

Decision PROPOSED DECISION OF ALJ GALVIN (Mailed 11/02/2005)

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

In the Matter of the Application of CALIFORNIA WATER SERVICE COMPANY (U 60 W), a corporation, for an order authorizing treatment of net proceeds from real property sales as subject to Public Utilities Code § 790.

Application 03-12-008  
(Filed December 4, 2003)

In the Matter of the Application of CALIFORNIA WATER SERVICE COMPANY (U 60 W), a corporation, for an order authorizing replacement of the operations center and customer center in the Chico District and treatment of their net sale proceeds as subject to Public Utilities Code § 790.

Application 04-08-017  
(Filed August 17, 2004)

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**OPINION ON TREATMENT OF PROCEEDS FROM SALES  
OF PROPERTY FORMERLY INCLUDED IN RATE BASE**

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## **OPINION ON TREATMENT OF PROCEEDS FROM SALES OF PROPERTY FORMERLY INCLUDED IN RATE BASE**

### **I. Summary**

California Water Service Company's (CWS) sale of its old Chico operations and customer centers, which constitute real property no longer necessary or useful for its public utility duties, is not subject to Public Utilities Code Section (Section) 851.<sup>1</sup> The remaining \$1,182,462 investment in the new Chico District consolidated operations and customer center investment not yet in rate base shall be included in rate base, and CWS shall have an opportunity to earn a fair return on that investment through a \$171,300 revenue requirement change.

CWS is authorized to establish its Historical Infrastructure Memorandum Account (HIMA) and prospective Infrastructure Memorandum Account (IMA). The real properties included in CWS's HIMA were not necessary or useful for public utility purposes and are not subject to Section 851 approval. However, these properties are subject to Section 790, so CWS shall continue to track the net sale proceeds in these memorandum accounts pending resolution of gain on sales issues for all regulated water utilities in Rulemaking (R.) 04-09-003. CWS shall also update the information in its IMA as part of its ongoing rate case filings until the Commission establishes a report procedure for all water utilities.

### **II. Background**

CWS filed test year 2002 general rate case (GRC) applications for 15 of the 24 districts in which CWS provides water service, affecting approximately 287,000 customers. These proceedings were consolidated and largely resolved by Decision (D.) 03-09-021, dated September 4, 2003. In that decision, the

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<sup>1</sup> All statutory references are to the Public Utilities Code unless otherwise stated.

Commission took official notice of CWS's 2001 annual report to its shareholders. The annual report explained that CWS and its affiliates, owning more than 900 real estate properties, embarked on a multi-year process to liquidate over \$10 million in property. CWS expected this real estate program to continue for a period of several years, so that, through sales or leases, it could realize the value of surplus properties no longer necessary or useful. In 2001, CWS completed \$3.9 million in pretax sales and expected to complete sales in excess of \$3 million in 2002.<sup>2</sup>

The Commission could not conclusively determine in D.03-09-021 that the properties included in the real estate program of CWS were not subject to Section 851,<sup>3</sup> nor could the Commission determine the proper ratemaking treatment of the amounts realized from those transactions. Thus, D.03-09-021 required CWS to submit an application that fully explained its real estate program from its inception, including rationale and support for removing property from rate base. CWS was also required to seek authority to establish an IMA pursuant to Section 790, the Water Utility Infrastructure Improvement Act of 1995. Finally, the decision required CWS to file an application for authority to replace its Chico operations and customer centers with a combined operations and customer center.

CWS filed Application (A.) 03-12-008 seeking authority to establish its IMA and to explain its real estate program. Approximately eight months later, CWS

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<sup>2</sup> D.03-09-021, *mimeo*, p. 76.

<sup>3</sup> Section 851 provides that every subject transaction made other than in accordance with the order of the Commission authorizing it is void but that nothing in this section prevents the sale by any public utility of property which is not necessary or useful in the performance of its duties to the public.

filed A.04-08-017 seeking authority to replace its Chico operations and customer centers. These applications were consolidated into one proceeding on October 6, 2004. We first address the Chico District issues.

### **III. Chico District Issues**

As part of its Chico District test year 2002 GRC, CWS proposed to charge its ratepayers at least \$1.4 million to build a new combined operations and customer center, declare its old operations and customer centers no longer necessary or useful in the performance of its public utility duties, and to give its shareholders all of the proceeds from the sale of the old centers.

Application 04-08-017 provides additional information on the need of CWS to replace its old Chico operations center and customer center with a new combined Chico operations and customer center. CWS seeks a Commission finding that the old Chico District operations and customer centers were no longer necessary or useful within the meaning of Sections 790 and 851. CWS also seeks authority to include in rate base the remaining \$1,182,462 of the total \$3,109,694 Chico combined operations and customer center costs not yet included in rate base, increase its Chico District rates by \$171,300 so that it may have an opportunity to earn a return on that additional rate base, and treat the entire \$519,751 net sale proceeds from the two real properties, comprising the old Chico operations center and customer center, in accordance with Section 790.

#### **A. The Old Operations Center**

The 50 year old operations center, located on a 1.2 acre parcel of land at 215 Orange Street, Chico, was acquired by CWS in 1940 for \$3,319. On this property was a 2,688 square foot manufactured steel building containing a meeting room, shop room, and storage room. Also on this property was a radio building, fuel storage tanks, carports for 14 vehicles, open parking spaces for

25 vehicles, sand and gravel storage bins, an outdoor storage area, a pump house, a well, and an elevated water tank.

