

Decision **PROPOSED DECISION OF ALJ VIETH (Mailed 6/20/2005)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the matter of the Application of the
SOUTHERN CALIFORNIA WATER COMPANY
(U 133 W) for an order authorizing it to increase
rates for water service in 2004 in its Region 1
Customer Service Areas by \$179,200 or 2.62% in
the Arden-Cordova CSA; \$93,400 or 1.98% in the
Bay Point CSA; and \$115,900 or 4.55% in the Ojai
CSA; and various other relief.

Application 03-10-057
(Filed October 30, 2003)

O'Melveny & Myers, LLP, by Patricia A. Schmiede,
Attorney at Law, for Southern California Water
Company and Cleveland Lee, Attorney at Law,
for the Office of Ratepayer Advocates.

OPINION ON PHASE 2 ISSUES

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OPINION ON PHASE 2 ISSUES

1. Summary

After reviewing the settlements that resolve the groundwater contamination lawsuits, we approve amortization of the balance in the Arden-Cordova Litigation Memorandum Account (memorandum account), as shown in Appendix A to this decision. Accordingly, we authorize Southern California Water Company (SCWC) to collect the balance, \$21,298,491, through a rate surcharge, which will continue for no longer than 20 years. This balance is \$815,971 less than the amount that SCWC requested because we have moved responsibility for carrying charges on \$8 million in capital expenditures from ratepayers to shareholders, given the terms of the settlement.

If development of land in and around Rancho Cordova in Sacramento County occurs as presently forecast, that development will fund repayment of much of the memorandum account balance through an assessment on new water connections. Under such circumstances, ratepayers actually will pay as little as 30% of this balance and the repayment obligation will be shortened considerably, perhaps to less than eight years.

The settlements provide customers with a secure and reliable replacement water supply, provide shareholders with out-of-pocket cost recovery for capital expenditures they made to prevent any service lapse, and offer ratepayers a means for potential recovery of a substantial portion of the litigation costs. We authorize amortization of the memorandum account balance to avoid the significant write-off that the record indicates would be likely otherwise.

Table 1 shows the impact of today's decision on the average monthly bill for ratepayers in SCWC's Arden-Cordova customer service area.

Table 1
Summary of Surcharge Impact for Typical Customers

Bill Type	Increase in Typical Bill	% Increase Over Present Rates	Typical Bill with Approved Surcharge
AC-1 (Metered rate, 116 Ccf average usage)	\$13.92	19.15%	\$86.60
AC-2 (Flat rate)	\$4.72	14.89%	\$36.42

We direct SCWC, working with the Commission's Public Advisor, to prepare a bill insert to explain the terms of the settlements that resolve the groundwater contamination lawsuits and the reason for the surcharge. We also require annual status reports to the Director of the Water Division on the progress of development until the memorandum account is fully amortized.

2. Background

2.1 Memorandum Account – Origin and Prior Amortization

Commission Resolution W-4181, dated February 3, 2000, authorized SCWC to establish the memorandum account to record certain costs associated with two water contamination lawsuits. SCWC, together with its parent, American States Water Company, filed the lawsuits in October 1999 on behalf of the Arden-Cordova customer service area after high levels of two rocket fuel additives, perchlorate and n-Nitrosodimethylamine (NDMA), were found in

several wells serving the Cordova system, which has approximately 12,000 connections.¹

Resolution W-4181 permits memorandum account entry of litigation expenses and costs related to the development of alternative sources of water supply (e.g., financial carrying costs of capital projects and increased operation and maintenance expenses), but expressly prohibits recovery of public relations costs. Consistent with standard regulatory policy, the resolution does not guarantee rate recovery of any of the recorded costs, but conditions recovery upon future reasonableness review. Finding and Conclusion 4 provides: “SCWC should be required to justify the reasonableness of all expenses associated with the memorandum account, offset by insurance proceeds and / or proceeds from the polluters, before it is granted relief.” (Res. W-4181 p. 4.)

The resolution’s Discussion section explains that SCWC “proposes to pass on all money received from defendants to its ratepayers, including punitive damages, as long as ratepayers pay for all the litigation expenses.” (*Id.* p. 3.) It then states: “Water Division agrees and notes this is consistent with the long established Commission policy, which was reconfirmed in Bakman Water Company’s Resolution No. W-3785 dated June 23, 1993.” (*Ibid.*)

Ordering Paragraph (OP) 7 of Resolution W-4181 directs the utility to follow

¹ The Arden-Cordova customer service area is a single ratemaking district with two, physically separate water systems. The smaller Arden system, which has approximately 2,000 connections, is not affected by the groundwater contamination at issue in this litigation. In a single ratemaking district, capital and operational costs are treated as common costs, however, in order to spread cost recovery across a broader base and minimize rate shock and other financial problems that can befall small water systems with few customers.

through, requiring it to “promptly credit its memorandum account herein by all amounts, including punitive damages, it receives from defendants.” (*Id.* p. 7.)

The Commission’s conceptual support for a strong litigation stance is evident in the Resolution. In the Discussion section, the Commission states its expectation that SCWC will “aggressively pursue the two legal actions for compensation from the polluters.” (*Ibid.*) The resolution’s OP 5 urges SCWC to “use every means possible to maximize its insurance proceeds and to seek restitution from the polluters of the basin so as to lessen any possible regulatory burden on its customers.” (*Id.* p. 5.) In February 2001, by Advice Letter 1086-W-A, SCWC sought to amortize \$1,792,000, the balance in the memorandum account as of August 31, 2000. Though the litigation was still pending, Resolution W-4257, dated April 19, 2001, approved the amortization. The resolution’s Discussion section states that “the Commission should approve the recovery subject to refund as a message of support for the utility.” (Resolution W-4257, p. 3.)

2.2 Phase 1 Decision

The Phase 1 decision in this proceeding, Decision (D.) 04-08-052, approved the parties’ Stipulation. D.04-08-052 thereby resolved all general rate case issues and deferred SCWC’s request for authority to amortize the balance in the memorandum account to a second phase.² Paragraph 3.02 of the Stipulation describes the deferred issues as follows:

² The Stipulation was filed June 4, 2004 as an attachment to the parties’ *Joint Motion to Adopt Stipulation and For an Order of an Additional Phase to This Application*.

