Decision **PROPOSED DECISION OF ALJ MCVICAR (Mailed 8/2/2005)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of California-American Water Company (U210W) for Authority Pursuant to Public Utilities Code Section 454 to Restructure and Consolidate its Rates for its Monterey and Felton Districts.	Application 04-08-012 (Filed August 11, 2004)

Lenard G. Weiss, Christine J. Hammond, and Lori Anne Dolqueist, Attorneys at Law, and David P. Stephenson, for California-American Water Company, applicant.
J. Jason Reiger, Attorney at Law, and Diana Brooks, for the Commission's Office of Ratepayer Advocates, protestant.
Miriam L. Stombler, Attorney at Law, for County of Santa Cruz; Edward W. O'Neill, Attorney at Law, and Tod Landis, for Felton FLOW; David C. Laredo, and Frances M. Farina, Attorneys at Law, for Monterey Peninsula Water Management District; interested parties.

OPINION REJECTING DISTRICT CONSOLIDATION

TABLE OF CONTENTS

Title **Page**

Summary 2
Background 2
 CalAm's Request 3
 ORA's Position 4
 FLOW's Position 5
 Santa Cruz's Position 6
 MPWMD's Position 6
 The Proceeding 7
Discussion 8
 Rate Consolidation Guidelines 8
 Rate and Revenue Requirement Impacts 13
 Operational Efficiencies 18
 Service Impacts 20
 Regulatory Impacts 22
 Public Ownership 25
 Customer Preferences 27
 Alternatives 29
Conclusion 31
Comments on Draft Decision 33
Assignment of Proceeding 34
Findings of Fact 34
Conclusions of Law 36
ORDER 37

OPINION REJECTING DISTRICT CONSOLIDATION

Summary

This decision denies California American Water Company's (CalAm) request to consolidate its rates for Monterey and Felton Districts. Instead, CalAm is directed to implement two-thirds of the Felton general rate increase found reasonable but deferred in Decision (D.) 04-05-023, and to continue accumulating the revenue shortfall in its balancing account. Implementing the remainder of the general rate increase and amortizing the accumulated shortfall in the balancing account will be considered in CalAm's pending general rate case. This proceeding is closed.

Background

Application (A.) 04-08-012 has its roots in the Commission's D.04-05-023 issued in CalAm's last general rate case for Felton District. In that decision, the Commission found reasonable a 34.6% increase for test year 2003 and a further 7.1% for 2004,[1] but deferred imposing the higher rates immediately out of concern for their possible rate shock effect on Felton customers. Instead, CalAm was required to continue charging its then-current Felton rates, to accumulate the shortfall in a balancing account, and to file a new application proposing district consolidation and a method to amortize the accumulated balancing account shortfall.

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[1] CalAm had previously agreed to postpone any 2004 increase to 2005, in accordance with the Commission's earlier order approving CalAm's acquisition by RWE Aktiengesellschaft, Thames Water Acqua Holdings GmbH (RWE).

CalAm's Request

CalAm serves about 1,300 customers in its Felton District, and about 39,000 in Monterey District. In this application, it proposes: (a) the revenue requirement for Felton be combined for ratemaking purposes with that for Monterey; (b) consolidated rates be developed based on the combined revenue requirement of the districts; (c) consolidated rates be implemented immediately in Felton;[2] (d) development of the combined revenue requirement not include source of supply, water production and water treatment costs; (e) Felton rates not be affected either by Monterey's current inverted rate structure or by any past or future costs associated with efforts to develop one or more water supply projects in Monterey designed to comply with California State Water Resources Control Board orders; and (f) the Felton District not be affected by Monterey's past, present and future costs associated with efforts to strengthen or decommission any of the current dams in Monterey District.[3] New consolidated rates determined by this method would take effect when revised rates are implemented in CalAm's two recently filed general rate cases, A.05-02-012 (Monterey) and A.05-02-013 (Felton). In the meantime, Felton's rates would shift with this decision to those of the Monterey standard rate design currently

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2 *Sic.* The "consolidated rates" CalAm intends be implemented immediately in Felton under item (c) are apparently those based on Monterey's standard rate design rather than the item (b) consolidated rates developed from the combined revenue requirement. See the explanation following.

3 A.04-08-012, page 2.

approved but not in actual use,[4] resulting in a modest increase over today's rates, but still less than approved for Felton in D.04-05-023.

CalAm further proposes to recover the Felton revenue balancing account shortfall accumulated up to the date of this decision from Felton District customers over five years by a rate surcharge. Once this decision is issued, a new, second balancing account would begin accumulating the shortfall resulting from the difference between rates approved in D.04-05-023 and the consolidated rates resulting from this decision, and the balance in that account would later be recovered from all Felton and Monterey District customers as a surcharge to the quantity rate eventually approved in A.05-02-012, the Monterey general rate case.

Four parties protested the application and followed through by participating in the evidentiary hearing and briefing: the Commission's Office of Ratepayer Advocates (ORA); Felton FLOW; County of Santa Cruz; and Monterey Peninsula Water Management District (MPWMD).

ORA's Position

ORA recommends the Commission deny CalAm's proposal. According to ORA, approval would be based on unreliable data, violate the Commission's rate

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[4] In Monterey District's last general rate case, D.03-02-030, the Commission generated a steeply inverted water conservation rate design (termed the per capita rate design) and an underlying standard rate design, both to match the same Monterey District revenue requirement. Most Monterey District customers are on the per-capita rate design; those served by four small systems (Ambler Park, Bishop, Hidden Hills, Ryan Ranch) within Monterey District are not. Any difference between actual Monterey revenues under the per-capita rate design and what would have been collected under the standard rate design are tracked in a balancing account for later true-up.

consolidation guidelines,[5] leave Felton ratepayers at risk for large future rate increases, require Monterey ratepayers to subsidize Felton ratepayers, deviate from cost-based rates, move the Commission towards untested statewide water rates, and allow water utilities to increase costs while decreasing service. ORA urges the Commission to instead adopt ORA's proposal to phase in Felton's increases and incorporate low-income and conservation programs in the rate design.