A consultant hired by CWS in 2000 discovered that excessive mold and moisture levels existed in the old building due to water intrusion throughout the building. Tests showed concentrations of aspergillus and penicillium which cause allergic responses such as asthma, headaches, nose bleeds, dermatitis, conjunctivitis, and rhinitis. Unsuccessful attempts to repair the leaks continually exposed employees and customers to harmful mold levels.

Since 1986, the Chico District has grown by 62% or nearly 10,000 customers, and is expected to grow further at an annual 2.5% rate. The old building provided an average of 128 square feet of space for each of its 22 employees working in the building, a smaller square footage allowance than most of its other districts.<sup>4</sup> The storage room was also too small to accommodate materials and supplies, and the meeting room had insufficient space to accommodate all employees, requiring employees meetings to be held at alternative locations.

### **B. The Old Customer Center**

The old customer center was acquired by CWS in 1926 and was located at 1540 Esplanade, a few miles away from the old operations. This property consists of three lots, on which are a 1,925 square foot customer center wood frame office building, parking facilities, a well, and a water storage tank. The old customer center provided an average of 241 square feet of work space for each of

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<sup>4</sup> For example, the operations center in the Mid-Peninsula District had 195 square feet per employee, the Los Altos District 190 square feet, and the Bakersfield District 180 square feet.

its eight employees working in the customer center, a lesser space than in most of CWS's other districts.<sup>5</sup> There was also a shortage of customer parking stalls that required employees to park offsite, no conference room for employee meetings, no room for additional file cabinets or storage, and outdated wiring.

### **C. New Combined Customer Center**

The new Chico District customer center combines the old operations center, customer center, and warehouse operations in one building. It is located on a three acre developed site at 2222 Whitman Avenue, Chico. The total cost of this complex was \$3,109,694, as detailed in Exhibit B and C.

The combined customer center has approximately 7,240 square feet compared to 1,925 square feet at the old customer center. This new customer center has a reception area with three work stations for customer service representatives and cubicles for other customer service representatives, meter readers, collectors, service persons, and other office personnel such as the water quality manager and electrical mechanical technician. Offices are also included for the district manager, customer service manager, general superintendent, and an insurance program supervisor. This customer center also has a storage area, break room, conference room, and parking for customers and employees.

The combined operations center has approximately 5,105 square feet compared to 2,688 square feet at the old operations center. This new operations center has a meeting room large enough to hold all district employees, offices for the general foreman and two superintendents, and work stations for the storekeeper, operations clerk, locator and two foremen. The new operations

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<sup>5</sup> For example, the customer center in the Los Altos-Suburban District had 440 square feet per customer center employee and the Bakersfield District 500 square feet.

center also has a pump operator's room that houses hardware for a "SCADA" system, pump charts, water samples, and work station for the operators.

The new warehouse is approximately 5,655 square feet and offers indoor storage space for the storage of new panel boards, generators, and other large items awaiting installation at pump stations that previously had to be stored outside. The new warehouse also provides space for deliveries, pump operations, fabrication, and protection from rain and heat.

The consolidation of its operations center, customer center, and warehouse at one location has enabled CWS to increase efficiencies and to better serve its customers. The new combined office complex is located in a commercial area with convenient access and brings together at one location customer representatives, meter readers, pump operators, collectors, service personnel, and warehouse operations previously spread throughout the entire district.

#### **D. Necessary and Useful**

Although the Office of Ratepayer Advocates (ORA) recommended that the old operations and customer centers either be repaired or rebuilt on the same locations, CWS concluded that neither option was cost effective nor feasible because of the need to comply with stringent land use, local building, local zoning, and Americans With Disabilities Act requirements. Hence, CWS proceeded with the construction of a combined operations and customer center and warehouse.

CWS then assessed the necessity and usefulness of the old operations and customer centers upon being vacated in 2002. Based on that assessment, it subdivided the old operations center in October 2002 to retain the necessary and useful portion, which contained a well, pump house and water storage tank.

CWS also subdivided the old customer center in 2002 to retain a portion of one lot with a well and water tank.

The remaining parts of the old subdivided properties were no longer necessary or useful. With no plan or need for their use, CWS sold the old operations and customer properties to CWS Utility Services for appraised values of \$150,000 and \$325,000, respectively, which, in turn, was sold for approximately \$550,000.

We find that CWS's process to assess its old operations and customer centers was reasonable and appropriate. The sale of these centers, no longer necessary or useful for public utility purposes, does not require Section 851 approval because Section 851 is applicable to only "property necessary or useful in the performance of [the utility's] duties to the public."

As requested by CWS, the net sale proceeds of the centers should be accounted for as described in the following section of this order. CWS has complied with D.03-09-021.

The remaining \$1,182,462 of the new Chico customer center costs not yet in rate base should be included in rate base so that CWS may have an opportunity to earn a fair return on that investment. In this regard, CWS must file an advice letter with the Water Division Director for authority to increase its Chico District rates by \$171,300 as set forth in Exhibit H. Treatment of the \$519,751 net sale proceeds from the two real properties comprising the old Chico centers should be deferred pending resolution of R.04-09-003, where we will address water utility gain on sale issues in accordance with Section 790.