These issues include, but are not necessarily limited to: the treatment of a potential shortfall in recovery from Aerojet by Southern California Water Company of all expenses booked into the memorandum account; the accounting treatment of the funds in the account, which could include the potential amortization of the account; and a determination as to whether the ratepayers or shareholders should bear the responsibility of helping Southern California Water Company recover the expenses recorded in the memorandum account. (D.04-080-052, Attachment A.)

D.04-08-052 also extended the expiration date of the memorandum account by one year, until January 1, 2006, in order to permit sufficient time for resolution of Phase 2.

2.3 Phase 2 -- Procedural History

On September 16, 2004, the assigned administrative law judge (ALJ) commenced Phase 2 with a prehearing conference (PHC) and thereafter, as Pub. Util. Code § 1701.1(b) requires, the Assigned Commissioner issued a Scoping Memo.³ The September 21, 2004 scoping memo confirmed the scoping and scheduling agreements reached at the PHC and also extended the Commission's Phase 1 categorization determinations (ratesetting; hearings) to Phase 2. The scope included the issues in Paragraph 3.02 of the Stipulation and all other matters material to resolution of those issues.

³ Unless otherwise indicated, all subsequent citations to sections refer to the Public Utilities Code and all subsequent citations to rules refer to the Commission's Rules of Practice and Procedure, which are codified at Chapter 1, Division 1 of Title 20 of the California Code of Regulations.

On December 14, 2004, SCWC filed a motion seeking an additional amortization of \$6 million, part of the balance then existing in the memorandum account, prior to the Phase 2 hearings. By joint ruling on January 26, 2005, the Assigned Commissioner and ALJ denied SCWC's request, noting, among other things, that hearings on the merits would be held in less than two months.

Hearings were held on March 14 and 15, 2005. The parties filed concurrent opening briefs on April 20 and concurrent reply briefs on May 5. The ALJ submitted Phase 2 for decision on May 6, 2005.

3. Public Comment on the Application

As related in D.04-08-052, public attendance at the March 17, 2004, Phase 1 public participation hearing (PPH) in Rancho Cordova was light but a number of those present raised issues about the water contamination litigation. In response, Roland Tanner, then SCWC's Manager of Regulatory Affairs, made a brief presentation, explaining that the utility had reached a Memorandum of Understanding (MOU) with Aerojet General Corporation (Aerojet) but that many details remained to be worked out. The PPH transcript reflects that Tanner indicated the utility hoped to be made whole by Aerojet for all the expenses associated with the contamination litigation, including those already being amortized in customers' rates.

The Commission has received limited additional public comment (via letter or email) regarding the Aerojet litigation or recovery of the memorandum account during Phase 2. At hearing Tanner, now Vice President of Customer Service for Region 1 (and the sponsor of Ex. 1 / Phase 2), stated that SCWC engaged in "significant public outreach" prior to the time it filed this application but that, other than the Phase 1 PPH, he was not aware of any outreach efforts subsequent to the filing. Witness Denise Kruger, who served as

Vice President for Water Quality when SCWC became aware of the contamination problems (she is now Senior Vice President of Operations), offered additional information. Kruger testified that SCWC has participated in several community meetings sponsored by the Environmental Protection Agency and others where the topics discussed have include the status of the contamination, responses to it, and the progress of the lawsuits. She also testified that local media has covered these matters regularly.

4. Discussion

The issues before us concern ratemaking. SCWC has not asked us to approve its settlements with the State and with Aerojet, and we have no jurisdictional need to do so. However, we must review the terms of the settlements to inform our assessment of the ratemaking issues, and we do so in Section 4.3, below. The dispute between the parties primarily concerns how to apply credits against debits entered in the “Cost” portion of the memorandum account – given the context of the Aerojet settlement and Resolution W-4181. The parties’ differences affect the way they calculate the shortfall between incurred expenses and anticipated expense reimbursements, which in turn affects their amortization proposals.

4.1 Impact of the Contamination on the Cordova System

We begin by reviewing the record on the status of the contamination, since in order to evaluate the various settlements that give rise to the ratemaking issues before us, it is necessary to understand how the contamination has affected the Cordova system’s water supply. Traditionally, the Cordova system has been groundwater “rich.” Though it has long met its water supply demands with a combination of groundwater and American River surface water purified

at the Coloma Surface Water Treatment Plant (Coloma Treatment Plant), groundwater has predominated. A maximum contaminant level (MCL) or advisory level (AL) for perchlorate did not exist in February 1997, when the perchlorate contamination was first measured. However, the Department of Health Services recommended that SCWC remove three affected wells from service, and the utility did so. Subsequently, high levels of perchlorate in other wells caused SCWC to remove them from service. Perchlorate is an inorganic chemical used in solid rocket propellant and in missiles, as well as in other explosives. The prepared testimony of SCWC's witness Kruger states that perchlorate "is commonly thought to interfere with iodine uptake by the thyroid gland, which can lead to a decreased production of thyroid hormones." (Ex. 2/Phase 2 p. 5.) In the spring of 1998, tests showed high levels of NDMA in several wells. NDMA is used in the production of liquid rocket fuel, among other things, and is classified as a carcinogen. SCWC removed several additional wells from service after discovering the NDMA contamination.

Today, according to tables in the prepared testimony of SCWC's witness Kruger, eleven groundwater wells, with an aggregate capacity of 9,525 gallons per minute (gpm), remain out of service because of perchlorate and/or NDMA contamination. Thirteen active wells produce 20,420 gpm and the Coloma Treatment Plant produces an additional 7,140 gpm, for a total capacity of 27,560 gpm. Planned upgrades at the Coloma Treatment Plant, to be financed by Aerojet, will increase its capacity by another 3,500 gpm. However, if the contamination plumes move and cause perchlorate or NDMA levels in several active wells to rise, additional groundwater --perhaps as much as 6,895 gpm -- may be lost.

