Decision 11-03-005 March 10, 2011

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the matter of the application of Alco Water Service, (U206), (Alco) a California Corporation, for an order 1) authorizing it to increase rates for water service by $3,709,633 or 62.6% in test year 2010; 2) authorizing it to increase rates on July 1, 2011 by $1,752,844 or 18.2% and July 1, 2012 by $1,016,639 or 8.9% in accordance with Decision 08-11-035, and 3) adopting other related rulings and relief necessary to implement the Commission's ratemaking policies.	Application 10-02-006 (Filed February 1, 2010)

DECISION ON THE APPLICATION BY ALISAL WATER CORPORATION, DBA ALCO WATER SERVICE, FOR A GENERAL RATE CASE WITH A TEST YEAR 2010 AND ATTRITION RATE ADJUSTMENTS FOR 2011 AND 2012

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DECISION ON THE APPLICATION BY ALISAL WATER CORPORATION, DBA ALCO WATER SERVICE, FOR A GENERAL RATE CASE WITH A TEST YEAR 2010 AND ATTRITION RATE ADJUSTMENTS FOR 2011 AND 2012

1. Summary

This decision adopts a proposed settlement between Alisal Water Corporation, dba Alco Water Service (Alco), and the Division of Ratepayer Advocates and it further resolves all outstanding litigated issues not otherwise addressed in the settlement. We adopt a cost of capital of 8.81% with a return of equity of 10.70%. Alco must file another general rate case application no earlier than a test year 2013. Finally, this decision institutes a ban on any transactions between the utility and any member of the owner's family.

This decision results in a rate increase. The adopted revenue requirement for test year 2010 is $8,141,291 which is an increase of $2,189,524, or 36.79%. This proceeding remains open to address one issue, a proposal for an advanced metering infrastructure.

2. Standard of Review

Alisal Water Corporation, dba Alco Water Service (Alco) bears the burden of proof to show that the rates it requests are just and reasonable and the related ratemaking mechanisms are fair.

In order for the Commission to consider any possible proposed settlement in this proceeding as being in the public interest, the Commission must be convinced that the parties had a sound and thorough understanding of the application, and all of the underlying assumptions and data included in the record. This level of understanding of the application and development of an adequate record is necessary to meet our requirements for considering any settlement.

3. Adopting a Proposed Settlement

As the United States Court of Appeals for the Ninth Circuit has observed, in evaluating a settlement the agreement must stand or fall on its own terms, not compared to some hypothetical result that the negotiators might have achieved, or that some believe should have been achieved:

> Settlement is the offspring of compromise; the question we address is not whether the final product could be prettier, smarter or snazzier, but whether it is fair, adequate and free from collusion. (*Hanlon v. Chrysler Corp*., 150 F.3d 1011, 1027 (9th Cir. 1998).

Based upon our review of the extensive prepared testimony, evidentiary hearings and comprehensive briefing of the litigated applications, we find that the parties to the settlement had a sound and thorough understanding of the application, and all of the underlying assumptions and data included in the record and, thus, we can consider the settlement as offered by competent and well-prepared parties able to make informed choices in the settlement process.

3.1. Pertinent Commission Rules

The Commission's Rules of Practice and Procedure (Rules) specifically address the requirements for adoption of proposed settlements in Rule 12.1 *Proposal of Settlements*, and subject to certain limitations in Rule 12.5 *Adoption Binding, Not Precedential*.[1] Specifically, Rule 12.1(a) states:

[1] http://docs.cpuc.ca.gov/published/RULES_PRAC_PROC/105138-11.htm#P623_143939.

> Parties may, by written motion any time after the first prehearing conference and within 30 days after the last day of hearing, propose settlements on the resolution of any material issue of law or fact or on a mutually agreeable outcome to the proceeding. Settlements need not be joined by all parties; however, settlements in applications must be signed by the applicant and, in complaints, by the complainant and defendant.
>
> The motion shall contain a statement of the factual and legal considerations adequate to advise the Commission of the scope of the settlement and of the grounds on which adoption is urged. Resolution shall be limited to the issues in that proceeding and shall not extend to substantive issues which may come before the Commission in other or future proceedings.
>
> When a settlement pertains to a proceeding under a Rate Case Plan or other proceeding in which a comparison exhibit would ordinarily be filed, the motion must be supported by a comparison exhibit indicating the impact of the settlement in relation to the utility's application and, if the participating staff supports the settlement, in relation to the issues staff contested, or would have contested, in a hearing.

