is based on a flawed analysis. According to ORA, other factors besides size, contribute to differences in earnings.

ORA also disputes San Gabriel's contention that the newly adopted procedures for balancing account recovery increases risk. According to ORA, the revised balancing account recovery mechanism authorized by the Commission in D.03-06-072 continues to allow the utility the opportunity to earn its authorized return, which is all that is required by the Supreme Court. ORA believes that since the risk faced by the water utilities is not increased, no addition to ROE is necessary.

3. Discussion

Ultimately, the choice of factors used to measure an appropriate return on investor's equity is a matter of judgment. Both parties rely on DCF and RP analyses that we have consistently accepted in the past for water companies. In ORA's analysis, we are troubled by the large disparity (163 basis points) between the DCF and RP results. ORA has not explained the reasons for the disparity, nor the logic of averaging two such different results to arrive at a recommended ROE of 9.43%.

By the same token, San Gabriel's use of data including use of a "comparable group" of gas utilities to perform its DCF analysis comparison is questionable. Further, with the availability of memorandum accounts and balancing accounts, we do not find San Gabriel's arguments for a special premium persuasive. In D.92-01-025, p. 23, the Commission stated "Due to the revenue recovery mechanisms for water utilities, we find that water utilities do not face the overall risks as energy and telecommunications utilities." Also, San Gabriel's use of three water utilities rather than the seven as used by ORA, tends to detract from the reliability of San Gabriel's sample. Accordingly, we find that San Gabriel's analysis produces a ROE higher than warranted (12.25%).

On balance, we conclude that an ROE at the upper end of ORA's range of 8.61% -- 10.24% is reasonable and appropriately recognize the business risk facing San Gabriel. Accordingly, we adopt a 10.10% ROE for the period 2003-2006. This constant ROE equates to returns of 9.41% on rate base for test year 2003, 9.40% for test year 2004, and 9.40% for attrition year 2005, as set forth below. We note that a 9.40% return on rate base was adopted by the Commission in D.02-10-058, in the last GRC proceeding for San Gabriel's Los Angeles Division.

	Capital Ratio	**Cost Factor**	**Weighted Cost**
TEST YEAR 2003			
Long-Term Debt	40%	8.38%	3.35%
Common Equity	60%	10.10%	6.06%
Total	100%		9.41%
TEST YEAR 2004			
Long-Term Debt	40%	8.36% *	3.34%
Common Equity	60%	10.10%	6.06%
Total	100%		9.40%
Attrition Year 2005			
Long-Term Debt	40%	8.35% *	3.34%
Common Equity	60%	10.10%	6.06%
Total	100%		9.40%

- Updated DRI January 2004 forecast.

X. Revenue Recovery Issues

A. Balancing and Memorandum Accounts

San Gabriel requests amortization of its balancing and memorandum accounts, the continued availability of existing supply cost balancing accounts, and the addition of a new water quality memorandum account.

1. Amortization of Existing Balances

San Gabriel requests that balances in the water production, purchased power, DHS/EPA, and water quality litigation accounts be amortized through a surcharge or a surcredit, as of the date the Commission issues its decision in this proceeding. The updated undercollected balances for which amortization is requested are as follows:[12]

Balancing and Memorandum Account	Balance	Date of Balance	$/Ccf
Water Production	($1,329,744)	December 2002	($0.0678)
Purchased Power	$2,990,913	December 2002	$0.1526
WQ Litigation	$1,027,047	July 2003	$0.0520
DOHS/EPA	$ 32,413	December 2001	$0.0017
Total	$2,720,629		$0.1385

The requested surcharge/surcredit rates are calculated using Test Year 2004 sales, with interest on the balances continuing to accrue at the 90-day commercial paper rate. San Gabriel meets the earnings test required by D.03-06-072.

We agree that as set forth above, San Gabriel should be authorized a surcharge of $0.1385/Ccf for 12 months to amortize the balances in these four accounts.

[12] Reflects latest figures in Errat to Applicant's Briefs dated December 17, 2003.

2. Continued Need for the Full Cost Balancing Account

San Gabriel maintains a water production balancing account and a purchased power balancing account. Both of these are "full cost" rather than "incremental" balancing accounts, as differences in actual costs versus amounts collected through rates are recorded dollar-for-dollar in these accounts. An incremental balancing account only records expense differences caused by supplier unit price changes but ignores any differences caused by changes in supply mix.