#### **IV. Infrastructure Act Memorandum Account**

Section 790 requires that whenever a water utility sells any real property that was formerly necessary or useful in the performance of the utility's duties,

the utility shall invest the net sale proceeds, if any (including interest at the rate that the Commission prescribes for memorandum accounts) in water system infrastructure, plant, facilities, and properties that are necessary or useful. For purposes of tracking the net proceeds and the required investments, the Commission has directed CWS to establish an IMA.

CWS now seeks authority to establish two IMAs. The first memorandum account is historical, the HIMA, which would record net sale proceeds of all real properties included in rate base at any time that was reclassified out of rate base and either sold outright or transferred to its affiliate, CWS Utility Services, prior to December 31, 2003. The other memorandum account is a prospective IMA, which would be applicable to such properties beginning January 1, 2004. The net sale proceeds of these real properties would be subject to Section 790.

As proposed, the HIMA would include approximately 60 real properties. Each of these real properties was at one time in rate base as either utility plant in service (UPIS) or plant held for future use (PHFU) and reclassified out of rate base to non utility property (NUP). The real properties included in the HIMA remained out of rate base an average of six years prior to either being sold outright or transferred at fair market value by CWS to CWS Utility Services.<sup>6</sup> None of these real properties was disposed of by CWS while classified as UPIS or

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<sup>6</sup> Exhibit F.

PHFU.<sup>7</sup> The total net book value of these properties was approximately \$776,000, and the net sale proceeds were approximately \$19,268,000.<sup>8</sup>

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<sup>7</sup> Reporter's Transcript Vol. 1, p. 57, lines 19 through 22.

<sup>8</sup> Exhibit F.

### **A. Real Estate Program**

Prior to 1997, the Engineering Department of CWS assessed the usefulness of its real properties 10 years or more into the future. Subsequent California Department of Health Services (DHS) establishment of more stringent water quality standards and availability of improved water testing instrumentation to detect groundwater constituents and contaminants at minute levels resulted in CWS reducing its long range assessment to five years.

This shorter assessment period increased the number of real properties perceived to have no likely future use for utility purposes. Some 36 of the real properties included in the HIMA were reclassified out of rate base prior to the establishment of CWS's real estate program; they remained on books of CWS as NUP until sold or transferred to CWS Utility Services. This large inventory of NUP was not providing CWS any return on its investment.

CWS established its real estate program in 1997 to realize value from its NUP inventory through reinvestment into its utility infrastructure, as detailed in Exhibit A.<sup>9</sup> Also, some NUP consist of "nuisance" real property that is a liability to CWS due to trespassing, vandalism, and maintenance problems. In some instances, the cost to patrol the properties and to control vegetation exceeds their public utility usefulness.<sup>10</sup>

Under its real estate program, CWS periodically inventories its real properties to identify the properties or portions of properties no longer necessary or useful. These are reviewed individually by the Engineering Department and individual districts of CWS to determine if there is a continued present use for

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<sup>9</sup> Exhibit A, p. 3.

<sup>10</sup> Reporter's Transcript Vol. 2, p. 158, lines 13 through 26.

the property, and if not, whether there is a future use. The latter is determined by considering property size, location, elevation, and history of water and soil quality. Detailed requirements for potential future use as a storage tank, booster station, or well site are set forth in Exhibit A. If a site does not meet the requirements, CWS estimates the cost to rehabilitate the site for utility use.

CWS prepares a written memo for each site it determines no longer necessary or useful, explaining the basis of its determination.<sup>11</sup> The real property is then decommissioned and transferred out of rate base to a non utility classification until sold or transferred, as described above.<sup>12</sup> CWS discontinued the practice of transferring real property no longer necessary or useful to CWS Utilities Services in the spring of 2003.<sup>13</sup> A detailed present and future use assessment of each real property included in the proposed HIMA of CWS is set forth in Exhibits A and D.

## **B. ORA's Analysis**

ORA selected several of the higher valued properties included in the HIMA for inspection and field visits. ORA also reviewed the work papers and exhibits of CWS. From its inspection and review, ORA acknowledged merit of the reasons cited by CWS for taking real properties out of UPIS and PHFU. However, ORA believes that CWS could have rehabilitated some sites. ORA

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<sup>11</sup> Although this is a consistent company policy, CWS acknowledged that some of the memos declaring real property no longer useful prior to 1975 were not available and apparently lost. *See Reporter's Transcript Vol. 2, line 16 through p. 161, p.13.*

<sup>12</sup> Real property transferred from CWS to CWS Utility Services was valued at the fair market value of the property at the date of transfer. Fair market value was determined from an appraisal, except for nominally valued property which was valued internally. *See Reporter's Transcript Vol. 1, p. 25, lines 3 through 7.*

<sup>13</sup> Exhibit A, p. 7.

used as example the well sites reclassified out of UPIS and PHFU due to declining water production, sand, or high concentrations of contaminants (such as nitrates, arsenic and salt water intrusion). ORA believes that CWS could have blended the water with better quality water, treated the contaminants with chemicals, or deepened the wells.<sup>14</sup>

ORA concluded that CWS did not carry its burden of substantiating that the sites it sold were not necessary or useful prior to sale. ORA further concluded that CWS violated Sections 851 (because CWS either sold or assigned used or useful real property without first obtaining Commission authority) and violated Section 455.5 (because CWS did not notify the Commission within nine months that it had taken any production facilities out of service).