Rule 12.1(d) provides that:

> The Commission will not approve settlements, whether contested or uncontested, unless the settlement is reasonable in light of the whole record, consistent with law, and in the public interest.

Rule 12.5 limits the future applicability of a settlement:

> Commission adoption of a settlement is binding on all parties to the proceeding in which the settlement is proposed. Unless the Commission expressly provides otherwise, such adoption does not constitute approval of, or precedent regarding, any principle or issue in the proceeding or in any future proceeding.

3.2. Required Findings – Rules 12.1(d) and Rule 12.5

Based upon the record of this proceeding we find the parties complied with Rule 12.1(a) by making the appropriate filings and noticing a settlement conference. Based upon our review of the settlement documents we find that they contain a statement of the factual and legal considerations adequate to advise the Commission of the scope of the settlement and of the grounds for its adoption; that the settlement was limited to the issues in this proceeding; and that the settlement included a comparison indicating the impact of the settlement in relation to the utility's application and issues the Division of Ratepayer Advocates (DRA) contested in its prepared testimony, or would have contested in a hearing. These two findings that the settlement complies with Rule 12.1(a) allow us to conclude, pursuant to Rule 12.1(d), that the settlement is reasonable in light of the whole record, consistent with law, and in the public interest.

Based upon our review of the settlement document we find, pursuant to Rule 12.5, that the proposed settlement would not bind or otherwise impose a precedent in this or any future proceeding. We specifically note, therefore, that Alco must not presume in any subsequent applications that the Commission would deem the outcome adopted herein to be presumed reasonable and it must fully justify every request and ratemaking proposal without reference to, or reliance on, the adoption of this settlement.

4. Summary of Test Year Settlement Agreement

On September 15, 2010 DRA and Alco filed a joint motion for the adoption of a proposed settlement agreement (settlement) resolving most of the disputed issues in the proceeding.[2] The City of Salinas was granted party status and was a relatively inactive party. It did not serve testimony, examine witnesses in the evidentiary hearings, or file briefs. The City of Salinas did affirm that it supported the settlement. We will note that the settlement is unopposed and hereafter refer to it as a settlement between DRA and Alco, the most active parties and the parties necessary and able to satisfy Rules 12.1, 12.5, 12.6,[3] and 12.7.

The proposed settlement includes revenue requirement and rate design for test year 2010 and escalation years 2011 and 2012 for Alco's operations in its certificated service area in and around Salinas, California. The settlement addresses all significant elements of Alco's revenue requirement, including number of customers, sales and supply, rate design, operations and maintenance expenses, administrative and general expenses, allocated expenses, utility plant additions, depreciation expense and reserve, various taxes, the net-to-gross

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[2] The proposed settlement agreement is filed and available at http://docs.cpuc.ca.gov/efile/motion/12351.pdf.

[3] Rule 12.6 Confidentiality and Inadmissibility, imposes limitations on the settling parties to protect the confidentiality of the settlement process and that if the settlement is not adopted its terms are not generally admissible. Rule 12.6 does apply to the City of Salinas.

multiplier, and Alco's ten special requests[4] included in its application. (Settlement Motion at 3.)

5. Litigated Issues

5.1. Summary

There are a number of litigated issues including six proposed new wells; water capacity for blending sources; "other equipment" forecasts; Office Plant including "special request #5 (special requests are required to be identified in the rate case plan); three new trucks; equipment acquired from the Adcock family or other family businesses; cost of capital; automated metering infrastructure (special request #10); and energy efficient pump upgrades. We defer to a separate decision the question of a proposed advanced metering infrastructure which was not included in the proposed decision for party comment.