4.2 The Lawsuits

SCWC's evidence on the lawsuits provides the necessary backdrop for the subsequent settlements. SCWC filed one lawsuit against the State of California, together with several state agencies (California Water Resources Control Board, California Regional Water Quality Control Board, Central Valley Region and the Department of Toxic Substances Control). It filed the other lawsuit, referred to in the course of this proceeding as the Aerojet litigation, against Aerojet and its subsidiary, Cordova Chemical Company.

Each of the lawsuits sought attorneys' fees and costs, as well as damages, in connection with the perchlorate and NDMA groundwater contamination. Simply put, the lawsuits attributed the contamination to Aerojet's improper handling of the chemicals over several decades, its ineffective clean-up activities, and the State's faulty and/or complicit oversight of both. Ex. 4/Phase 2, the prepared testimony of SCWC's witness Gary Ottoson, co-lead counsel for the utility in both lawsuits, relates the strategy underlying the lawsuits, their conduct, and nature of the costs incurred in prosecuting them. The two lawsuits engendered extensive and complex discovery, which continued into 2002. Early that year, the parties retained a professional mediator and retired federal judge, the Honorable Layn Phillips, in an effort to reach settlement. In the fall of 2002, SCWC and the State negotiated a settlement. Witness Ottoson's prepared testimony also discusses this settlement and we review its principal terms below.

Ex. 6/Phase 2 and Ex. 7/Phase 2, the prepared testimony of SCWC's witness Scott S. Slater, who served as legal counsel throughout the settlement negotiations and took a lead role in drafting the settlement documents, describes the progress of the litigation after the settlement with the State. In summary, discovery resumed and the Aerojet litigation proceeded alone until October 10,

2003, when the parties reached a final, binding settlement agreement in a “principals” only meeting attended by Aerojet and SCWC management and officiated by Judge Phillips. This agreement is memorialized in the MOU prepared that day with Judge Phillips’ assistance. It is included with the prepared testimony of both Ottoson and Slater, respectively Ex. 4/Phase 2 at Ex. D and Ex. 6/Phase 2 at Ex. C. SCWC portrays the act of settlement, itself, as quite a feat. According to Ottoson’s prepared testimony:

Research of past litigation involving Aerojet as a defendant reflected that Aerojet rarely settled cases, and when it did, it was only on the courthouse steps, due to the fact that Aerojet received reimbursement from the Department of Defense of 88% of its legal costs. (Ex. 4/Phase 2 p. 19.)

The additional, supplemental implementation agreements that the MOU requires took another year to finalize. Part of the delay occurred when the settlement process derailed temporarily after Aerojet challenged the MOU in the Sacramento Superior Court. On January 18, 2004 the Court ruled that the MOU was indeed binding and the parties returned to the task of completing the supplemental documentation. The complexity of this task and the inter-relationship of its parts did not permit a quick resolution; the supplemental documentation took more time to finalize than the parties initially contemplated.

4.3 The Settlements

The record includes copies of all the settlement documents and extensive testimony on SCWC’s rationale for settling rather than continuing to litigate. As explained by SCWC’s witness Slater, four primary objectives drove the utility’s litigation and settlement strategy. Most importantly, SCWC wanted a “service cure” in the form of a substitute supply of deliverable, potable water. (Tr. p. 111.) It also sought reimbursement for expenses actually incurred in

seeking the cure; a contingency plan that would serve as “insurance” to protect the utility and its customers if some part of the agreed-upon service cure did not work as planned; and retention of all control over utility operations, rather than ceding some of the decisionmaking about “where water ought to go and how” to Aerojet or others. (*Id.* pp. 111-112.) In other words, the utility wanted to retain “day-to-day management discretion.” (*Id.* p. 119.) SCWC believes its settlements with the State and with Aerojet meet all of its litigation / settlement objectives.

SCWC’s settlement with the State, executed in January 2003, provided the utility with a monetary payment and a critical, powerful ally in its effort to obtain replacement water supplies from Aerojet. The full text of the agreement (entitled “Settlement Agreement and Release”) is included in the evidence as Ex. C to Ex. 4/Phase 2. In summary, in return for a full release from the lawsuit against it, the State agreed to:

- pay SCWC \$2,475,000 toward incurred costs;
- require that Aerojet, as an interim measure for each well taken out of service because of contamination, provide SCWC with a secure replacement source (i.e., potable water, available within 24 hours, actually deliverable to the area served by the lost well);
- assist in developing a plan for Aerojet to provide SCWC with a permanent source of replacement water.

The subsequent settlement with Aerojet is much more complex. Its basis is the MOU, which we reference above in Section 4.2. The MOU plainly states: “It is understood that this settlement will require extensive documentation. This MOU, however, sets forth the principal deal points associated with the settlement.” These “deal points” constitute the financial terms agreed between the parties, obligating Aerojet to pay:

- a total of approximately \$8,750,000⁴ to reimburse SCWC for capital expenditures necessary to enable delivery of short-term, replacement water supplies and for interim replacement water purchased from the Sacramento Municipal Utility District (SMUD). In addition, Aerojet agreed to assume responsibility to make ongoing payments under the SMUD contract.
- \$8 million (guaranteed) in reimbursement for additional capital costs and \$17.5 million (not guaranteed) in reimbursement for litigation costs.⁵
- 100% of SCWC's costs (if any) under a contingency plan effective if Aerojet's groundwater remediation plans to do not succeed and the utility must take additional wells out of service.

The MOU identifies the source of the future \$8 million and \$17.5 million payments as a Water Supply Availability Assessment, subsequently termed the Water Availability Fee (WAF). As further described in the record, as Aerojet develops certain land that it owns within or adjacent to the municipal boundaries of Rancho Cordova in Sacramento County, Rancho Cordova (or other local land use jurisdiction) will assess a WAF of approximately \$6,000 on each equivalent development unit (EDU) of new housing, collect it from the builder / developer, and transmit it to SCWC. Payment of the \$8 million earmarked to complete reimbursement of capital expenditures is guaranteed in five installments with final payment by December 31, 2013. In other words, if the WAF funds available on each installment date are insufficient, Aerojet will make up the difference.

⁴ The reimbursement actually owing has proved to be slightly less, \$8,734,964.