FLOW's Position

FLOW maintains CalAm's consolidation proposal is not in the short-term or long-term best interests of customers in either Monterey District or Felton District. In the short term, Monterey would be required to subsidize Felton at a time when Monterey ratepayers are facing enormous increases in their own rates as a result of CalAm's costly proposals to address water shortages on the Monterey Peninsula. Felton customers have made considerable progress toward forming a public agency and acquiring CalAm's Felton District facilities, and any consolidation the Commission were to approve in the interim could tend to obscure the cost and effect on rates that CalAm's continued ownership and operation of the Felton District would have. FLOW asks the Commission to hold further consideration of rate shock mitigation proposals in Felton District in abeyance, including FLOW's own alternative proposal to consolidate Felton, Larkfield and Sacramento Districts for ratemaking, until Felton voters have

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[5] The guidelines are a set of criteria jointly developed by the former Division of Ratepayer Advocates (now ORA) and the regulated water industry for reviewing water rate consolidation proposals.

expressed their preferences in the upcoming district formation and bond measure election.

Santa Cruz's Position

Santa Cruz favors public acquisition and urges the Commission to deny CalAm's consolidation proposal. Having undertaken the process of forming a Mello-Roos Community Facilities District to finance acquisition of the Felton water system, Santa Cruz is concerned that consolidating the Felton and Monterey revenue requirements will financially entangle or obfuscate Felton District's costs and mislead and confuse the public. Santa Cruz believes consolidation for ratemaking purposes may be one appropriate method of addressing Felton rate shock, but faults CalAm for not having addressed the primary intent of the Commission's earlier order by examining other, better alternatives, including consolidation with CalAm's Sacramento District.

MPWMD's Position

MPWMD joins ORA, FLOW and Santa Cruz in opposing consolidation. MPWMD points to the unfairness of requiring Monterey, a district that CalAm's own figures show faces massive water supply challenges that will double its stand-alone rates by 2008 and more than triple them by 2010, to subsidize Felton, a district with higher average and median household incomes. MPWMD sees as better any one of the three alternatives the other parties propose: rate increase phase-in, public takeover, or Felton's consolidation with Larkfield and Sacramento Districts. If the Commission does order a consolidation, MPWMD urges it be structured such that all ratepayers of both districts share equally all financial burdens. There should be no exclusions for source of supply, water production and water treatment costs, or for capital expenditures necessary to address Monterey's water problems.

The Proceeding

Administrative Law Judge (ALJ) McVicar held a prehearing conference in San Francisco on September 20, 2004. Assigned Commissioner Susan Kennedy issued her Scoping Memo on September 30, confirming this as a ratesetting proceeding needing an evidentiary hearing and establishing the issues and timetable. The Scoping Memo called for public participation hearings in Monterey and Felton on December 6 and 7, 2004 and evidentiary hearings in San Francisco on January 4, 2005. The public participation hearings are described below in the Customer Preferences section of this decision.

At the January 4 evidentiary hearing, it was determined that there were errors in the application figures. In addition, CalAm's rebuttal testimony had presented new material and issues the opposing parties would need time to assess. CalAm had also recently tendered notices of intent for general rate cases in Felton and Monterey Districts, and the very high increases being requested would have significant effects on the potential rates and subsidies in this proceeding. The ALJ granted the opposing parties' motion for a continuance and allowed the intervenors to submit new responsive testimony and CalAm to submit new rebuttal. After three days of evidentiary hearing February 28 through March 2, 2005, the proceeding was submitted on receipt of closing briefs April 29, 2005.

Discussion

The parties brought up a wide range of arguments why CalAm's proposal is or is not in the public interest, and advocated several alternative proposals to address the impact of Felton's postponed general rate increase. We have considered all of their arguments and list and discuss the more significant points below.

Rate Consolidation Guidelines

In 1992 the Commission's Division of Ratepayer Advocates (ORA's predecessor) and the Class A water companies jointly developed a set of policy guidelines to be considered in district rate consolidations.[6] Those guidelines establish four criteria: proximity, rate comparability, water supply, and operation.

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[6] Exhibit CA-5H.

1. Proximity: The districts must be within close proximity to each other. It would not be a requirement that the districts be contiguous as it is recognized that present rate-making districts consist of separate systems which are not connected. It was suggested that districts within 10 miles of each other would meet the location criteria.

2. Rate Comparability: Present and projected future rates should be relatively close with rates of one district no more than 25% greater than rates in the other district or districts. To lessen the rate impact of combining districts it may be necessary to phase in the new rates over several years.

3. Water Supply: Sources of supply should be similar. If one district is virtually dependent upon purchased water, while another district has its own source of supply, future costs could change by a greater percent for one district versus the other. This could result in significantly different rates in the future even if present rates were quite similar.

4. Operation: The districts should be operated in a similar manner. For example, if a single district manager presently operates two or more districts and the billing system is common to the same districts, such an operation would support the combination of the districts.

It was agreed that no districts would be combined for the express purpose of having one district subsidize another.

Although these criteria remain relevant to our consideration, we have previously stated, and reiterated in the Felton District decision that led to today's proceeding,

> [W]e believe that Branch's reliance on our Water Division's 1992 guidelines for combining water utility districts is misplaced. As the testimony at hearing showed, the guidelines were intended then, and continue today, to set criteria for single tariff pricing that, when met, establish prima facie reasonableness of the proposed consolidation. A number of rate consolidations have been approved pursuant to the guidelines without opposition by the Commission's advocacy staff. The guidelines, however, implicitly permit proposals for broader rate consolidations, with the understanding that such proposals are likely to be protested by the advocacy staff in order that a full record can be developed for Commission consideration.[7]

Regarding these guidelines, CalAm and ORA both make statements we agree with and accept for our purposes here. From ORA, "When the DRA Guidelines are not met there is no *prima facie* reasonableness and thus the burden of showing that the advantages of consolidation outweigh the disadvantages falls upon the applicant."[8] And from CalAm, "[T]he Commission may approve a consolidation proposal even though it does not exactly meet the criteria set forth in the Guidelines…. Although the DRA Guidelines are not dispositive, they are still helpful in evaluating California American Water's rate consolidation proposal."[9] With these considerations in mind, we review this proposal's relationship to each criterion.