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[4] The application listed the following special requests: 1. Tiered Rate Design and Water Conservation Memorandum Account; 2. Increased Rate of Return for Energy Efficiency Upgrades; 3. Increased Reconnection Fees and Incorporation of Fire Flow Test Fee; 4. Recovery of $20,000 Incurred in Defending Against Division of Ratepayer Advocates' Motion of Sanctions in I.07-06-020; 5. Customer Information and Billing System; 6. Amortization of Purchased Power Memorandum Account; 7. Amortization of Engineering, Legal and other Professional Fees and Expenses for the Water/Energy Nexus Demonstration Project Memorandum Account; 8. Inclusion of Rosehart Industrial Park Water System in Alco's Certificated Service Area and Authority to Charge Commission Authorized Rates; 9. Water Quality Finding; 10. Ratebase Offset of Construction Projects Provided as Proposed Projects; and 11. Water Conservation Program Expansion Balancing Account and Surcharge. (Application at 2 7.)

For all the disputed capital construction or equipment acquisition approved in this decision we will direct Alco to file advice letters seeking authorization to include in rate base, upon completion or purchase and the plant is used and useful, the actual costs of the plant additions set forth herein and to receive a corresponding rate adjustment for the additional rate base. This is a reasonable outcome for these disputed projects (wells, new trucks, and pumps) because it allows Alco timely recovery if it actually builds the project, or acquires the equipment, and it becomes used and useful, so this outcome therefore protects the ratepayers from paying on projects or equipment which do not materialize on time or ever. We do this because we are mindful of the significant cost impacts on customers of a small water company when a major item (in terms of that operation) is added to rates, and because we are equally mindful of the need to provide safe and reliable water in adequate quantities. For the remaining disputed additions we address the ratemaking in detail as appropriate.

5.2. New Wells and Pumps

We will not devote a lot of time to authorizing new energy efficient pumps: DRA argues that Alco failed to include the new pumps for energy efficiency upgrades in the disclosure of the rate impact of the application. (DRA Opening Brief at 33.) That is a procedural discrepancy, which should have been corrected shortly after filing, but was not. The additional cost of the pumps is far less than the revenue requirement reduction due to the settlement and the disallowance of one new well, below. We agree with Alco that energy efficient pumps are a reasonable acquisition. We therefore find this does not require additional notice under Rule 13.1(b). We will therefore authorize the installation of the new energy efficient pumps. Alco must file an advice letter to include them in rates only after they are installed and are used and useful.

Alco states that it has older wells that need replacement or augmentation to supply safe water.[5] Alco argues that it can currently comply with California Department of Public Health requirements in Title 22, § 64554(b) and (c) (i.e., meet its maximum daily demand with the largest source off line). But, if Alco lost any other source it would be unable to do so until a new 5 million gallon storage tank comes online sometime in 2012. (The tank is included in the settlement.) If Alco were to lose any of its five currently active sources, even its lowest producing well, it would not meet § 64554(a)(1) requirements for peak hourly demand. Therefore Alco requests to add the six additional sources, two of which have already been drilled. (Alco Opening Brief at 5.)

DRA argues that Alco can easily meet demand and argues further that Alco incorrectly applies a water supply requirement that only applies the moment a company first qualifies as a water utility. Section 64554(c)[6] requires that Alco must be able to serve customers without its largest source on-line. As illustrated in Table 1, DRA argues:

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[5] "Alco's Exhibit A-17 shows the ages of Alco's existing wells. Of the five active wells, the Alma well is 65 years of age; the County well is 34 years of age; and the Alisal and Santana wells are each 23 years of age. CPUC Standard Practice U-4-SM provides (at Appendix C, Sheet 1) that the suggested average service life of wells is 30 years." (Alco Opening Brief at 10.)

[6] c) Community water systems using only groundwater shall have a minimum of two approved sources before being granted an initial permit. The system shall be capable of meeting MDD with the highest-capacity source off line. http://www.cdph.ca.gov/certlic/drinkingwater/Documents/Lawbook/dwregulations-06-24-2010.doc#_Toc263920789.

> … the requirement that [maximum daily demand] be met with the largest source off line only governs water utilities applying for an initial permit for a groundwater only system, and is inapposite to existing systems. Since Alco's system is an existing system consisting of five wells which are permitted and certified as active by the [California Department of Public Health], the more stringent standard under Section 64554(c) does not apply to Alco. (DRA Opening Brief at 5.)