San Gabriel states that the extreme volatility of Fontana Division's supply mix and the large difference in cost among the different sources of supply require retaining the full cost balancing accounts the Commission has approved in previous Fontana Division rate cases. Further, San Gabriel states that a full cost balancing account protects both customers and San Gabriel from significant deviations from GRC forecasts of these expenses and from any supply cost or mix changes that cannot be forecasted before the rates have been determined. Because of these full cost balancing accounts, San Gabriel was able to refund approximately $5 million to its Fontana Division customers through a surcredit that was effective from 1994 through 2000 (Advice Letters 281 and 297). In addition, the $1.3 million overcollection in the water production balancing account shown above is the direct result of savings achieved when a change in the supply mix allowed Fontana Division to use lower cost supplies that could not be forecast in the GRC. According to San Gabriel, without the full cost balancing account, these savings would not flow to the customers.

We note that for Fontana Division, both water production and power supply costs are subject to wide variations, and the supply mix is determined by hydrological conditions that are beyond San Gabriel's ability to predict or control. The full cost balancing account mitigates the risk of inaccurate forecasting and changed hydrological conditions, and ensures that customers only pay the actual cost of service. There is no opposition to Fontana Division's continued use of full cost balancing accounts. Therefore, we grant San Gabriel's request.

3. Requested Water Quality Memorandum Account

San Gabriel requests a water quality memorandum account to record all costs incurred and proceeds received for the capital and operating costs of treatment of contaminated groundwater not yet reflected in rates. Consistent with the Commission-approved practice in the Los Angeles Division (D.02-10-058), San Gabriel proposes in this proceeding to record in the water quality memorandum account any reimbursement from polluters or government funding proceeds ultimately received, so these proceeds can be used to reduce rates. We grant San Gabriel's request for a water quality memorandum account since this proposal is identical to that approved by the Commission for the Los Angeles Division.

4. Proposed Low Income Rate Program

In this application, San Gabriel proposed a low-income rate for qualifying customers. Subsequent to this filing, the Commission declined to approve a similar request in the Los Angeles Division GRC and ordered San Gabriel to file a different proposal that addressed specified matters. (D.02-11-058, Ordering Paragraph 12.) San Gabriel filed A.03-04-025 in compliance with that order. When a decision is issued by the Commission in that proceeding, it should apply to Fontana Division also.

5. Requested Advice Letter Treatment

San Gabriel requests advice letter treatment for six of the seven planned wellhead treatment facilities (the first one was constructed during Test Year 2003) and for the portions of the planned new Westside Treatment Plant (Plant F52) that are not scheduled to be constructed by the end of Test Year 2004. San Gabriel made a similar request with regard to the upgrades to the existing Sandhill Treatment Plant and to the CCWD Interconnnection. San Gabriel's request for separate advice letter treatment of the capital costs for these projects is denied. All capital costs for these projects must be within the rate base cap discussed above. However, after each project is completed and placed into service, San Gabriel may file an advice letter requesting that the operating costs be added to rates if not already included. San Gabriel must supply detailed supporting cost information with its advice letters. Any costs San Gabriel is able to recover from third parties would reduce the amounts San Gabriel proposes to recover from customers. Such advice letter filings will be allowed only once each year.

XI. Alleged Rule 1 Violation

On October 31, 2003, ORA filed a motion requesting that San Gabriel be sanctioned for violations of the Commission's Rule 1. ORA alleges that San Gabriel intentionally misled the Commission by falsely claiming that utility plant had been built and requesting recovery for such expenditures, falsely claiming wells have been shut down to justify funding for new construction, falsely claiming that it received far lower amounts in proceeds from condemned property than it actually had, and failing to disclose important facts relating to condemnation proceeds, and contributions and advances from developers thereby causing the need for rate increases to be overstated by a substantial amount. San Gabriel responded to these allegations on December 19, 2003.

We agree that the burden of proof required in rate case applications falls to the utility and in this specific case, the utility did not present their best case at the outset. Much of the utility's original application was supplemented, updated, or replaced by rebuttal testimony. Under the new general rate case plan proposed in the Water Rate Case Rulemaking 03-09-005, ORA will have a short of amount of time to review GRC applications. San Gabriel's filings in this proceeding would not provide ORA a sufficient opportunity to review the application. We do not find at this time that San Gabriel intentionally misled the Commission, but will place the company on notice that with the rigid schedule proposed in the water rate case plan, this behavior will not be acceptable. ORA's motion is denied.

XII. Comments on Proposed Decision and Alternate Proposed Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure. Comments were filed on April 7, 2004, and reply comments were filed on April 12, 2004 by City, ORA, San Gabriel and School District. Clarifications and corrections were made where necessary.