ORA recommends that the request of CWS for authority to apply Section 790 to the sale and transfer of real property under its real estate program be denied, and that CWS be fined \$160,000 for its failure to comply with Section 851. ORA further recommends that the Commission ensure ratepayers receive the benefit from the net proceeds of sales and transfers listed in the HIMA. ORA would implement this recommendation by requiring CWS to reduce the cost of replacement real property within an eight year period subsequent to any such sale or transfer.<sup>15</sup>

### **C. Discussion**

To determine whether CWS properly included the approximately 60 real properties in its HIMA, We first review the difference between UPIS, PHFU, and NUP. These differences are identified in the Uniform System of

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<sup>14</sup> Exhibit G, p. 11.

<sup>15</sup> *Id.*

Accounts (USOA), which was adopted by the Commission for Class A Water Utilities in D.50185, as modified by D.57578.

UPIS consists of real property owned and used by a utility to perform its public utility function. PHFU consists of real property held for future utility use under a definite plan. NUP property consists of property not currently being used for a utility purpose and having no definitive plan for a future utility purpose. UPIS and PHFU investments are components of rate base; these investments and associated expenses are recoverable through water rates. NUP investments and associated expenses are excluded from rate base and not recoverable through water rates.

Of some 60 real properties in CWS's HIMA, 47 are well sites. The majority of these sites were acquired more than 30 years ago, dating back as far as 1927 when land use requirements were minimal and acceptable contaminate levels were much less restrictive than they are now. CWS reclassifies a well site from UPIS to NUP if the site is no longer necessary or useful; it reclassifies a well site from UPIS to PHFU only if the individual site not currently necessary or useful has the potential to comply with local agencies' current permitting requirements and DHS requirements, including minimum square footage requirements for the construction of a well and related wellhead treatment facilities.<sup>16</sup> The current minimum square footage required by CWS for a well site is 10,000 square feet. This requirement was recently increased from 6,000 square

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<sup>16</sup> Exhibit D, p. 3-5.

feet to allow space for treatment facilities to meet more stringent water-quality requirements.<sup>17</sup>

Of these 47 no longer necessary or useful well sites, 38 were not suitable for future use primarily because of the minimum square footage criterion; of these, 10 have even less than 6,000 square feet.<sup>18</sup> As an example, retired BK Well Station #31 acquired in 1928 (inconsistently identified as reclassified to NUP in 1980 in Exhibit D and 1992 in Exhibit E) had not been in service since 1962 due to a drop in the water table. Although this UPIS well site was taken off line in 1962, CWS kept it in UPIS for backup supply and fire protection.

CWS, no longer needing the well for backup supply or fire protection, began decommissioning the well in 1977 pursuant to DHS requirements. CWS filled the well with concrete up to a depth of six feet underground, and completed the filling process with soil. All pipes and buildings were then removed. Upon completion of decommissioning and satisfying DHS requirements in 1980, the site was reclassified to PHFU.

In 1992, as part of its review of PHFU sites, CWS determined that the 3,801 square foot parcel was no longer potentially necessary or useful because the site was substantially below its current minimum 10,000 square foot requirement for a well site.<sup>19</sup> This site was reclassified to NUP from PHFU.

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<sup>17</sup> Reporter's Transcript Vol. 2, p. 156, lines 4 through 27.

<sup>18</sup> Poor water quality caused by salt water intrusion was the other major reason well sites were no longer necessary or useful. For example, the Hermosa Redondo Well Site #13 with 40,266 square feet was reclassified no longer necessary or useful in 1988 due to salt water intrusion.

<sup>19</sup> Reporter's Transcript Vol. 2, p. 156, lines 4 through 27.

CWS explained that, over the years, it has consistently applied sound engineering principles to analyze potential future necessity or usefulness of its well sites. It also acknowledged that some of its records were lost over the years.<sup>20</sup> There is no evidence to support the apparent inclusion of this Bk Wall Station #31 in rate base as PHFU from completion of the decommissioning process in 1980 to the date it was actually transferred to NUP in 1992. However, this site, having a book value of \$434, did not materially impact ratepayers during the dozen years it was erroneously classified as PHFU. CWS should strengthen its record keeping process to avoid this type of error in the future and to ensure that its written assessments of UPIS and PHFU determinations are included in the original property records of each site. The IMA requirements we adopt today will complement this strengthened record keeping.

CWS did not dispute ORA's contention that CWS could have implemented measures to retain its BK Well Station #31 or its other real properties for utility use. However, CWS explained that the measures identified by ORA are not routine.<sup>21</sup> CWS would have to determine for each property the extent and costs of measures needed to keep the property necessary and useful. There is no evidence on the cost of measures needed to retain these well sites in UPIS or PHFU. However, there is evidence that blending water or drilling deeper or new wells in locations contaminated with saltwater, as proposed by ORA, would not necessarily achieve compliance with water quality

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<sup>20</sup> Reporter's Transcript Vol. 2, p.161.

<sup>21</sup> Reporter's Transcript Vol. 1, p.72 through p. 80.

requirements.<sup>22</sup> In any event, CWS would undertake only those measures that are cost effective.