Table 1			
Alco's Capacity to Meet Maximum Daily Demand (Based on Ex. D-7-R)[7]			
	Available Capacity for Max. Daily Demand in Gallons per Minute	DRA's Position	Required By § 64554(c)
(i)	Existing Five Active Wells	9,180	9,180
(ii)	Largest Well Off-line	N/A	6,803
(iii)	2010 Maximum Daily Demand	5,875	5,875
(iv)	2010 Margin above Maximum	(56%) 3,305[8]	(16%) 928[9]
(v)	2011 Maximum Daily Demand	5,990	5,990
(vii)	2011 Margin above Maximum	(53%) 3,190	(13.6%) 813
(viii)	2012 Maximum Daily Demand	6,075	6,075
(ix)	2012 Margin above Maximum	(51%) 3,105	(12%) 728

Use of DRA's interpretation of the applicability of § 64554(c) results in Alco having over 50% in excess capacity to meet maximum daily demands in 2010 - 2012, whereas Alco's interpretation and application of § 64554(c) would result in far lower margins around 12% (2012) and 16% (2010).

We find that DRA's reliance on § 64554(c) is a strained interpretation: DRA would have us accept that because Alco is not seeking an "initial" permit it need not have backup wells. This is not reasonable. Ratepayers need to have a

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7 Reformatted and re-captioned, and percentages added.

8 (9,180 – 5,875 = 3,305 and 3,305/5,875 = 56%.)

9 (6,803 – 5,875 = 928 and 928/5,875 = 16%.)

reliable water supply and the requirement makes little sense as applicable only at the time of permitting. The fundamental point of § 64554 is stated in its opening paragraph: "At all times, a public water system's water source(s) shall have the capacity to meet the system's maximum day demand (MDD)." We are not proposing some high level of redundancy to ensure water in every conceivable scenario; only sufficient resources to meet the requirements of § 64554 in normal circumstances.

Alco also argues for its new wells based upon a perceived need to meet a fire flow demand citing to General Order 103-A Section II.B.3.(b). (Alco Opening Brief at 8.) Alco further argues the data in DRA's Ex. D-7-R fails to include 2011 and 2012 fire flow requirements. "If Alco were authorized to construct all the wells and the pumping upgrades at the Santana well that it has requested [it] would have a total water production capacity of 15,003 [gallons per minute] with its two highest capacity wells sources offline." (Alco Opening Brief at 9.) Alco argues it needs one-and-a-half times its maximum daily demand to meet its demand plus fire flow after allowing for its two largest sources to be offline at the time, as summarized in Table 2 below.[10]

[10] Converting a long string of text to a table – Alco Opening Brief at 9 – 10.

Table 2	
Alco's Calculated Available Capacity & Required Capacity	
Alco's Available After 2 Wells Offline and New Pump	
Existing Capacity (gallons per minute)	9,180
6 New Wells Proposed by Alco	9,800
New Pump Effect Proposed by Alco	700
Largest Well Offline	-2,377
Second-Largest Offline	-2,300
Available Capacity - Alco	15,300
Alco's Maximum Daily Demand Plus Fire Flow	
Maximum Daily Demand[11]	9,575
Fire Flow Factor	1.5x
Required Capacity	14,236
Available Extra Margin of Water[12]	(7.5%) 1,064

We find Alco more persuasive than DRA on the need for at least some new wells. We will allow Alco to file an advice letter to put the actual cost of the wells in rates, subject to an individual construction cost cap based on the current forecast to complete the wells but only if and when the specific well has been constructed, are operational, and each one is therefore used and useful. We will now turn to the question of how many wells were justified.

Resolution W-4577 already authorizes three unnamed wells,[13] which are rated to produce 5,300 gallons per minute (gpm),[14] and we will not revisit the

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11 Alco's asserted Maximum Daily Demand – Alco Opening Brief at 9.

12 (15,300 – 14,236 = 1,064. 1,064/14,236=7.5%.)

13 In comments on the proposed decision, DRA questions which wells were authorized by Resolution W-4577 but the resolution is silent on specific wells. Therefore we presume the first three wells constructed or to be constructed by Alco are the three authorized by W-4577 and already included in rates adopted in the resolution.