⁵ The MOU identifies the non-guaranteed payment as \$15.5 million; in subsequent negotiations this sum was increased by \$2 million to \$17.5 million.

The documentation which fleshes out the complex implementation details consists of the Master Settlement Agreement and Release (MSA) together with the numerous other agreements attached to it, all part of Ex. 1 to Ex. 7 / Phase 2. Collectively, these agreements provide for a new supply structure for the Cordova System by introducing significant additional quantities of surface supply into the mix. On an interim basis, the surface supply is 10,000 acre-fee of surplus water from SMUD under a five-year contract. The infrastructure improvements necessary to deliver this supply include improvements to the Coloma Treatment Plant and construction of the East / West and North / South pipeline extensions into areas previously served by now-condemned wells. On a long-term basis, this same infrastructure together with Sacramento County's Regional Water Supply Project (County Project), a new treatment plant scheduled to be operational by December 2006, will deliver the permanent surface water allocations provided for under the various agreements. The source of much of this long-term, replacement water supply will be treated groundwater discharged by Aerojet into the American River where it will be diluted and then delivered (1) as untreated water to SCWC's Coloma Treatment Plant or (2) as treated water from the County Project to a separate location on the Cordova system.

Slater's prepared testimony states that:

The cost of water delivered from the County Project will be comparable to the cost of producing groundwater. Water treated at the Coloma Treatment Plant will require higher chemical cost. However, since Aerojet has contributed the capital cost, the melded costs per acre-foot will be less expensive than the production of groundwater through the use of wells financed by the SCWC. (Ex. 6 / Phase 2 p. 20.)

Slater's rebuttal testimony states that the various sources of supply will generate:

a reliable total supply of 20,200 acre-feet (5,000 acre-feet of American River rights, plus the 5,000 Annual Acre-Feet Allocation at the Coloma Treatment Plant, plus up to an additional 10,2000 acre-feet from SCWC's wells and / or replacement water made available through the County project). When combined with a minimum of 2,000 acre-feet of demand reduction, which SCWC can easily generate through conservation measures including metering, SCWC will be able to reliably satisfy the 20,200 acre-feet of demand at build-out for its existing service area that was previously projected in the Water Supply Assessment. (Ex. 7/Phase 2 pp. 4-5.)

Joel A. Dickson, SCWC's Senior Vice President, characterized this new supply arrangement as a very favorable one for the Cordova water system:

And this settlement is unique because it gives us something that we have now in this district that we don't have in any other district throughout the entire company, and that's a guaranteed supply of water for our customers. (Tr. 179.)

SCWC's consultant, Rodney T. Smith, an expert on water resources economics and policy, also provided testimony supportive of the Aerojet settlement in Ex. 5/Phase 2 and Ex. 8/Phase 2.⁶ In prepared rebuttal testimony written after the parties executed the MSA, Smith confirms his assessment that the Aerojet settlement provides economic advantages for SCWC's customers

⁶ Among other things, Smith is founder and co-editor of a monthly web-based publication and information service, *Water Strategist*, and is a Senior Vice President of Stratecon Inc., a strategic planning and economics consulting firm specializing in water and other natural resources.

compared to the alternative scenarios, either a “self-cure” without litigation or continued litigation to a final decision. He summarizes his view thus:

By avoiding litigation altogether, SCWC’s ratepayers would have faced costs with a present value of \$274 million (2004) (or about \$18,400 per the connections in the Cordova System on July 2003) to convert to a surface water system, with less reliable water service and no guarantee of success. By litigating to the end, SCWC would have incurred additional litigation costs in the face of a significant degree of uncertainty and risk, with potential prospect of not recovering litigation costs. Moreover, like the “self-cure” alternative, litigation may have provided money, but no guarantee of a replacement supply at the cost of groundwater without contamination. (Ex. 8/Phase 2 p. 7.)

Though it disagrees with the ratemaking treatment that SCWC proposes, Office of Ratepayer Advocates (ORA) concurs that the settlements are reasonable. Ex. 30, the ORA report sponsored by Raymond Charvez, the Project Manager, states:

Although SCWC did not get full reimbursement, ORA believes SCWC has reached a reasonable settlement with Aerojet in obtaining reliable water supplies for the future, a substantial reimbursement of the costs it incurred from the contamination of SCWC’s groundwater, and for the litigation expenses. (Ex. 30 p 9.)

4.4 Memorandum Account Entries and Amortization Proposals

The memorandum account contains two parts, “Costs” (recorded beginning February 2000) and “Capital Projects.” Each party’s prepared testimony includes a table that separately identifies each part and summarizes the debits and credits to it. Exhibit 1 to SCWC’s Ex. 1/Phase 1 lays out the utility’s proposal. Table A to ORA’s Ex. 30/Phase 2 updates the memorandum account balance to August 31, 2004 and shows the adjustments that ORA has

made to SCWC's proposal. Ex. 1 to SCWC's Ex. 9/Phase 2 illustrates SCWC's proposal, revised for many of ORA's adjustments and updated to January 31, 2005.

These iterative exhibits together with the record as a whole establish that the debits and credits to the "Capital Projects" portion of the memorandum account are not in dispute. In the five years since the Commission authorized SCWC to establish the memorandum account, the utility has spent approximately \$20 million on capital projects needed to replace lost water supplies. Aerojet has reimbursed all but about \$8 million of this sum and under the terms of its settlement, will reimburse the remainder in five roughly equal installments on December 31 of 2009, 2010, 2011, 2012 and 2013, with interest at 5% compounded monthly accruing from January 1, 2004. In fact, Aerojet's reimbursements for capital expenditures will yield a surplus (estimated at \$125,423 as of January 31, 2005), which will be applied as a credit to the expense portion of the memorandum account.

There is no dispute over most of the expense line items, either. Drawing from the record, SCWC's opening brief usefully tallies the January 31, 2005 net balance of expenses over reimbursements, segregated by lawsuit. We reproduce the figures in the table below.