The remaining real properties included in the HIMA consisted of tank, reservoir, booster pump, and operations center sites. CWS used the same necessity and usefulness criteria for these sites that it used to assess its well sites. For example, tank and operations center sites such as the Dominguez tank and operations center and the Hermosa-Redondo District operations center were classified no longer necessary or useful due to the Dominguez Water Company merger into CWS. This merger resulted in a water system interconnection and an operational and administrative consolidation of the two companies into a single district and new regional operations building.<sup>23</sup>

The criteria CWS used to reclassify its UPIS and PHFU properties to NUP are reasonable and consistent with the requirements set forth in the USOA for Class A Water Utilities, as adopted by this Commission. CWS followed these criteria in classifying its properties as NUP prior to being sold. We find that the properties CWS included in its HIMA are appropriately includable in its HIMA.

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<sup>22</sup> *Id.*

<sup>23</sup> D.00-05-047 *mimeo*, Ordering Paragraph 2.c. Subsequently, in Dominguez District's A.03-01-037 GRC, CWS and ORA entered into a settlement agreement on the sale and exchange of real properties used to acquire the new regional operations center. The agreement provided that CWS would report the sale of Dominguez District real properties in accordance with D.03-09-021, and that Dominguez District ratepayers would continue to pay the revenue requirement associated with operating Dominguez' pre-merged headquarters pending Commission resolution of the gain on sale of Dominguez' real property pertaining to the new regional operations building.

#### **D. Applicability of Section 851**

Section 851 precludes any public utility from selling real property that is necessary or useful in the performance of its public utility duties without first having secured Commission's authorization.

ORA does not object to CWS removing from rate base, without Commission approval, the real property CWS considers no longer necessary or useful.<sup>24</sup> However, ORA does object to CWS selling the property prior to obtaining Section 851 approval from the Commission.<sup>25</sup> Because CWS neither requested nor received Commission permission to sell any of the real properties included in its HIMA, ORA recommends a \$160,000 fine (based on \$20,000 per year from the beginning of the real estate program in 1997 to 2005) for Section 851 violations.<sup>26</sup>

In support of its position, ORA cites a Southern California Water Company (SCWC) decision in which the Commission fined SCWC for not seeking Section 851 approval to lease a portion of certain water rights.<sup>27</sup> The Commission held that consideration of whether Section 851 approval is needed is made only after a utility files an application seeking Section 851 approval, and that the issue of necessity or usefulness is factual and subject to Commission review.<sup>28</sup>

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<sup>24</sup> Reporter's Transcript Vol. 2, p. 244, line 24 through p. 245, line 2.

<sup>25</sup> *Id.*, p. 245, line 3 through 10.

<sup>26</sup> Exhibit G, p. 14 and 15.

<sup>27</sup> D.04-03-009, as modified by D.04-04-069 and further modified by D.04-09-028, *mimeo*, p. 8, as part of an order denying rehearing.

<sup>28</sup> D.04-09-028 (2004) *mimeo*, p. 7 and 8.

The SCWC situation is different from the situation before us. SCWC acquired water rights as part of its acquisition of Natomas Water Company. Because it was common practice to not assign any monetary value to water rights at the time SCWC acquired the water rights, the value of those water rights was included in rate base as part of the overall purchase price paid by SCWC. Ratepayers were paying shareholders a rate of return on that investment, and shareholders were not responsible for recovery of any of the carrying costs.<sup>29</sup> Therefore, at the time SCWC leased a portion of those water rights to the City of Folsom, the value of such water rights remained in rate base and never transferred into NUP.

In contrast, CWS transferred the entire value of each real property out of rate base to NUP from either UPIS or PHFU and kept them out of rate base an average of six years prior to selling.<sup>30</sup> Irrespective of any differences between the SCWC decision and CWS's position, the key point in the SCWC decision to consider in this proceeding is that the issue of necessity or usefulness is a factual one that the Commission has the option to review.

ORA appears to interpret the SCWC holding to be that, without exception, a utility must obtain Section 851 approval prior to selling real property that was at any time in rate base. We note that, based on the CWS sale of real properties included in its HIMA, CWS would have averaged 7-8 (approximately 60 real properties over an eight year span from 1996 through 2003) Section 851 applications per year.

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<sup>29</sup> *Id.*, p. 20.

<sup>30</sup> Exhibit F.

As an alternative to CWS filing individual Section 851 applications, ORA recommends that CWS seek, as part of its three-year GRC cycle, specific Section 851 approval for real properties it determines no longer necessary or useful. ORA already reviews the status of CWS's real property as part of ORA's Master Data Request and analysis of rate base. However, historically, CWS has not included Section 851 approval requests for the sale or transfer of property in its GRCs.

As discussed above, the Commission has discretion to review a utility's decision to sell real property that was formerly in rate base. We decline, however, to require CWS to seek specific Section 851 approval for each of its real properties determined by CWS to be no longer necessary or useful. We have already found CWS' UPIS and PHFU criteria to be reasonable and consistent with the USOA as adopted by this Commission. It is sufficient for purposes of regulatory oversight that we ensure CWS applies those criteria to its properties in a regular and consistent fashion.

The real properties included in the HIMA are not subject to Section 851 approval, and should not subject CWS to any penalty. In so holding, we retain our power to review the reasonableness of decisions by utility management, in particular, those decisions relating to continuing real or other property in rate base. Utility property is occasionally retired too early, and it is occasionally retained in rate base far too long. Both these management decisions can result in harm to ratepayers. Nothing in this decision limits our power to protect ratepayers in those circumstances.

### **E. Applicability of Section 455.5**

Section 455.5 requires, among other things, that a water utility notify the Commission of water production facility which, after having been placed in service, remains out of service for nine or more consecutive months.