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[7] D.00-06-075, as cited in D.04-05-023. "Single tariff pricing" is another term for consolidating rates across systems or districts.

[8] ORA Opening Brief, page 12.

[9] A.04-08-012, page 12.

CalAm concedes that combining Felton and Monterey Districts does not meet the proximity criterion.[10] Instead, CalAm argues that advances in communications and connectivity mean that proximity is no longer necessary. CalAm urges the Commission to think of this as the first step in a consolidation of *all* of CalAm's districts throughout the state, in which case distance is irrelevant. ORA emphasizes that these districts are approximately 45 miles apart, in different watersheds, in different counties, and there is no indication that either system is equipped with technology of a type that would relieve CalAm from having to continue to operate it locally. Moreover,

> Water is a scarce resource, like land. It is important that when people choose where to live and industry chooses where to locate that the true environmental costs be reflected in the costs of the land and water. If water is subsidized, more people will choose to live in unsustainable areas. Local control, environmental impacts and growth are intricately linked. Severing the link between rates and costs will adversely impact local land-use planning. The proximity criterion reflects more than the ability to remotely manage an area like an absentee landlord.[11]

We agree with ORA. While not determinative, the proximity criterion is nonetheless relevant for the reasons ORA outlines and for others.

Combining Felton and Monterey Districts does not meet the rate comparability criterion, but may come close depending on how and when the percentage is measured, which rate design is used, and what customer usage level is assumed. Taking revenue requirement as a surrogate for rates overall avoids the need to choose which Monterey rate design and what level of

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[10] A.04-08-012, pages 12, 13; and CalAm Opening Brief, footnote 4.

[11] ORA Opening Brief, page 14.

customer usage to apply for the comparison.[12] CalAm's corrected application figures (Table 1, following section) show that Felton would need a subsidy equivalent to approximately 20% of its revenue requirement to move from today's approved (but not implemented in rates) revenue requirement to a fully combined rate structure in 2005.[13] The subsidy would remain there through 2009, then step up to about 25% each year for the following decade. Under CalAm's general rate case proposed rates for test year 2006 and beyond, the annual subsidy needed would be about 28% of Felton's revenue requirement in 2006 and drop slowly to about 25% over the following decade (Table 2).[14] Since moving Felton customers to the combined rates entails a smaller subsidy than would moving them to the even slightly lower standard Monterey rates, we can conclude with confidence that Felton's rates overall are more than 25% above Monterey's by all of these measures. Felton and Monterey do not meet the rate comparability criterion for consolidation.

With respect to water supply, we previously noted in D.04-05-023 that Felton relies on ample supplies from its creeks and springs, whereas CalAm's

[12] CalAm implicitly endorses using revenue requirement as a measure of rates overall. Exhibit CA-4, page 20.

[13] If Monterey's rates were 20% lower than Felton's, Felton's rates would be 25% higher than Monterey's. The specific wording of the rate comparability criterion suggests the latter, higher figures would be used, in which case the two districts do not meet the rate comparability criterion.

[14] All references to CalAm's proposed figures in its current Monterey and Felton general rate cases are to those in its proposed applications, the latest available at the time the parties were preparing for evidentiary hearing. The figures from CalAm's applications as subsequently filed may have changed slightly, and in any case may differ from those the Commission ultimately adopts.

Monterey water supply comes primarily from wells and dams on the Carmel River and wells elsewhere and is fraught with complication and subject to great uncertainty over the coming years.[15] The evidence in this case reconfirmed that conclusion: The two districts do not meet the water supply criterion.

We also noted in D.04-05-023 that the districts are operated in a similar manner in that they share common upper management, sources of capital, and billing and accounting resources. Each uses its own local personnel for day-to-day operations on site but relies on the same out-of-state personnel for customer service functions. Again, the record in this proceeding confirms our earlier conclusion. Combining Monterey and Felton does meet the operation criterion.

Thus, CalAm's proposed consolidation meets only one of the four rate consolidation criteria. Were we to rely solely on the guidelines, we would reject CalAm's proposal.

Rate and Revenue Requirement Impacts

CalAm cites as precedent for this consolidation one earlier decision in which the Commission approved a Southern California Water Company proposal to introduce single tariff pricing for eight water districts comprising a single region in the Los Angeles area.[16] In rejecting CalAm's consolidation

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[15] This is, in fact, a major concern of local Felton customers, Felton FLOW and Santa Cruz. They fear that, notwithstanding today's intention to insulate Felton ratepayers from Monterey District's problems, if the districts are consolidated there will eventually be pressure to require Felton customers to share the pain of Monterey's very expensive water supply projects.

[16] D.00-06-075 in A.98-09-040. To illustrate that the Southern California Water decision was not unique, CalAm also notes that the Commission has approved at least three

Footnote continued on next page

proposal in D.04-05-023, we noted the earlier decision and the fact that we had sufficient information in that proceeding to examine the Southern California Water proposal and its short and long-range effects in great detail, including the average annual water bill it would produce in each district at stand-alone rates and the proposed regional rates over the following fifteen years. In contrast, the record on which we based D.04-05-023 was much less complete. CalAm has attempted to cure that in this proceeding by providing estimates of each district's stand-alone and combined revenue requirement and rates each year from 2005 through 2019. The rate comparisons are not meaningful, however, because they were based on the Monterey standard rate design that few if any Monterey customers pay, and because the customer effects would vary greatly depending on what consumption levels are assumed.

The revenue requirement comparisons are less sensitive to these assumptions and are therefore more enlightening. The following two tables show CalAm's estimates of the annual revenue requirement shift (*i.e.*, the subsidy) in dollars and what that shift represents as a percentage of each district's stand-alone annual revenue requirement. Table 1 draws on the data CalAm presented in the application (and later corrected) before the new Monterey and Felton general rate cases were filed. Table 2 assumes CalAm's general rate case proposed application requests were granted in full.[17]

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other single-tariff pricing proposals in non-precedential decisions approving settlements.