Lawsuit:	State of California	Aerojet
Total Expenses	\$5,548,507	\$16,942,157
Reimbursements from Defendant	\$2,475,000	\$ 15,000
Insurance reimbursements	\$ 0	\$ 3,255,444
Amortization from Customers (Resolution W-04257)	\$ 502,793	\$ 519,568

Net Balance	<u>\$ 2,570,715</u>	<u>\$13,152,146</u>
Combined Net Balance		\$15,722,861

The table does not include roughly half a million dollars in costs that have not been segregated between the two lawsuits: \$459,415 in lab testing fees and other litigation support expenses and \$31,230 in purchased power costs.⁷ The parties agree with the accounting of costs up to this point, which totals \$16,213,506.⁸ The record supports a finding that these costs were reasonably incurred and reimbursements received to date have been properly applied against them.

The parties differ somewhat on the accounting for two other line items: carrying costs on the outstanding \$8 million capital reimbursement and interest on litigation expenses. By SCWC's calculations, these additional costs increase the memorandum account balance by another \$5,900,956, for a total of \$22,114,462. Typically the Commission allows memorandum account entry of carrying costs on capital projects, calculated at the utility's authorized rate of return (ROR). SCWC claims this is the approach that should be followed here, and that Aerojet's payments should be entered as memorandum account credits.

⁷ SCWC also incurred over \$1 million in purchased water costs, but Aerojet has reimbursed this expense.

⁸ In the course of its review, ORA located entries for approximately \$900,000 in public relations costs in the memorandum account. ORA informed SCWC, and the utility removed them all before distributing its prepared rebuttal testimony. Consistent with ORA's recommendation, SCWC has also removed depreciation expenses and instead accounted for Aerojet's reimbursement of capital additions as Contribution in Aid of Construction (CIAC).

ORA proposes that the carrying cost entries (from September 1, 2004 through December 31, 2013) should be limited to the difference between the utility's ROR and the 5% interest due. At hearing, witness Charvez clarified ORA's proposal, which is not reflected in its Table A. In ORA's view, the utility should be permitted to recoup the 5% outside of the memorandum account mechanism by retaining interest payments as they are received rather than crediting them to the account.⁹ We resolve this matter in Section 4.6.

Under the terms of the Aerojet settlement, as Aerojet's property development goes forward, SCWC stands to receive additional reimbursements toward its costs of up to \$17.5 million, plus interest at the three-month commercial paper rate. This sum is not guaranteed but is wholly contingent upon the development occurring as projected. However, the Aerojet settlement does not set a cut off, or outer limit, on the final payment date.

The parties' major dispute concerns the ratemaking treatment for this \$17.5 million. SCWC's contends that because it is a contingent payment, it should not be entered into the memorandum account. Hence, SCWC's approach creates the shortfall in the memorandum account identified above -- \$22,114,462, as of January 31, 2005. The utility asks the Commission to order amortization of this amount over 20 years as a rate surcharge (about \$1.28 million per year), with "true-ups" every three years in Arden-Cordova's general rate case. For residential customers on Tariff AC-2 (flat rate service), that amortization would result in an increase of \$5.68 per month, raising the monthly bill to \$37.38. For customers on Tariff AC-1 (metered service) with an average monthly usage of

⁹ As of August 2004, SCWC's ROR was 8.94%.

116 Ccf, generally commercial customers, the increase would be \$16.70, raising the average monthly bill to \$89.38.

Amortization of the full \$22.1 million is SCWC's "worst case" scenario; it assumes that no WAF payments materialize during the next 20 years, leaving ratepayers to reimburse all litigation expenses. Under positive development scenarios, the regular receipt of WAF payments will shorten the amortization period, and under such circumstances, SCWC proposes to step-down the amortization rate in subsequent general rate case cycles. The "best case" scenario shows ratepayers actually paying about \$6.2 million, less than a third of SCWC's amortization request, and the amortization period running for about eight and one half years, not 20. We examine the assumptions behind these scenarios in Section 4.5.

In ORA's view, the entire \$17.5 million sum should be entered in the memorandum account as an offset against costs, effective August 31, 2004. ORA does not consider the contingent nature of the payment to be material to the consideration. ORA's witness Charvez testified:

The reason why I've made that adjustment is ... it, in essence, has the ratepayer as an interim financing tool to cover the company until such time as it fully recovers the amount which the master settlement agreement identifies that Aerojet is responsible for.
(Tr. p. 311.)

ORA argues that, from a ratemaking standpoint, shareholders, not ratepayers, should bear the risk of recovery under a settlement fashioned by utility management and its lawyers. ORA's Table A calculates the resulting shortfall at approximately \$4 million as of August 31, 2004. At hearing, however, Charvez agreed that when adjusted to include the carrying costs omitted from

Table A, the shortfall is closer to SCWC's best case scenario projection, where ratepayers pay \$6.2 million. We resolve this issue in Section 4.6.

4.5 The Interplay of Ratemaking and Accounting Issues

Before resolving how to handle the shortfall between what the groundwater contamination has cost and what the settlements offer in monetary recovery, we need to consider several other factors: the likelihood of receipt of the \$17.5 million and the implications of excluding it from amortization in customer rates.

As already noted, the WAF receipts are intended to fund both the future \$8 million guaranteed payment and the \$17.5 million contingent payment.

Asked by the ALJ why the \$8 million payment is guaranteed but the larger one is not, witness Slater testified:

The foundation is that Aerojet is notorious for not agreeing to attorney fees in any settlement that it has ... it has a very unique arrangement with the federal government where the federal government picks up a large percentage of its defense cost. So it is never exposed in defending a case for its attorneys fees because of this backstop of the federal government, and it is [sic] taken a scorched earth policy with regard to the payment of attorneys fees.

On the other hand, the company, until present, has been unwilling to accept any settlement that did not account for the payment of attorneys fees. We constructed an architecture to this settlement that would provide a way for Aerojet to pay those attorneys fees without calling them an attorneys fee payment. The method of payment had to be highly likely, and so we chose a vehicle whereby that highly likely development would then fund the pay down of those attorneys fees and engineering fees.

... the 17.5 million is coming forward in the form of the water availability fee distribution. So Southern California Water Company

is reimbursed without calling it a payment for attorneys fees. In fact, you will see the settlement agreement refer to it as “response costs.” (Tr. 146-147.)