CWS did not dispute ORA's assertion that CWS did not notify the Commission when the real properties listed in its HIMA had been out of service for nine consecutive months. In its defense, CWS explained that the water facilities it routinely takes out of actual service for at least six months while remaining in rate base are exempt from being reported to the Commission because such water facilities are not "major facilities" critical for its public utility duties. Such properties have included water tanks taken out of service for maintenance and cleaning and wells placed on standby for only fire service due to taste, odor or coloration problems.<sup>31</sup> Further, the properties included in its HIMA were no longer necessary or useful.

CWS considers whether an individual real property has a significant effect on providing water service as the criteria for determining whether the facility taken out of service is a major facility. For example, if a well taken out of service is in a district having only that one well, it meets CWS's major facilities criterion and would be reported to the Commission. However, if the well taken out of service is in a district having 200 wells, like the Bakersfield District, that well would not be considered a major facility and the removal would not be reported to the Commission. This is because that one well would not have a material impact on CWS providing public water service.<sup>32</sup>

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<sup>31</sup> *Id.* p. 179, lines 14 through 28.

<sup>32</sup> *Id.* p. 182, lines 4 through line 13.

Subsection (f) of Section 455.5 is reasonably consistent with this position of CWS. The subsection limits the reporting requirement to those water production facilities that the Commission determines to be a “major facility” of the utility, and does not include any facility determined by the Commission to constitute PHFU. Although major facility is not defined in the code, the Commission has proposed in R.04-09-003 to define a major facility as it pertains to Section 455.5. For lack of a Commission definition of major facility at this time, we look to the evidentiary record to determine what impact, if any, these real properties taken out of service had on CWS providing public water service.

Consistent with the definition of CWS, ORA defined a major facility to be an item that would have a significant effect on the operation of a water system, with “significant” meaning to have some sort of impact on the water system.<sup>33</sup>

The record in this proceeding does not share any such impact. Notice of the applications to the customers of CWS did not result in the receipt of any customer complaints regarding CWS’s water service. Further, no formal complaints were brought at the Commission that relate to production facilities taken off line during this time period.

Although Section 455.5(f) leaves the determination of major facilities up to the Commission, it is impracticable for this Commission to categorize each of the over 900 real properties owned by CWS. In so holding, similar to our Section 851 discussion, we retain our power to review the reasonableness of decisions by utility management. Until such time that the Commission clarifies

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<sup>33</sup> *Id.* p. 242, lines 7 through 13.

the definition of major facilities, we concur with CWS's and ORA's assessment that the criterion for determining which real property is a major facility should be whether the property has a significant effect on providing water service.

We conclude from this major facility definition, and from the lack of any evidence that the real properties included in the HIMA had any impact on the ability of CWS to provide water service, that CWS has not violated Section 455.5.

#### **F. Applicability of Section 790**

There is no dispute that Section 790 requires CWS to establish an IMA and to include in the IMA sale proceeds of real property that was at any time, but is no longer, necessary or useful. However, ORA does oppose CWS including real property in the memorandum accounts prior to CWS obtaining Commission approval to sell the property. Once approval is obtained, ORA recommend that CWS include the sale proceeds in an IMA and track the sale proceeds for eight years. During this time period, the net sale proceeds would be "used to reduce the cost of any necessary replacement property." If no replacement property was necessary during that time period, the net proceeds would then be awarded to the shareholders. CWS would be allowed to earn a return on the net proceeds only to the extent that CWS invested an amount that is equal or greater than the net proceeds in its infrastructure.<sup>34</sup>

This ORA recommendation is not completely consistent with Section 790. Subsection (b) of this section specifically requires **all** utility infrastructure acquired by investments from an IMA to be included among its other utility property upon which the utility has an opportunity to earn a

reasonable return. The code makes no distinction between replacement and other infrastructure property. Therefore, sale proceeds reinvested into CWS's infrastructure should be available to provide CWS an opportunity to earn a reasonable return.

CWS's HIMA appears to be in compliance with Section 790. The net proceeds, along with debt financing during the same period of time, were exceeded by CWS's investments in its utility infrastructure from 1997 to 2004.<sup>35</sup> However, approval of the amount of sale proceeds included in the HIMA for reinvestment into the infrastructure of CWS should not be granted at this time. This is because the sale proceeds included in CWS's HIMA is an issue in our R.04-09-003, regarding allocation of gains on sale, where we will create guidelines and a specific rule on allocation of the gain on sale between shareholders and ratepayers, so that allocation of the gain for a specific sale is easy and clear-cut.<sup>36</sup> With respect to water utilities, gain on sale issues being addressed on a generic basis include whether the entire gain is included in rate base pursuant to Section 790, a reconciliation between Section 790 and Section 851, and the amount, if any, of gains from non-shareholder investments that should be included in rate base.<sup>37</sup> Therefore, CWS should continue to track the sale proceeds in its HIMA and IMA pending a R.04-09-003 resolution of Section 790 gain on sales.

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<sup>34</sup> Exhibit G, p. 11.

<sup>35</sup> Appendix A to A.03-12-008.

<sup>36</sup> RE: Order Instituting Rulemaking Regarding Allocation of Gains On Sale By Energy Utilities, Incumbent Local Telecommunications Carriers and Water Companies. R.04-09-003 (September 2, 2004) *mimeo*, p. 3.

<sup>37</sup> *Id. mimeo*, p. 31.