[17] Table 1 data from CalAm's Exhibit CA-1, Tabs J and K. Table 2 data from Exhibit CA-2, Tabs N and O.

Table 1
Proposed Annual Subsidy (Before Pending Rate Cases)

Year	Monterey to Felton Subsidy	% of Revenue Requirement	
		Monterey	Felton
2005	$250,000	0.68%	19.92%
2006	283,000	0.71	21.54
2007	288,000	0.59	20.64
2008	305,000	0.48	20.74
2009	317,000	0.37	20.53
2010	397,000	0.45	24.46
2011	418,000	0.47	24.59
2012	440,000	0.48	24.77
2013	463,000	0.50	24.94
2014	486,000	0.52	25.10
2015	512,000	0.53	25.38
2016	534,000	0.55	25.45
2017	557,000	0.56	25.56
2018	582,000	0.58	25.67
2019	608,000	0.59	25.87

Table 2
Proposed Annual Subsidy (Including Pending Rate Cases)

Year	Monterey to Felton Subsidy	% of Revenue Requirement	
		Monterey	Felton
2006[18]	526,000	1.20	28.52
2007	534,000	1.00	28.13
2008	543,000	0.89	28.49
2009	539,000	0.57	26.34
2010	557,000	0.53	25.35
2011	548,000	0.53	25.71
2012	566,000	0.54	25.62
2013	583,000	0.56	25.50
2014	600,000	0.57	25.42
2015	617,000	0.58	25.32
2016	633,000	0.59	25.18
2017	650,000	0.59	25.05
2018	670,000	0.60	25.02
2019	683,000	0.60	24.79

Tables 1 and 2 show that under either scenario (considering or not considering CalAm's pending general rate increase requests), under a combined rate structure Monterey customers would provide Felton customers significant and increasing subsidies in the coming years. What these tables do not show, but the underlying data do, is that Monterey customers would be providing these

[18] 2005 data not applicable. Proposed rates would take effect in January 2006.

subsidies at the same time CalAm projects Monterey's stand-alone revenue requirement to climb more than 130%, from $40 million in 2006 to $94 million in 2010. Meanwhile, Felton customers' stand-alone revenue requirement would climb 15% over the same period.[19] The largest part of the disparity is due to CalAm's proposal here to hold separate Monterey's looming water supply infrastructure development bill and to charge that bill to Monterey customers alone. CalAm's proposal thus could widen, rather than narrow, today's rate disparity between these districts after the first few years.

CalAm's response to the parties' criticism on this and other points was to urge the Commission to judge its Felton and Monterey consolidation proposal not entirely on its own merits, but rather as the first step in a new and totally different proposal not mentioned in the application. For the first time in its rebuttal testimony (CalAm prepared no direct testimony to support its application), CalAm described its Monterey and Felton consolidation proposal as a short-term solution with short-term benefits, one that would be a necessary first step toward statewide rate consolidation.[20] On cross-examination, CalAm's witness elaborated, describing a longer term plan under which Monterey and Felton would be consolidated for ratemaking now, Sacramento and Larkfield Districts would be brought in with Felton within three to five years, and all of CalAm's California districts would be combined for ratemaking within five to seven years. Monterey would be the exception. At some unspecified point in that seven-year consolidation process, Monterey would once again be cut loose

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[19] CalAm Exhibit CA-2, Tabs N and O.

[20] Exhibit CA-4, pages 7 and 25.

from Felton and all of CalAm's other districts to stand on its own for ratemaking.[21]

As CalAm sees it, a primary purpose of consolidation is to provide a benefit to its ratepayers in the form of rate equalization and long-term water affordability. Assuming CalAm's long-term objective is indeed statewide consolidation of all districts except Monterey to achieve these ends, to begin by consolidating Monterey with Felton, only to have to split Monterey back out in, at most, seven years because of its water affordability problems, is extraordinarily unhelpful. Thus, CalAm's vision of a long-term, statewide consolidation does nothing to strengthen its case here.

Operational Efficiencies

One factor we would give considerable weight in evaluating this consolidation is any operating efficiencies the two districts combined would have over the two operating separately. In this case, there would be no net operating efficiencies generated.

CalAm's presentation does indeed cite cost savings as a consolidation benefit. "A combined rate schedule can lower operation, maintenance, administrative and regulatory costs…."[22] On closer examination, however, these are not savings in costs, but shifts in cost allocations from Felton customers to Monterey. CalAm characterizes these two districts as "fully integrated" from the perspective of operations and control, with Monterey personnel providing backup support for Felton and all of Felton's operations personnel being

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[21] RT 339-341.

[22] Application at page 9; and Exhibit CA-4, page 18.

managed from Monterey.[23] Although there are specific operations personnel assigned to each separate district, the management staff and specialists within CalAm's Coastal Division are already assigned to both districts. As CalAm states, "[T]he requested consolidation will not modify any of California American Water's operations or the number of personnel in the Felton and Monterey Districts."[24] Thus there are no efficiencies to be gained in that area. Likewise, the two districts already share the same billing system.[25] CalAm claims as benefits reduction of administration costs.[26] However, any claims of improved accounting and administrative efficiencies must be weighed against this CalAm statement:

> To address any concerns regarding accounting of costs and revenues for the Felton District, California American Water will continue to track the revenue requirements of the Monterey and Felton Districts both in combined form and separately. California American Water will not do anything to change the way it records data on the books.[27]

There is, in fact, evidence to show that at least some costs will actually *increase* as a result of consolidation. As Santa Cruz points out, CalAm has proposed a highly complex consolidation which will require segregating and

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[23] Exhibit CA-4, page 18.

[24] California-American Water Company's Motion to Strike Portions of Testimony of Flow and of the Monterey Peninsula Water Management District (December 21, 2004) at pages 2,3.

[25] Exhibit CA-4, page 14.

[26] Exhibit CA-4, page 18.