The Aerojet property targeted for development in connection with the settlement lies west of Rancho Cordova’s Hazel Avenue and has been referred to in this proceeding as “West of Hazel.” Other Aerojet property is in various stages of planning or permitting for housing development, but West of Hazel is not yet at the “entitlement” stage. How likely is the West of Hazel development and if it goes forward as contemplated, how soon will SCWC receive WAF payments toward the \$17.5 million?

SCWC’s testimony on this subject is bullish, but stops short of promising full recovery. Demand for housing in the Sacramento area has caused land values to escalate dramatically and has increased pressures to develop.

According to Slater:

Aerojet as a company has transformed itself ... into being a development company. It is one of the reasons why we believe in the settlement is that we see this huge asset being carried on their books. (Tr. p. 136.)

Slater testified that, to his knowledge, there are no land or water pollution bars to the proposed development, and the Aerojet property has sufficient water to serve it. He recognized, however, that “the rate of development could come to a screeching halt and it could be 1989 all over again.” (Tr. p. 152.)

The first property West of Hazel likely to be developed, approximately 1500 acres targeted for 4,500 equivalent development units, has been termed the

Westborough Project.¹⁰ SCWC's witness Dickson, the sponsor of Ex. 9/Phase 2, testified that communications with the Aerojet Vice President in charge of the development suggests the following, likely schedule: 2005 -- 2007, general map amendment approval and large lot map approval; 2008 -- subdivision and backbone infrastructure construction, small lot map approval; 2009 -- home construction commences at 300 units per year, first WAF payments toward guaranteed \$8 million capital reimbursement.

In developing scenarios for his prepared rebuttal testimony to illustrate SCWC's amortization proposal, Dickson assumed 375 units of housing per year, more than Aerojet's figure but rather less than the 50 per month (or 600 per year) that Slater used in prepared testimony written before the MSA was finalized. Dickson termed his own estimate "conservative" based on the current rapid pace of Sacramento area development, both in SCWC's service territory and elsewhere. (Tr. 169.) We refer, above, to Dickson's "best case" amortization scenario. This scenario, Ex. 10-A to Ex. 9/Phase 2, which builds on the Aerojet scheduling projections, shows ratepayers actually paying about \$6.2 million over approximately eight and one half years. It steps the surcharge down twice -- from the initial \$1.28 million, to \$631,861 (in the 2008 general rate case cycle), and then to \$373,536 (in the 2011 general rate case cycle). This scenario assumes steady WAF payments of \$2.25 million from 2009 forward and begins to apportion them toward paying down the litigation expenses in 2012. The

¹⁰ Development east of Hazel Avenue, outside the current municipal border of the City of Folsom, may or may not occur. If it does go forward, the water provider could be the City of Folsom or one of several other providers, including SCWC. This development scenario is too speculative to factor into any assessment of the amount or timing of future WAF payments -- at least at this time.

combination of ratepayer amortization payments of approximately \$1.28 million per year plus estimated, annual WAF payments of \$2.25 million per year leaves a nominal unpaid balance of \$4,262 by the end of 2025. These calculations assume interest accruing on the unpaid litigation expense balance at 2.50% per year (an estimate of the three-month commercial payment rate.)

The two other scenarios, Ex. 10-B and -C to Ex. 9/Phase 2 both look at the impact on the memorandum account balance if the \$17.5 million in WAF payments fails to materialize. Ex. 10-B shows that under such circumstances, amortization of \$1.28 million per year for 20 years leaves a memorandum account balance of approximately \$5.91 million still owing in 2025. Ex. 10-C zeros that memorandum account balance by stepping up the amortization rate to \$1.450 million in 2011, \$1.596 in 2014, \$1.653 in 2017 and \$1.717 in 2025. Under these scenarios, over the years ratepayers would pay on the order of \$11 million in interest (and carrying costs) on the unpaid balance in the memorandum account.

Since establishment of the memorandum account, SCWC has capitalized the litigation expenses on its financial statements as a regulatory asset under the authority of Generally Accepted Accounting Principles and Statement of Financial Accounting Standards No. 71 (FAS 71). FAS 71 permits such accounting when an incurred cost, which would otherwise be charged to expense, meets two criteria:

- (a) it is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes; and (2) based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. (Ex. 10/Phase 2 p. 3.)

According to Robert J. Sprowls, the Chief Financial Officer, Senior Vice President – Finance, and Corporate Secretary for both the utility and its parent, consistent with FAS 71 (SCWC) “has capitalized these litigation expenses on its accounting records as it has believed it is probable that these costs will be recovered through rates charged to customers.” (*Ibid.*) Were the utility to rely solely upon WAF funds as the recovery source, it would be obliged to treat the future payment as a gain contingency under FAS 5, since “companies are not allowed to record gain contingencies prior to their realization.” (*Ibid.*) Sprowls testified that a write-off about \$11 million would be quite likely absent recovery of something on the order of “\$15 million or north.” (Tr. 264.) He added: “I’m not guaranteeing it, but I would say I’m about – I would say I’m 90 percent sure that’s how we’ll deal with it.” (*Ibid.*) Sprowls identified the \$15 million as an approximation of the utility’s current regulatory asset. He derived the \$11 million figure by subtracting \$4 million (ORA’s Table A amortization proposal) from \$15 million.

Sprowl’s testimony anticipates several domino-like ramifications from a write-off of this magnitude: the resulting reduction to net income could violate the minimum net income requirements in two revolving debt agreements, require a \$89 million capital infusion to cure the default (a sum not readily available to the utility), increase the cost of future debt, increase the cost of future capital, and thereby increase customer’s water rates.

ORA does little to advance this dialogue. With regard to FAS 71, ORA claims insufficient expertise to interpret the rule. ORA has portrayed Sprowls’ testimony as unsupported, self-serving opinion. In response to questioning on cross-examination, however, Charvez admitted that he had seen minutes of board meetings which included redacted versions of outside audit reports that

expressed concern about this financial situation, though he could not recall specific comment about a write-off. With respect to the financial impact of an \$11 million write-off on the utility or its ratepayers, Charvez testified that he had no opinion. He stated:

I would presume that that was a factor that corporate management would have had in mind during the period they were negotiating the Master Settlement Agreement.