Regarding the Dominguez real property subject to a settlement agreement between CWS and ORA included in the HIMA, the parties shall abide by terms of that agreement and upon a R.04-09-003 gain on sale resolution. If CWS is ordered to share Section 790 gains with ratepayers, it shall, in its next GRC for that district, provide testimony on charging an equivalent rent to its ratepayers. However, if CWS is not required to share the gain on sale, ratepayers shall continue to pay the revenue requirement associated with the costs of owning and operating the pre-merger Dominquez District headquarters. If the Commission orders CWS to take action other than sharing or not sharing the gain with ratepayers, CWS and ORA agree not to be bound by the settlement agreement and may litigate the Dominguez real property issue in the next GRC.<sup>38</sup>

ORA also recommends that CWS file an annual IMA report that includes a description and status of all real properties approved by the Commission for sale and disposition of the net proceeds. We concur that there is a need for periodic reporting. However, we are reluctant to burden CWS and Commission staff with separate preparation and review, respectively, of an additional yearly filing. Instead, we will require CWS to report and ORA to review CWS's IMA as part of its ongoing GRC filings until the Commission establishes a reporting procedure for all water utilities.

CWS has complied with Ordering Paragraph 13 of D.03-09-021.

## **V. Procedural Matters**

By Resolutions ALJ 176-3125 and ALJ 176-3138, dated December 18, 2003 and September 2, 2004, respectively, the Commission preliminarily categorized these proceeding as ratesetting, and preliminarily determined that hearings were

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<sup>38</sup> D.04-04-041 *mimeo*, Settlement Agreement, Section 2.2.

necessary. Notice of A.03-12-008 and A.04-08-017 appeared in the Commission's Daily Calendar of December 10, 2003 and September 3, 2004, respectively. The Scoping Memo and Ruling of the Assigned Commissioner confirms that the category for this proceeding is ratesetting.

A Prehearing Conference (PHC) on A.03-12-008 was held on January 23, 2004 and continued to February 27, 2004 so that CWS could supplement its prepared testimony. A PHC on A.04-08-017 was held on October 6, 2004, at which time A.04-08-017 was consolidated with A.03-12-008 upon the request of ORA.<sup>39</sup> An evidentiary hearing was held on March 7 and 8, 2005. This matter was submitted upon the receipt of reply briefs on April 29, 2005.

## **VI. Comment on Proposed Decision**

The proposed decision of the ALJ in this consolidated matter was mailed to the parties in accordance with Section 311(d) and Rule 77.1 of the Rules of Practice and Procedure. Comments were filed on \_\_\_\_\_.

## **VII. Assignment of Proceeding**

Susan P. Kennedy is the Assigned Commissioner and Michael J. Galvin is the assigned Administrative Law Judge in this proceeding.

## **Findings of Fact**

1. The old Chico operations center office had excessive mold and moisture levels causing allergic responses.
2. The Chico District has grown by 62% or nearly 10,000 customers since 1986 and is expected to grow at an annual 2.5% rate in the future.

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<sup>39</sup> Reporter's Transcript PHC, p. 1.

3. The old Chico operations center office provided an average of 128 square feet of space for each of its 22 employees working in the building, a smaller square footage allowance than most of CWS's other districts.

4. The old Chico customer center office provided an average of 241 square feet of work space for each of its eight employees working in the building, a smaller work allowance than most of its other districts.

5. Land use, local building, zoning, and Americans with Disabilities Act requirements have become more restrictive since the old operations and customer centers were constructed.

6. Total cost of the new combined Chico customer center was \$3,109,694.

7. The new operations center has approximately 5,105 square feet of space compared to 2,688 square feet at the old operations center.

8. The new warehouse has approximately 5,655 square feet of indoor storage space compared to limited outdoor storage space at the old operations center.

9. The new customer center has approximately 7,240 square feet of office space compared to 1,925 square feet at the old customer center.

10. The consolidation of its operations center, customer center, and warehouse at one location has enabled CWS to increase efficiencies and to better serve its customers.

11. The old operations center real property contained a well, pump house, and water tank that are still necessary and useful for public utility duties. The remaining real property is no longer necessary or useful, and has been separated from the useful real property.

12. The old customer center real property contained a well and water tank that are still necessary and useful for public utility duties. The remaining real

property is no longer necessary or useful, and has been separated from the useful real property.

13. Section 790 treatment of gain on sales is an issue in R.04-09-003.

14. CWS seeks authority to establish a HIMA to record the net proceeds of the sale of its real properties between January 1, 1996 and December 31, 2003.

15. The real properties included in the HIMA of CWS were not sold or transferred while in UPIS or PHFU.

16. Real properties included in the HIMA remained out of rate base an average of six years prior to either being sold outright or transferred at fair market value by CWS to its affiliate CWS Utility Services.

17. CWS established a real estate program to realize value from its increasing inventory of non operating real properties through reinvestments into its utility infrastructure and disposition of nuisance real property.

18. Over half of the real properties included in the HIMA were reclassified out of rate base prior to the establishment of the real estate program in 1997 and remained on the accounting books of CWS as NUP until subsequently sold outright or transferred to its affiliate at fair market value. NUP consists of property not currently being used for a utility purpose and having no definitive plan for a future utility purpose.

19. CWS is a Class A water utility subject to the USOA adopted by the Commission and prescribed for Class A Water Utilities.