An alternate proposed decision by Commissioner Geoffrey F. Brown was mailed on May 13, 2004. Comments were filed on ____________________, and reply comments were filed on ________________.

XIII. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and Bertram D. Patrick is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. Fontana Division was barely able to meet its 2003 summer peak-day demand following four years of drought and closure of seven wells due to perchlorate contamination.

2. Fontana Division expects to obtain 80% of its water supply from the Chino Basin; therefore, cleanup of the basin is a high priority matter.

3. The full extent of the perchlorate contamination plume in the Chino Basin has not been defined, and DHS has yet to announce its latest drinking water standard; therefore, San Gabriel needs flexibility to deal with events as they unfold.

4. Fontana Division is adding over 1,000 connections per year and this rate of growth is expected to continue for the next few years, requiring the addition of considerable infrastructure.

5. It is not reasonable to defer addition of new plant in Fontana Division until outside funding is received for contamination cleanup of the Chino Basin.

6. San Gabriel's proposed construction program, while necessary, needs to be spread over more years to reduce rate shock to its customers.

7. The recorded five-year average growth rate of rate base in Fontana Division was 10%.

8. The School District's proposed cap of 2.7% corresponding to the city's growth rate does not appropriately account for water contamination.

9. A cap based on the company's recorded plant additions for the past three years reflects a realistic construction program that accounts for necessary infrastructure improvements and customer growth.

10. The company's recorded plant additions for the period 2001-2003 was $7.6 million.

11. San Gabriel needs flexibility within the rate base cap to make its own decisions about the need for and timing of projects, and to make changes and substitutions as necessary to its proposed construction program.

12. San Gabriel's proposed construction program is reasonable, but should be spread over more years to reduce rate shock.

13. Deferral of the proposed new office building will reduce rate shock to Fontana Division customers. However, purchase of land for the building would be in ratepayer's best interests since land for such a facility in Fontana may not be available later.

14. The cap adopted in this proceeding should include all capital costs that San Gabriel had in its application proposed to recover by advice letter filing. Therefore, San Gabriel should not be authorized to file advice letters to recover any additional capital costs. However, operating costs if not included in rates may be recovered by advice letter filing.

15. San Gabriel has shown a need for nine new O&M positions, four new A&G positions, and three new General Office positions.

16. Each new position authorized today should be included in rates after San Gabriel has filled the position and filed an advice letter for inclusion of the cost in rates. Such advice letter filings will be allowed once each year.

17. Section 790 does not apply to condemnation proceeds that San Gabriel received from the County of San Bernardino; therefore condemnation proceeds from the County should be treated as contributions and not included in ratebase.

18. The record is not sufficient to make a determination on the condemnation proceeds received by San Gabriel.

19. An audit is necessary to address the proceeds from the County of San Bernardino.

20. A ROE of 10.10% and return on rate base of 9.4% for Fontana Division should allow San Gabriel to issue debt at reasonable cost and provide reasonable return on investment.

21. The record does not support a reduction in San Gabriel's executive salaries for being unreasonable compared to other utilities.

22. San Gabriel allocates its Chairman's and President's salaries based on actual time spent on affiliate matters.

23. No need has been shown to change the cost allocation method between San Gabriel and its affiliates approved in D.03-09-036.

24. Consistent with the Commission-approved practice in its Los Angeles Division, San Gabriel proposes to record in a water quality memorandum account any reimbursements from polluters or proceeds ultimately received, so that they can be used to reduce rates. Such a memorandum account should be authorized.

Conclusions of Law

1. The rates and charges set forth in Appendix D to this decision are just and reasonable for application by San Gabriel in its Fontana Division in the test years and attrition years as set forth below.

2. San Gabriel's proposed construction program should be approved subject to the cap proposed in this proceeding.

3. Commission review of the reasonableness of San Gabriel's investment in the proposed new office building should be deferred to the next GRC proceeding. However, San Gabriel should be authorized to purchase land for such a building and include the cost in rate base subject to the rate base cap.

4. Fontana Division rates should be set to reflect rate base increases of $7.6 million per year for test year 2004 and, subject to any otherwise applicable earnings test, for each of attrition years 2005 and 2006.

5. In its next NOI filing, San Gabriel should address the use of reclaimed water in Fontana Division.

6. Water Division should perform an audit of the condemnation proceeds received from the County of San Bernardino from 1996 onwards prior to Fontana Division's next GRC so that the Commission can fully address the disposition of the proceeds.