14 Verona at 2,300 gpm, Bardin at 1,500 gpm, and East Laurel Heights at 1,500 gpm. (See Ex. D-6.)

authority to construct them here. In Resolution W-4577 the adopted revenue requirement for the three wells was $555,000. (Resolution W-4577 at Appendix E lines 1 and 9.)

There is a significant problem with the cost of the three advice letter wells: Alco has spent, or is expecting to spend far more than the amount initially authorized in Resolution W-4577. As shown in Table 3, below, Alco has spent significant amounts on all three wells and projects final costs in this rate case ranging from $935,505 for Verona to $1,802,235 for East Laurel Heights. If these three wells are not used and useful when Alco files its next general rate case we may decide to examine these costs that are placed in rate base and determine whether these wells should be abandoned and removed from rate base.

Table 3
Costs of Three Advice Letter Wells

	Name of Wells from W-4577	Authorized by W-4577	Pre-2009 CWIP[15]	2009 CWIP	Rate Case Forecast
1	Verona	$185,000	$222,971[16]	$555,934[17]	$953,505
2	Bardin	$185,000		$750,345[18]	$1,689,130
3	East Laurel Heights	$185,000		$57,000[19]	$1,802,235
		$555,000			$4,444,870

It appears from the record that only two wells, Verona and Bardin are partially built and are not yet in service. Clearly the resolution allowance bears no resemblance to the actual costs to date for the three wells. Based on the

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15 Construction Work in Progress – the recorded costs of a project before it enters service, usually including labor, materials, and an allowance for interest costs.

16 $194,674 (Verona Well) + $28,297 (Well pumping equipment) = $222,971 authorized in AL 111-W filed February 15, 2007, and effective May 8, 2007, because the total cost was less than the $555,000 authorized in Resolution W-4577.

17 Exhibit D-1, p.7-12, Table 7-H.

18 Exhibit E, at 2.

19 Exhibit E, at 2.

record we find that the estimated cost to complete these wells is a reasonable estimate. We must therefore resolve and clarify the cost and ratemaking treatment of the three wells already approved by Resolution W-4577. We will allow Alco to include in rate base the Pre-2009 CWIP ($222,971) already in rates plus the additional 2009 CWIP ($555,934) which is a total of $778,905 for the Verona Well, and the 2009 CWIP ($750,345) for the Bardin Well. These amounts must be recorded in Plant Held for Future Use, a rate base account which will allow Alco to earn a return on the investment. We will also allow Alco to put the $57,000 costs in construction work in progress, through 2009, for the East Laurel Heights Well into Plant Held for Future Use. For all three wells, we will authorize Alco a cost cap set at the rate case forecast of total costs, i.e., we will now place an upper limit or cap on the costs recoverable in rates for these wells. Upon completion of each of these wells Alco must file a Tier 2 Advice Letter in order to recover any additional costs up to the individual caps. Therefore Alco may still recover $174,600 for the Verona Well; $938,785 for the Bardin Well; and $1,745,235 for East Laurel Heights.[20]

Turning to the additional three rate case wells, we must still decide if Alco needs the three further new wells, to produce an additional 4,500 gpm,[21] first requested in this application. There appear to be two reasons we must consider these additional wells. The first is arsenic contamination – Alco's existing wells

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20 For Verona, subtracting $778,905 in total CWIP from the forecast $953,505 leaves a balance under the cap of $174,600. For Bardin, subtracting $750,345 in CWIP from the forecast $1,689,130 leaves a balance of 938,785 under the cap. For East Laurel Heights, subtracting $57,000 in CWIP from the forecast $1,802,235 leaves a balance of $1,745,235 under the cap.

21 Monte Bella at 1,500 gpm, Surrey at 1,500 gpm, and Hibino at 1,500 gpm. (Id.)

and stand-by wells all have various levels of arsenic and blending sources is needed to maintain a safe level. The second is whether Alco is correct with both proposed supply adjustments: the "minus-two largest wells" and "1.5 times maximum daily demand" used by Alco to justify an available supply of 15,300 gpm (see Table 2 above).