If there was a concern with respect to the time in which they were to receive the moneys from Aerojet, it should have been considered at that time. (Tr. 347.)

4.6 Authorized Memorandum Account Treatment and Conditions of Approval

Taken together, the settlements with the State and with Aerojet provide for viable replacement water supplies, both short-term and long-term, which permit SCWC to meet its current and projected long-term supply requirements under a gallons per minute (peak day and fire flow) standard, as well as an annual acre-foot standard. Indeed, ratepayers are made whole from this standpoint. The settlements cover the shareholders' out-of-pocket costs of plant necessary to develop or deliver these supplies and shareholders are made whole from this standpoint.

In response to the ALJ's question at hearing about whether the settlements provide any shareholder benefits, SCWC argues that there are none. We think this is an overstatement, though we agree that quantification is difficult. To be sure, the capital infrastructure for which Aerojet has paid or will reimburse the utility will not be eligible for inclusion in ratebase, and shareholders will not earn a return on it. However, if SCWC's service territory expands to include Aerojet development West of Hazel or elsewhere, both shareholders and the ratepayers in the current service territory may benefit from a larger, comparatively newer water system (shareholders from future opportunities for earnings on shareholder-financed plant and ratepayers from potential cost reductions attributable to any scale economies). The greatest potential benefit to shareholders appears to be the most speculative one – if the contamination plumes do not force SCWC to remove additional wells from service, the increased capacity at its Coloma Treatment Plant could provide service territory expansion opportunities that did not exist before.

The settlements also offer potential recovery of a substantial portion of the litigation expense -- but guarantee none of it. Ratepayers have already paid about \$1 million toward litigation expenses incurred to combat the contamination problem. Under the proposals before us, they could pay as little as \$6.2 million more or they could pay over \$30.4 million, nearly half of it carrying costs and interest (assuming amortization of the full \$22.1 memorandum account balance). The surcharge necessary to recovery this additional amortization would continue for anywhere from eight and one-half years to 20 years.

We recognize that, under any amortization scenario, ratepayers do not find themselves standing in the same shoes they stood in prior to discovery of the groundwater contamination. We also recognize that litigation costs are a cost element for which recovery at trial was uncertain at best and one which Aerojet had little inclination to reimburse directly. Under SCWC's "best case" scenario, we think that both ratepayers and shareholders fair very well. Should reality shift toward the worse case scenarios, shareholders' position does not change at all. For ratepayers, however, the settlements prove increasingly costly.

The great unknown, of course, is the future. How many housing units will Aerojet be permitted to develop and how quickly will the approved development proceed to yield the WAF payments needed to minimize ratepayer funding of the memorandum account balance? We conclude ratepayers deserve some protection from the repayment obligations they face if the future realizes a significantly lesser or slower development pace - but we find our options quite limited.

We agree with SCWC that the contingent nature of the future \$17.5 million payment prevents its entry in the memorandum account as a credit against costs now. The memorandum account should be credited as the WAF payments are received. Meanwhile, the unpaid litigation cost balance should continue to be carried forward, with interest at the three-month commercial paper rate. Were we able to ignore FAS 71, however, we would authorize amortization of the full memorandum account balance on a conditional basis only. In order to provide some risk reduction to ratepayers, we would not guarantee full payment with interest if the WAF payments are limited or do not materialize at all. However, FAS 71 appears to curtail our options, since we wish to protect both utility shareholders and ratepayers from the consequences of a major write-off.

Therefore, the modest solution we fashion limits ratepayer responsibility for carrying costs on the unpaid \$8 million capital reimbursement by ending that responsibility on December 31, 2003, since Aerojet has guaranteed reimbursement of the \$8 million with interest at 5% compounded monthly from January 1, 2004. We conclude this is fair because these capital costs reflect a direct response to the contamination, and thus would be properly included in any tally of damages at trial. As utility management agreed to the deferred reimbursement the Aerojet settlement provides, we think it is reasonable for shareholders to bear the financial costs associated with delayed recovery. We will not require ratepayers to guarantee the full ROR on this portion of the utility's capital expenditure. Thus, shareholders must absorb the difference between the utility's ROR and the 5% interest rate, from January 1, 2004 until the sum is fully repaid, recouping their investment under the terms of the settlement, which provides for the first of Aerojet's five installment payments in late 2009.

We direct SCWC to accomplish this result by restricting memorandum account debits for carrying costs on the \$8 million, and interest on those carrying costs, to the period ending December 31, 2003. Beginning on January 1, 2004, SCWC shall remove the \$8 million to a deferred account with interest at 5%. SCWC shall credit the deferred account with the each of the five installment payments scheduled for December 31 of 2009 through 2013, and shall apply the excess as a credit to the memorandum account, as it has proposed to do. This accounting adjustment effectively removes \$807,576 in carrying costs from the memorandum account as of January 2005 and reduces ratepayers' amortization obligation by over \$200,000 a year, from about \$1.28 million to \$1.06 million, annually.

Though SCWC proposes to step-down the surcharge once in every rate case cycle (given WAF receipts under "best case" or other favorable scenarios), utility management testified that it would not oppose a more frequent true up. If the utility receives WAF monies at a rapid rate, we want to reduce ratepayers' monthly bills more quickly than once-in-three years. Therefore, in any year that receipt of WAF monies will permit a reduction in the AC-2 monthly bill of \$ 0.50 or more, we direct SCWC to file an advice letter for this adjustment, concurrent with any annual attrition-year or step-increase filing.

We also require SCWC to do the following:

- Include, as a bill insert in the first billing cycle that collects the new surcharge, a letter to customers that explains the terms of the settlements with the State and with Aerojet and the reason for the surcharge. SCWC shall work with the Commission's Public Advisor to prepare the letter.

- Submit to the Director of the Water Division, within 45 days of the end of each calendar year, by letter, a status report for the Aerojet development associated with the WAF reimbursements of \$8 million and \$17.5 million. The status update shall summarize the current timeline for Aerojet development milestones; the number of EDUs permitted in the prior year and the number anticipated to be permitted in the ensuing five years; and the amount of WAF monies received in the prior year and amount anticipated to be received in the ensuing five years. This requirement will expire when the memorandum account is fully authorized.