7. San Gabriel should be authorized to open a water quality memorandum account for Fontana Division to record all costs incurred and proceeds received for treatment of groundwater contamination, as approved in D.02-10-058 for its Los Angeles Division.

8. Today's decision should be made effective immediately.

O R D E R

IT IS ORDERED that:

1. San Gabriel Valley Water Company (San Gabriel) is authorized to file in accordance with General Order 96-A, and to make effective on not less than five days' notice, the revised tariff schedules included as Appendices A through D to this order. The revised tariff schedules shall apply to service rendered on and after their effective date.

2. Advice letters for authorized rate increases shall be filed in accordance with General Order 96-A, no earlier than November 1 of the preceding year. The filing shall include appropriate work papers. The increase shall be the amount authorized herein, or a proportionate lesser increase if San Gabriel's rate of

return on rate base, adjusted to reflect rates then in effect, normal ratemaking adjustments, and the adopted change to the pro forma test, for the 12 months ending September 30 of the preceding year, exceeds the lower of (a) the rate of return on rate base found reasonable by the Commission for San Gabriel for the preceding year in the then most recent rate decision, or (b) the return on rate base authorized herein for the preceding year. The advice letters shall be reviewed by the Water Division for conformity with this decision, and shall go into effect upon Water Division's determination of compliance, not earlier than January 1 of the year for which the increase is authorized, or 30 days after filing, whichever is later. The tariffs shall be applicable to service rendered on or after the effective date. The Water Division shall inform the Commission if it finds the proposed increase does not comply with this decision or other Commission requirements.

3. San Gabriel in its next Notice of Intent (NOI) filing for Fontana Division, shall provide a report detailing its efforts to supply reclaimed water to large customers able to use this water for non-potable uses. If necessary, San Gabriel may hire the services of a consultant to assist in this matter, and may request recovery of reasonable costs for such services. San Gabriel is placed on notice that failure to address this matter thoroughly will result in a penalty being assessed against it.

4. San Gabriel's proposed priority list (Exhibit 54) of plant additions proposed to be implemented through 2006, with the exception of the proposed new office building, is adopted subject to the cap imposed by today's decision. The cap is based on the company's recorded plant additions for the period 2001-2003 which was $7.6 million

5. San Gabriel may purchase land in Fontana for an office building and include the cost in rate base, subject to the rate base cap imposed by today's

decision. In its next general rate case proceeding, if San Gabriel requests authorization to construct a new office building, San Gabriel shall address the ratemaking treatment of the proceeds from sale of the existing facility.

6. San Gabriel is authorized to recover through advice letter filings the operating costs for new projects not included in rates.

7. San Gabriel is authorized 13 new positions in its Fontana Division and three new positions in its General Office. The costs for these positions are not included in rates at this time. After San Gabriel has hired personnel for these new positions, it may request rate recovery of these costs by means of an advice letter filing. Such advice letter filings shall be allowed only once every year.

8. Water Division staff should perform an audit of the condemnation proceeds received from the County of San Bernardino from 1996 onwards prior to San Gabriel's next GRC so that the Commission can fully address the disposition of the proceeds.

9. The motion of the City of Fontana for an audit of sale and condemnation proceeds is denied.

10. The motion of the Office of Ratepayer Advocates for sanctions against San Gabriel for violation of the Commission's Rule 1 is denied.

11. For its Fontana Division, San Gabriel is authorized returns on rate base of 9.41% for Test Year 2003, and 9.40% for Test Year 2004 and Attrition Years 2005 and 2006.

12. San Gabriel may amortize through rates all existing balances in its balancing and memorandum accounts, as detailed in today's decision.

13. San Gabriel is authorized use of full cost balancing accounts for Fontana Division subject to the limitations prescribed in Decision 03-06-072.

14. San Gabriel is authorized to implement a water quality memorandum account and it may add to this account future expenditures related to water quality, including operations and maintenance expenses of needed wellhead treatment facilities that cannot reasonably be forecasted, and also to record any reimbursements from polluters or government funding proceeds received for the construction and operation of the new treatment facilities.

15. In its next NOI filing, San Gabriel shall include a report on water quality served to its customers, so that the Commission has a record on which it can make a finding that drinking water quality standards have been met in Fontana Division. A copy of that report shall be provided to Department of Health Services.

16. San Gabriel shall, when the Commission adopts such a program, implement a Low Income Rate Program in Fontana Division identified to that to be authorized by the Commission in Application 03-04-025, for its Los Angeles Division.

17. This proceeding is closed.

This order is effective today.

Dated ____________________________, at San Francisco, California.