5.2.1. Arsenic

Alco must blend some of its water and can only carefully use its standby wells because of contamination, primarily arsenic. Thus, with its existing storage and new 5 million gallon storage tank to be in service by 2012, the company can blend a potable supply. The company argues it needs six new wells, three of which were already authorized and three more first proposed here in this proceeding. Alco calculated its current and standby wells produce approximately 2 pounds of arsenic per day.[22] (Alco Opening Brief at 11 - 12.) After some fancy math[23] this computes to 10.792 parts per billion (ppb) when the standard is 10ppb. (Id.)

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[22] ".. for all five of Alco's active sources plus the three standby sources, a result of 2.019 pounds of arsenic per day produced from all eight wells." (Alco Opening Brief at 12.)

[23] First Alco calculated for each well the arsenic content of its water: [(Well capacity in gpm) x (1,440 minutes/day) x (8.34 pounds/gallon) x (arsenic concentration in ppb/1,000) x (1/1,000,000 pounds) = pounds of arsenic per day per well source.] Then Alco calculated its blended arsenic content for all wells producing the system's maximum supply 15,579 gpm: [(2.01 lbs/day) x (1 day/1,440 mins) x (1/15,579 gpm) x (1 gal/8.34 lbs) x (1,000,000 lbs/1 parts per million) x (1,000 ppb / 1 parts per million) = 10.792 ppb.] (Alco Opening Brief at 11 – 12.)

Alco derives the maximum it can blend from the standby wells to reduce the arsenic from 10.792 ppb to a more drinker-friendly 7.5 ppb, a 25% factor below the maximum for safe water. Alco makes an assumption that the new wells (because they are still in the Salinas area) will have the weighted average arsenic of its five active wells, which is 4.3 ppb. (Id at 13.)

5.2.2. Supply Adjustments

General Order 103-A, Section II.B addresses service standards for quantity of water. Section B(3)(a) addresses potable water system capacity by saying the utility needs to meet the source capacity requirements defined in the California Waterworks Standards, CCR Title 22, Div. 4, Ch. 16, Article 2, § 64554. In it, § B(3)(b) states:

> … if a system provides potable water for fire protection service, new portions of the system shall have supply and storage facilities that are designed to meet [maximum daily demand] plus the required fire flow at the time of design.

In General Order 103-A, § VI addresses average statewide fire flow requirements. For initial construction, extension, or modification of a water system, the facilities shall be designed to be capable of providing, for a minimum of two hours, at a minimum pressure of 20 pounds per square inch, the flows specified in the 2007 California Fire Code, Appendix B. California Waterworks Standards, § 64554(a), states that for systems with 1,000 or more service connections:

> … the system shall be able to meet fours hours of peak hourly demand (PHD) with source capacity, storage capacity, and/or emergency source connections.

Furthermore, § 64554(b) states a system shall estimate maximum daily demand and peak hourly demand for the water system as a whole and for each pressure zone within the system. Peak hourly demand is estimated as follows:

> "If daily water usage data are available, identify the day with the highest usage during the past 10 years to obtain [maximum daily demand]; determine the average hourly flow during [maximum daily demand] and multiply by a peaking factor of at least 1.5 to obtain the [peak hourly demand]."

Therefore, it appears to us that Alco's use of 1.5 times maximum daily demand is a short-hand characterization of the requirement in the California Waterworks Standards, Section 64554. However, we do not find in either General Order 103-A or the California Waterworks Standards a requirement to include a contingency of minus-two largest wells when calculating existing source capacity.

DRA argues that Alco misrepresents the Maximum Daily Demand as 9,575 gpm before fire flow and that the actual Maximum Daily Demand, as provided by Alco, is 6,075 gpm in 2012 which is 9,575 after fire flow requirements are added. (Ex. D-6.) Applying a 1.5 factor to 6,075 gpm results in a required 9,113 gpm, however the data provided by Alco is 9,575. We will conservatively use this higher figure.[24]

5.2.3. Conclusion

We accept Alco's asserted need to meet 1.5 times maximum daily demand for fire flow, but we are not persuaded that we must also provide for this standard to be met with Alco's two largest wells offline. In an emergency the customer cannot expect normal full service. We agree there is a need for some margin in the water supply and we calculate in Table 4 (rounding a little) that if

[24] In the proposed decision mailed for public review and comment we relied on the higher amounts shown in Alco's Opening Briefs. Based on DRA's comments and further review of the underlying record we agree with DRA that 9,575 gm is shown in the record to be after an allowance for fire flow and requires no further adjustment.

either one of the two largest wells is offline there would still be a significant and sufficient supply. We therefore authorize Alco to construct none of the three proposed "rate case wells" in addition to the three wells already authorized by Resolution W-4577.