[27] Exhibit CA-4, page 15.

accurately accounting for a large array of Monterey District expenses and investments to ensure they are correctly allocated to the proper sets of customers, Monterey or Felton. CalAm's witness' testimony in response to cross-examination made clear what a challenge that will be for CalAm.[28] We believe that CalAm will have to invest more effort, not less, in ensuring costs are accurately segregated between districts, and thus its costs in this area will be higher than without consolidation. CalAm claims that regulatory costs would decrease, but we believe they will increase, as we will discuss in the Regulatory Impacts section following.

Service Impacts

FLOW indicated in the prehearing conference that it intended to show service quality in the Felton District is inadequate. In response, the ALJ cautioned the parties that service quality *per se* in the Felton District would not be an issue in the proceeding, but if parties could demonstrate that consolidating the districts would cause a degradation of service quality, that would be relevant. ORA limited its position to stating that CalAm's proposal would not bring service improvements; it did not claim that service would deteriorate.[29]

FLOW spent considerable time and effort developing its position. It presented anecdotal evidence of several Felton District customer service problems, described them in great detail, and attributed them to ownership and management deficiencies. According to FLOW, Felton's service problems have

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[28] *See, e.g.*, RT 331-349.

[29] Exhibit ORA-1, page 25.

worsened since Citizens Utilities Company of California departed and first American Water Works and then RWE Aktiengesellschaft took ownership.

What FLOW did not demonstrate, however, was any credible connection between its quality of service showing and this consolidation proposal. Despite FLOW's claims,[30] there is little or no evidence in the record to show that consolidating Felton and Monterey for ratemaking as CalAm proposes will have any effect, either positive or negative, on service quality in either district. CalAm states that it will continue to operate both districts as it does today, using the same upper management, the same district and regional operating personnel, the same billing system, and the same customer service center, a claim that went largely unchallenged and that we accept for our purposes here. We conclude that CalAm's proposed consolidation would not affect service quality provided to either district.

Regulatory Impacts

CalAm claims that this consolidation would reduce regulatory costs. "…[W]e have shown a variety of benefits beyond subsidization, including… lower costs of rate cases (only one application)…."[31]

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[30] "FLOW believes that further consolidation of the Felton and Monterey Districts, for ratemaking purposes, under RWE's inattentive corporate oversight and the Monterey District's ineffective managements would only serve to further aggravate the problems Felton has experienced." (FLOW"s Exhibit F-1, page 10).

[31] Exhibit CA-4, page 18. CalAm also foresees lower regulatory costs from its longer term, statewide consolidation plan: "Ultimately, rate consolidation of all of California American Water's operating companies and districts throughout the state will benefit all customers through savings achieved in combining administrative and regulatory costs, and through improved rate and revenue stability." (CalAm Opening Brief, page 4, citing Exhibit CA-4, p18).

ORA sees the opposite. "Contrary to reducing regulatory burdens on the Commission, this proposal would add to them by requiring careful scrutiny of which costs are separate and which are combined. While a portion of the rates would be consolidated, CalAm also proposes district specific rate components, requiring more complex work when reviewing future rate cases."[32] Indeed, CalAm proposes to segregate out and insulate Felton customers from Monterey's source of supply, water production and water treatment costs, Monterey's past or future State Water Resources Control Board order-related costs, and Monterey's past, present and future dam strengthening or decommissioning costs. All of this additional accounting complexity will burden CalAm, the intervening parties and the Commission when evaluating rate increase requests.

The fact that CalAm would be able to file a single general rate increase application instead of two for these districts is of no consequence; the Commission already consolidates multiple districts from the same company into one proceeding when they are filed for the same test period. And, in any case, ORA and CalAm concur that consolidation, if approved, will require *double* regulatory accounting. In the only earlier decision CalAm cites as precedent, we required Southern California Water Company to continue to calculate its revenue requirements separately for each of the eight districts consolidated for ratemaking, and directed that each be subject to the same regulatory and community review as before in general rate cases.[33] If the Commission were to approve consolidating Monterey and Felton, ORA recommends the Commission

[32] Exhibit ORA-1, pages 3, 35.

[33] D.00-06-075.

impose those same requirements on CalAm.[34] CalAm seconds this recommendation and has indicated it would track the revenue requirements for the districts in both combined and separate forms.[35]

For its part, Santa Cruz doubts that CalAm is capable of handling the accounting burden it promises to undertake.

> In addition to the other negative impacts on ratepayers cited by ORA in its testimony, Cal-Am lacks the capacity to consistently segregate costs and maintain proper accounting. In both this application and Cal-Am's simultaneously filed application to consolidate its Sacramento and Larkfield districts, Cal-Am made significant errors in its applications that caused asymmetry in the amount of the subsidy from the larger district and the corresponding benefit to the smaller district. Notably, both of these errors were in Cal-Am's favor, and were detected, not by Cal-Am, but by the CPUC and intervening parties.
>
> Cal-Am has proposed a highly complex consolidation which will require segregating and accurately accounting for a large array of Monterey district expenses…. Cal-Am has not demonstrated that it has the aptitude to do this correctly…. Considering that Cal-Am cannot even get its CPUC consolidation applications right, Felton and Monterey ratepayers should not be placed in the precarious position of having to perpetually oversee the allocation of costs as between these two districts.[36] [citations omitted.]

[34] Exhibit ORA-1, pages 35, 39.

[35] CalAm Opening Brief, page 15, citing Exhibit CA-4, page 15.

[36] Santa Cruz Opening Brief, pages 10, 11.

CalAm did make the errors with which Santa Cruz charges it. CalAm minimizes their importance, but Santa Cruz' point is well taken. CalAm would have to step up its accounting and ratemaking effort to ensure ratepayers were not unjustly charged for costs not properly allocable to them, and it would fall to general rate case intervenors and the Commission to audit the result.

After examining the evidence presented, we conclude that consolidation would generate additional regulatory costs and burdens for CalAm, ORA, the other parties intervening in CalAm's general rate cases, and the Commission.