5. Assignment of Proceeding

Michael R. Peevey, the Commission's President, is the Assigned Commissioner in this proceeding and Jean Vieth is the assigned ALJ in this proceeding.

6. Comments on Proposed Decision

The proposed decision of ALJ Vieth in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Commission's Rules of Practice and Procedure. Comments were filed on _____ and replies were filed on _____.

Findings of Fact

1. Recovery of litigation costs at trial is uncertain in lawsuits such as the Cordova system groundwater contamination complaints that SCWC filed against the State and Aerojet.
2. SCWC's research shows that Aerojet typically has been disinclined to settle, since it has received reimbursement from the Department of Defense of 88% of its legal costs in litigation such as the Cordova system groundwater contamination lawsuit.

3. If the contamination plumes move, SCWC may be forced to take additional wells out of service. The Aerojet settlement provides for recovery of 100% of SCWC's costs in this event.

4. The various supply agreements which implement the Aerojet settlement will enable SCWC to satisfy the 20,200 acre-feet of demand at build-out for its existing service area, as projected in the applicable Water Supply Assessment.

5. The melded costs per acre-foot of groundwater supplies treated at SCWC's Coloma Treatment Plant will be less expensive than production of groundwater through new wells financed by SCWC.

6. A "self-cure" solution to the groundwater contamination (i.e., deciding to avoid litigation and focusing on developing alternative, surface water supplies) would have cost SCWC ratepayers about \$274 million (2004).

7. By litigating to the end, SCWC would have faced increased litigation costs and uncertainty; a judgment might have provided money but no guarantee of replacement water supplies.

8. There is no dispute between SCWC and ORA about the debits and credits to the "Capital Projects" portion of the memorandum account.

9. Aerojet has reimbursed SCWC for all but about \$8 million in capital expenditures and has guaranteed reimbursement of that \$8 million, plus interest at 5% compounded monthly, in five roughly equal installments between 2009 and 2013. Any WAF monies collected prior to each installment date will be applied toward that installment, and Aerojet will make up any shortfall.

10. Carrying costs on unreimbursed capital expenditures should be allowed as a debit in the "Costs" section of the memorandum account through December 31, 2003, but should be removed from January 1, 2004 forward, together with interest on those unreimbursed capital costs.

11. The Aerojet settlement provides potential reimbursement toward litigation expenses of \$17.5 million, plus interest at the three-month commercial paper rate, depending upon the pace of development of Aerojet's property West of Hazel and the rate of collection of WAF monies.

12. Because the \$17.5 million is a contingent payment, the memorandum account should be credited as WAF monies are received.

13. Under the applicable Financial Accounting Standards (FAS 5 and FAS 71), absent authorization to amortize at least \$15 million of the memorandum account balance, and to collect that amount in its customers' rates, SCWC faces a significant likelihood of having to write-off at least \$11 million.

14. The memorandum account balance shown in Appendix A to this decision should be amortized in customers' rates over 20 years.

15. If SCWC receives WAF monies at a rapid rate, ratepayers' amortization obligations should be minimized by reducing ratepayer' monthly bills more quickly than once-in-three years.

Conclusions of Law

1. The Commission has no jurisdictional need to approve SCWC's settlements with the State and with Aerojet.

2. As shown in Appendix A to this decision, which limits the debits for carrying costs on capital expenditures and associated interest to the period ending December 31, 2003, the debits and credits to the memorandum account are reasonable.

3. As utility management agreed to the deferred reimbursement the Aerojet settlement provides, it is reasonable for shareholders to bear the financial costs associated with delayed recovery of the approximately \$8 million in capital costs.

4. If SCWC receives WAF monies at a rapid rate, it is reasonable to minimize ratepayers' amortization obligations by reducing ratepayer' monthly bills more quickly than once-in-three years.

5. It is reasonable to require SCWC to explain to ratepayers in the Arden-Cordova customer service area the terms of the groundwater contamination settlements and the reason for the surcharge.

6. Given the uncertain nature of the proposed Aerojet development and the size of the memorandum account balance, it is reasonable to require SCWC to provide the Director of the Water Division with an annual status report, as detailed in this decision.

7. The revised rates, and tariff rule revisions set forth in Appendices B and C, are reasonable.

8. This decision should be made effective immediately to enable SCWC to implement the surcharge without delay.

O R D E R

IT IS ORDERED that:

1. Carrying costs on \$8 million in capital projects, and interest on those carrying costs, shall not be entered as a cost element in the Arden-Cordova Litigation Memorandum Account from January 1, 2004 forward.

2. Southern California Water Company (SCWC) is authorized to impose a surcharge in the Arden-Cordova customer service area to amortize the balance in the Arden-Cordova Litigation Memorandum Account adjusted consistent with Ordering Paragraph 1 to provide the results shown in Appendices A, B, and C.

3. In the first billing cycle that collects the new surcharge, SCWC shall include, as a bill insert, a letter to customers that explains the terms of the

settlements reviewed herein and the reason for the surcharge. SCWC shall work with the Commission's Public Advisor to prepare the letter.

4. Until the Arden-Cordova Litigation Memorandum Account is fully amortized, SCWC shall submit by letter to the Director of the Water Division, within 45 days of the end of each calendar year, a status report for the Aerojet development associated with the WAF reimbursements of \$8 million and \$17.5 million. The status report shall summarize the current timeline for Aerojet development milestones; the number of equivalent dwelling units permitted in the prior year and the number anticipated to be permitted in the ensuing five years; and the amount of WAF monies received in the prior year and amount anticipated to be received in the ensuing five years.

5. In any year that receipt of Water Availability Fee (WAF) monies will permit a reduction in the Tariff Schedule AC-2 monthly bill of \$ 0.50 or more, SCWC shall file an advice letter for adjustment of both Tariff Schedule AC-1 and AC-2, concurrent with any annual attrition-year or step-increase filing.

6. The memorandum account shall expire on January 1, 2006, consistent with Decision 04-08-052.

7. Application 03-10-057 is closed.

Dated _____, at San Francisco, California.