20. Of the 60 real properties included in the HIMA, 47 are well sites, the majority of which were acquired by CWS more than 30 years ago at a time when land use requirements were minimal and acceptable contaminant levels were much less restrictive than they are now.

21. CWS increased the minimum square footage requirement for its well sites to 10,000 square feet from 6,000 to allow space to install treatment facilities to meet DHS increasing water-quality requirements.

22. Of the 47 well sites included in the HIMA, 38 had less than 10,000 square feet of space, and 10 had less than 6,000 square feet of space.

23. The issue of necessity or usefulness is a factual one that the Commission may review.

24. ORA reviews real property CWS classifies no longer necessary or useful as part of ORA's Master Data Request to CWS and ORA's analyses of rate base in CWS's GRCs.

25. CWS has not notified the Commission when its real properties, including each of the real properties listed in its HIMA, have been out of service for nine consecutive months.

26. The reporting requirement for real properties out of service at least nine consecutive months pertains only to those water production facilities that the Commission determines to be a major facility of the utility, and does not include any facility determined by the Commission to constitute a PHFU.

27. The definition of major facility is being considered in R.04-09-003.

28. There is no opposition to CWS establishing a prospective IMA.

### **Conclusions of Law**

1. CWS has complied with Ordering Paragraph 11 of D.03-09-021's requirement to seek Commission authority to replace its Chico Operational Center.

2. Land use restrictions, local building codes and zoning requirements, and the Americans With Disabilities Act requirements made the rebuilding of office

buildings at the old Chico operations center and customer center not cost-effective or infeasible.

3. CWS should be allowed to include in rate base the remaining \$1,182,462 of the Chico customer center costs not yet in rate base and allowed an opportunity to earn on return on that additional rate base.

4. Treatment of the entire \$519,751 net sale proceeds from the two real properties comprising of the old Chico operations and customer centers in accordance with Section 790 should be deferred pending resolution of the water utilities gain on sale issues being addressed in R.04-09-003.

5. The criteria CWS used to reclassify its UPIS and PHFU real properties to NUP are reasonable and consistent with the requirements of the USOA for Class A Water Utilities adopted by this Commission.

6. The real properties CWS included in its HIMA were appropriately classified as NUP prior to being sold or transferred to CWS Utility Services.

7. CWS must seek Section 851 approval for the sale of real properties necessary or useful in the performance of its public utility duties.

8. The Commission should continue to treat the issue of necessity or usefulness as a factual one that the Commission may review at any time.

9. CWS's HIMA is reasonable and should be established as requested.

10. The properties included in the HIMA are not subject to Section 851.

11. Real properties included in the HIMA did not have a significant impact on the ability of CWS to provide public water service.

12. Section 455.5(b) requires CWS to notify the Commission of any portion of its water production facility which, after having been placed in service, remains out of service for nine or more consecutive months.

13. The Commission is proposing in R.04-09-003 to define a major facility as it pertains to Section 455.5.

14. CWS has not violated Section 455.5.

15. CWS should be authorized to establish its prospective IMA.

16. CWS has complied with Ordering Paragraph 13 of D.03-09-021 by explaining its Real Estate program and seeking authority to establish its IMA.

17. Section 790 requires CWS to establish an IMA to tack the net proceeds of real properties sold that was at any time, but no longer necessary or useful in the performance of its public utility duties. Section 790(b) requires all utility infrastructure acquired by investments from the HIMA and IMA to be included among CWS's other utility property upon which the Commission authorizes CWS an opportunity to earn a reasonable return.

18. CWS should continue to track its HIMA and IMA net sale proceeds pending the Commission's resolution of gain on sales issues in R.04-09-003.

19. CWS should include its IMA as part of its GRC filings.

20. Today's order should be made effective immediately.

## **O R D E R**

### **IT IS ORDERED** that:

1. California Water Service (CWS) is authorized to include in rate base the remaining \$1,182,462 of the new Chico District customer center not yet in rate base.

2. CWS shall implement the Chico District revenue requirement change authorized by this decision through an advice letter filing, as set forth in the body of this order. If the Water Division suspends any tariffs in that filing, such

tariffs shall become effective on the date the Water Division confirms that the tariffs are in compliance.

3. Treatment of the \$519,751 net sale proceeds from the two real properties comprising the old operations center and customer center no longer necessary or useful shall be deferred pending resolution of the water utilities' gain on sale issues being addressed in the Commission's Rulemaking (R) 04-09-003.

4. CWS is authorized to file an advice letter with the Water Division to establish its historical infrastructure memorandum account (HIMA) and prospective infrastructure memorandum account (IMA), as addressed in this order. CWS shall continue to track the net sale proceeds in its HIMA and IMA pending R.04-09-003 resolution of gain on sales issues.

5. CWS shall update its IMA, since last reviewed by the Commission, as part of its ongoing general rate case filings until the Commission establishes a report procedure for all water utilities. The update shall include, for properties newly added to the IMA, the parcel numbers, original book value, date purchased, date placed into utility plant in service or plant held for future use, date transferred to non-utility property, fair market value at date sold, name or purchaser, sales price, net book value at date sold, market value at date sold, net sale proceeds, and amount of the net proceeds reinvested into the infrastructure of the water system.

6. Applications (A.) 03-12-008 and A.04-08-017 are closed.

This order is effective today.

Dated \_\_\_\_\_, at San Francisco, California.