Public Ownership

At the time the proposed decision in this proceeding was being drafted, efforts were underway at the local level to convert CalAm's Felton District system to public ownership. Santa Cruz County had begun the process to form a Mello-Roos Community Facilities District to finance the acquisition of Felton's water system,[37] and several significant steps toward public acquisition had been completed.[38] Santa Cruz Local Agency Formation Commission had approved an application by the adjoining San Lorenzo Valley Water District (SLVWD) to expand its sphere of influence to include Felton District. Santa Cruz County and SLVWD had entered into a Mutual Aid and Cooperation Agreement in relation

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[37] The Mello-Roos Community Facilities Act of 1982, California Government Code Section 53311 *et seq.*

[38] On April 8, 2005, Santa Cruz filed its County of Santa Cruz Second Request for Official Notice; Declaration of Miriam Stombler. On April 29, 2005, Santa Cruz filed its County of Santa Cruz Third Request for Official Notice; Declaration of Miriam Stombler. Both motions seek to update the record as to the County's progress in forming and funding a community services district and calling a special election. Documents in the later motion effectively moot the earlier motion. No party responded to either motion. Santa Cruz's April 29, 2005 motion is granted.

to possible acquisition.[39] The Santa Cruz County Board of Supervisors had approved a FLOW petition and authorized funds to begin the process of forming a community facilities district, and had authorized a Joint Community Facilities Agreement with SLVWD. On July 26, 2005, Felton voters approved Measure W by a 74.8% to 25.2% margin, authorizing the formation of Community Facilities District No. 1 (Felton), issuance of up to $11 million in bonds to acquire CalAm's Felton water system, and a special tax based on water meter size to repay the bonds.[40] The new community facilities district will presumably either negotiate a purchase with CalAm or file suit in Superior Court to condemn and take over the Felton system.

The intervening parties all agree that public acquisition would be preferable to CalAm's consolidation proposal. ORA, Santa Cruz and FLOW fear that the Commission's approving consolidation with Monterey could hinder the public acquisition effort by obfuscating Felton District's cost and revenue accounting going forward. As they see it, any consolidation for ratemaking could obscure the cost and effect on rates of CalAm's continued ownership and operation of Felton District. They urge the Commission to either deny the application or hold off as long as public acquisition remains on the table.

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[39] According to FLOW, the Felton District and SLVWD systems were once interconnected and jointly owned and operated by Citizens Utilities Company of California. The SLVWD facilities were converted to public ownership in about 1965, while the Felton District facilities remained with Citizens and eventually were acquired by CalAm. (Exhibit F-1, page 2).

[40] We take official notice of the election result. Santa Cruz County Elections Department, http://www.votescount.com/jul05/.

CalAm disagrees, arguing that condemnation is an option a public agency can pursue at any time, irrespective of whether rates have been consolidated. We agree with CalAm. Public acquisition may well be the best option for the customers of privately owned water systems in some cases,[41] but that depends on many factors including, *e.g.*, the purchase price, the condition of the system, the acquiring district's ability to operate and maintain the system, and others, factors not developed in the record here. Although our approving or denying consolidation may have some influence one way or the other on the outcome, that possibility will not be a factor in our decision in this proceeding.

Customer Preferences

The major factor leading the Commission to consider consolidating Monterey and Felton's rates was its desire to relieve Felton District ratepayers of "rate shock," a large rate increase imposed over a short period of time. In D.04-05-023, the last Felton District general rate case, the Commission found that CalAm was due a 34.6% increase for test year 2003 and a further 7.1% for 2004, but deferred imposing the higher rates immediately out of concern for their possible rate shock effect on Felton customers. After the ALJ's proposed decision recommending the entire 34.6% increase be implemented in the first year was made public, members of the public and some parties expressed their disbelief that such a large one-time increase could possibly be justified, and urged the Commission to find a less-burdensome alternative. CalAm had proposed in that proceeding a Felton-Monterey consolidation to spread part of Felton's increased

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[41] *See, e.g.*, D.02-12-068 in which we found that public acquisition of CalAm's Montara system should result in short-term and long-term economic savings when compared with the alternatives.

revenue requirement to the much larger Monterey District, but the proposed decision had rejected consolidation as unsupported by the evidentiary record. In its final decision, the Commission agreed, but also determined to examine district consolidation more closely as a possible solution to rate shock. CalAm was directed to continue charging its then-current Felton rates, to accumulate the shortfall in a balancing account, and to file a new application proposing district consolidation and a method to amortize the accumulated balancing account shortfall.

During the course of this proceeding, it has become abundantly clear, however, that public opinion is overwhelmingly against consolidation, even as a solution to rate shock. The Commission has received many letters and e-mails in opposition from concerned customers in both districts. At the public participation hearing in Monterey, speakers objected to what they saw as a one-sided proposal that they subsidize Felton with no prospect of benefiting in return. A public participation hearing in Felton the following evening was particularly well attended, with speakers strident in their opposition to being linked with a Monterey system they saw as distant and troubled. Felton speakers, many of them aligned with FLOW, were energized in their opposition by the ongoing campaign being waged by locals to form a public district to acquire the Felton system, and a CalAm-supported counter-effort. At the last day of evidentiary hearing in San Francisco, FLOW presented four Felton customers (three to testify under oath, and one to make an unsworn statement) to describe their displeasure with CalAm, its service, and its consolidation proposal.

ORA contrasts the public's view here with that in the only other successful rate consolidation CalAm cites as precedent. In D.00-06-075, customer support was a positive factor in our decision: "The Commission has received several hundred letters from ratepayers, most of them representing high-rate districts and most of them favoring the regional rate plan."

Our aim in requiring CalAm to file this consolidation proposal was to explore what at the time seemed to be a viable solution to relieve Felton customers from rate shock, a solution seen as having only a small effect on Monterey customers. Whatever public support there may have been for consolidation with Monterey as a solution has now evaporated completely. Monterey customers' reaction is understandable; they would be asked to subsidize Felton. It has become clear, however, that the public in Felton is even more vigorous in its opposition.

Alternatives

The parties have suggested several alternatives to consolidation: public acquisition by a local district, consolidation with CalAm's Sacramento District (possibly including Larkfield District as well), and phasing in Felton's suspended rate increase.

FLOW would prefer we reject consolidation and hold the issue of alternatives in abeyance until the community's public acquisition efforts are further along. We have already explained that the pending acquisition effort will not be a factor in this decision. In addition, when this proceeding was submitted no date for a public vote on acquisition had been set. Now that our order will issue *after* the public's vote, we can be confident it will have no effect on the outcome.

FLOW believes that consolidating the three former Citizens districts, Felton, Larkfield and Sacramento, would be a superior alternative to consolidating Felton with Monterey. CalAm has neither proposed nor developed that alternative and opposes it.[42] Sacramento is a larger district than Monterey, has lower rates, and is not plagued by long-term problems as Monterey is. Thus, it may well be true, as parties have represented, that a Sacramento consolidation (with or without Larkfield) would generate a greater rate subsidy and fewer long term risks and uncertainties for Felton than would consolidation with Monterey. On the other hand, Sacramento is considerably more distant and appears to be less operationally coordinated with Felton than is Monterey. More importantly, stakeholders representing Sacramento ratepayers' interests could be expected to have strong views if they were asked to subsidize a CalAm district, and particularly one as distant as Felton, just as Felton and Monterey stakeholders do, yet they have not been provided notice and an opportunity to present those views. The record is insufficient to draw firm conclusions as to any of these factors. Consolidating Felton with Sacramento is not a viable solution to Felton rate shock in this proceeding.

ORA's preferred solution would be to deny the consolidation, order CalAm to phase the currently-suspended rates in over an 18-month period, continue to record the shortfall in the balancing account, and begin amortizing the balancing account over a five-year period after rates reach authorized levels.[43] To soften the effect on low-income customers, ORA would have CalAm establish a low-income program similar to that currently in effect in Monterey District. CalAm objects to the ORA proposal as delaying the implementation of rates the Commission has already approved, continuing to build up a shortfall in the

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[42] CalAm has filed a separate application to consolidate Larkfield and Sacramento (A. 04-08-013).

[43] Exhibit ORA-1, page 36.

balancing account for an additional 18 months, and not taking into effect CalAm's pending Felton general rate increase application.[44]

Conclusion

In D.00-06-075, the Southern California Water decision CalAm cites as precedent for this proceeding, we stated, "…[I]n the future, we will continue to consider proposals for cost averaging on a case-by-case basis, with the burden on proponents of such plans to show substantial benefits in the public interest." That remains our view today. While there may be water district consolidations that offer substantial benefits and are in the public interest, the record here shows that consolidating Felton with Monterey is not one of them. It meets only one of the four guidelines criteria (operational similarity). The intermediate and long-term rates that would result from the consolidation are impossible to quantify with even a modest degree of confidence, and consolidation could widen, rather than narrow, the rate disparity between the districts after the first few years. Consolidation would not lead to net operating efficiencies or service improvements, but would generate additional regulatory costs and burdens for CalAm, ORA, other parties, and the Commission. And consolidation is almost universally opposed by ratepayers in both districts who are its supposed beneficiaries, and by the parties representing their interests in this proceeding (ORA, Santa Cruz, FLOW and MPWMD). Even CalAm has acknowledged that

[44] CalAm has filed general rate increase requests for both Monterey District (A.05-02-012) and Felton District (A.05-02-013). In Felton, CalAm seeks increases in 2006, 2007 and 2008 of 105.2%, 3.44%, and 1.03%. CalAm's 105.2% request for 2006 includes the 44.2% increase already granted in D.04-05-023 (34.6% for test year 2003 and a further 7.1% for 2004). If the full 105.2% increase for 2006 were granted, that would represent a 42.3% increase over the rates approved but suspended in D.04-02-013 (*i.e.*, an increase from 144.2% of today's rates to 205.2% of today's rates).

Monterey District's problems are such that it should be separated from Felton District (and other California districts) for ratemaking in the longer term. Consolidation is not in the public interest.

There remains the challenge of how to bring Felton District's rates into conformance with the stand-alone revenue requirement we found justified in D.04-05-023. According to CalAm, Felton customers have not had an increase in their approved billed tariff rates since 1998.[45] That being the case, the 44.2% approved in 2004 would represent an average increase of 6.3% per year over the six-year period. While that is higher than the general rate of inflation over the same period, it is not shockingly so. Even if CalAm were to receive the full relief it seeks in A.05-02-013, it would amount to an average annual increase of 9.2% per year between 2004 and 2008. If the Commission were to cut CalAm's 105.2% request by one-third, that result would drop to an average 4.2% annual increase over the four-year period.[46]

These figures demonstrate that the "rate shock" problem has been caused in large part by long intervals between authorized increases, not by wildly excessive rate awards, and argue for an approach along the lines of ORA's proposal: smaller increases phased in over time. ORA suggests immediately increasing quantity charges to the level authorized but suspended in D.04-05-023, and increasing service charges in four equal steps six months apart, the first step to be implemented immediately. Raising the quantity charge first would have

[45] CalAm Exhibit CA-4, page 24.

[46] Our discussion here of CalAm's A.05-02-013 is not intended to prejudge the outcome of that case in any manner. Our decision there will be based entirely on the record developed in that proceeding.

the benefit of allowing cost-sensitive customers to limit their increases by reducing water usage. Considering the seven-year hiatus since the last increase in 1998, the rate at which the balancing account shortfall is growing,[47] and the possibility of an additional increase to come from the 2006 test year general rate case, it would be reasonable to implement the greater portion of the suspended rates sooner rather than later. If we were to raise Felton rates by 30%, that would achieve about two-thirds of the 44.2% suspended increase, leaving the remaining 14.2% to be phased in later as part of the rate design that emerges from the pending test year 2006 general rate case proceeding. A 30% increase would be reasonable and justified considering the circumstances here.[48] We will consider in the general rate case any proposals for low-income rates, and amortizing the accumulated shortfall in the balancing account.

Comments on the Proposed Decision

The principal hearing officer's proposed decision was filed with the Commission and served on all parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure. Comments were filed by _____________.

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[47] Using CalAm-provided figures, ORA estimated that by July 2005 the accumulated shortfall due from Felton's customers in the balancing account would be about $258,000, or $196 per customer, and would be growing at about $15 per customer per month. (Exhibit ORA-1, pages 4 and 12, and Appendix D).

[48] The Commission at one time had a policy of limiting Class A water company rate increases to 50% annually (and to 100% for smaller companies) to avoid rate shock. *See, e.g.*, D.82-03-071, D.83-10-045, D.90-02-045. Felton District has in fact benefited from that policy in the past. (D.82-05-038, May 4, 1982).

Assignment of Proceeding

Susan P. Kennedy is the Assigned Commissioner and James C. McVicar is the assigned ALJ in this proceeding.

Findings of Fact

1. In D.04-05-023, the Commission found reasonable a 34.6% increase in Felton District for test year 2003, and a further 7.1% for 2004, but deferred imposing the higher rates immediately out of concern for their possible rate shock effect on Felton customers. Instead, CalAm was required to continue charging its then-current Felton rates, to accumulate the shortfall in a balancing account, and to file a new application proposing district consolidation and a method to amortize the accumulated balancing account shortfall.
2. CalAm has complied with D.04-05-023, Ordering Paragraph 12, by filing this application.
3. Although the guidelines are not dispositive, they are helpful in evaluating CalAm's rate consolidation proposal.
4. Consolidating Felton and Monterey Districts for ratemaking does not meet the guidelines' proximity criterion, rate comparability criterion, or water supply criterion.
5. Consolidating Felton and Monterey Districts for ratemaking does meet the operation criterion.
6. The rate comparisons CalAm has provided are not meaningful because they were based on the Monterey standard rate design that few if any Monterey customers pay, and because the customer effects would vary greatly depending on what consumption levels are assumed. The intermediate and long-term rates that would result from this consolidation are impossible to quantify with even a modest degree of confidence.

7. The revenue requirement estimates CalAm has provided are useful as surrogates for comparing overall district rate levels.

8. Under a combined rate structure of the type CalAm proposes, Monterey customers would provide Felton customers significant and increasing subsidies in the coming years.

9. Using CalAm's figures, the subsidies Monterey customers would be providing to Felton customers would occur at the same time CalAm projects Monterey's stand-alone revenue requirement to climb more than 130%. Felton customers' stand-alone revenue requirement would climb 15% over the same period.

10. CalAm's proposal could widen, rather than narrow, today's rate disparity between Monterey and Felton Districts after the first few years.

11. Consolidating Monterey and Felton Districts for ratemaking would generate no net operating efficiencies.

12. If the districts were consolidated, CalAm would have to invest more effort in ensuring costs are accurately segregated between them, and thus CalAm's accounting expenses in this area would be higher than without consolidation.

13. Consolidation would generate additional regulatory costs and burdens for CalAm, ORA, the other parties intervening in CalAm's general rate cases, and the Commission.

14. CalAm's proposed consolidation would not affect service quality provided to either district.

15. The possibility of public acquisition is not a factor in our decision in this proceeding.

16. Public opinion in both districts is against CalAm's proposed consolidation.

17. Stakeholders representing Sacramento District ratepayers' interests could be expected to have strong views if they were asked to subsidize Felton ratepayers, yet they have not been provided notice and an opportunity to present those views in this proceeding.

18. Consolidating Felton with Sacramento is not a viable solution to Felton rate shock in this proceeding.

19. Consolidating Felton and Monterey Districts for ratemaking as proposed by CalAm does not offer substantial benefits in the public interest.

20. Felton customers have not had an increase in their approved billed tariff rates since 1998.

21. Felton's rate shock problem has been caused in large part by long intervals between authorized increases.

22. It would be reasonable to implement the greater portion of Felton's suspended rates sooner rather than later.

23. Raising Felton's rates by 30% immediately as a first step toward full parity with Felton's Commission-approved revenue requirement would be reasonable and justified.

Conclusions of Law

1. The guidelines set criteria for district consolidation that, when met, establish *prima facie* reasonableness. When the guidelines are not met, there is no *prima facie* reasonableness, and the burden of showing that the advantages of consolidation outweigh the disadvantages falls on the applicant.

2. Consolidating Felton and Monterey Districts for ratemaking as proposed by Cal Am is not in the public interest.

3. CalAm's request to restructure and consolidate its Felton District and Monterey District rates should be denied

4. CalAm should be ordered to increase its Felton District rates by 30% immediately, and to continue to accumulate in its existing D.04-05-023, Ordering Paragraph 6, balancing account the difference between revenues produced by the rates authorized in this decision and the revenues that would have been produced had the Felton District rates in Appendices B and C of D.04-05-023 taken effect.

5. This decision should be made effective immediately.

O R D E R

IT IS ORDERED that:

1. California American Water Company's (CalAm) request to restructure and consolidate its Felton District and Monterey District rates is denied.

2. Not later than 30 days after the effective date of this order, CalAm shall file in accordance with General Order 96, and make effective on five days' notice, revised tariff schedules for Felton District implementing an overall 30% revenue increase. The revenue increase shall be achieved by implementing the full quantity charge found reasonable but suspended in Decision (D.) 04-05-023 for test years 2003 and 2004 taken together, and then the necessary percentage of the D.04-05-023 adopted 2003 and 2004 general metered service charge increases (Schedule No. FE-1) and private fire protection service rate increases (Schedule No. FE-4) sufficient to bring the overall increase up to 30%.

3. CalAm shall continue to accumulate in its existing D.04-05-023, Ordering Paragraph 6, balancing account the difference between revenues produced by the rates authorized in this decision and the revenues that would have been produced had the Felton District rates in Appendices B and C of D.04-05-023 taken effect.

4. The rates and balancing account entries in Ordering Paragraphs 2 and 3 shall continue until further order of the Commission.

5. Application 04-08-012 is closed.

This order is effective today.

Dated __________________, at San Francisco, California.