Table 4	
Adopted Available Capacity & Required Capacity	
Alco's Available After New Pump and 1 Well Offline	
Existing Capacity (gallons per minute)	9,180
6 New Wells Proposed by Alco	9,800
New Pump Effect Proposed by Alco	700
First- ***or*** Second-Largest Offline	-2,300
Available Capacity - Alco	17,380
Less All 3 New Rate Case Wells	-4,500
Adjusted Available	12,880
Alco's Maximum Daily Demand Plus Fire Flow	
Maximum Daily Demand	6,075
Fire Flow Factor	1.5x
Required Capacity	9,575
Available Extra Margin of Water[25]	3,500

6. Need for Ongoing Independent Audits

6.1. Summary

The record in this proceeding does show that Alco has had its financial records audited by an independent certified public accountant (CPA) with utility client experience.[26]

We believe that audited financial statements are invaluable not just for the protection of shareholders in publicly traded companies but equally for the

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25 This table shows that Alco will have sufficient water without the three rate case wells.

26 In the proposed decision, the record was misunderstood; Alco is independently audited as noted by Alco in its comments, and the decision is therefore corrected.

protection of customers of any monopoly public utility. Audited financial statements provide a highly reliable foundation for cost of service rate regulation.

We have the inherent authority to order a jurisdictional utility to undertake an independent audit in order to ensure that "(a)ll charges demanded or received by any public utility, or by any two or more public utilities, for any product or commodity furnished or to be furnished or any service rendered or to be rendered shall be just and reasonable." (Pub. Util. Code § 451.) Second, we have the discretion to order an audit to ensure that Alco maintains its accounts in proper conformance with Pub. Util. Code § 792.[27] Third, we have the authority under Pub. Util. Code § 701 to order an audit to ensure that we are able to effectively and efficiently exercise our jurisdiction.[28] Fourth, Pub. Util. Code § 701.10 determines that the Commission must ensure that it authorizes adequate rates and therefore it must have access to independent reliable financial statements. And finally, Pub. Util. Code § 727.5(c)[29] allows the Commission to

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[27] Section 792. "The commission may establish a system of accounts to be kept by the public utilities subject to its jurisdiction, or classify such public utilities and establish a system of accounts for each class, and may prescribe the manner in which such accounts shall be kept. It may also prescribe the forms of accounts, records, and memoranda to be kept by such public utilities, including the accounts, records, and memoranda of the movement of traffic as well as the receipts and expenditures of moneys, and any other forms, records, and memoranda which in the judgment of the commission may be necessary to carry out any of the provisions of this part.

[28] Section 701: The commission may supervise and regulate every public utility in the State and may do all things, whether specifically designated in this part or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction.

[29] Section 727.5(c) The commission shall consider, and may authorize, a water corporation to establish a balancing account, rate stabilization fund, or other

Footnote continued on next page

authorize rate recovery of any cost necessary to ensure stable rates. An independent audit provides the necessary information to determine whether the utility is earning an adequate return and spending funds as authorized by the Commission.

All annual Alco audited financial statements, the related disclosures and attest opinion of the CPA must be filed with the Division of Water and Audits (or successor organization) annually within 90-days of filing the Annual Report required by General Order 104-A.

7. Family Transactions

The Commission recently adopted D.10-10-019 that established affiliate transaction rules for Class B water companies one of which is Alco.[30] These new rules focus primarily on inter-company transactions where those companies are financially related. The Commission rulemaking that led to these rules identified four goals:

1. Ensure ratepayers pay reasonable rates and receive high service water quality;
2. Ensure water and sewer utilities have the opportunity to earn reasonable profits so as to provide a high quality of service;

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contingency fund, the purpose of which shall be the long-term stabilization of water rates.

[30] "Our newly adopted rules address our goals of protecting ratepayers, ensuring the financial health of the utility, and preventing anti-competitive behavior in the competitive marketplace." (D.10-10-019 at 2.) The detailed goals as discussed in D.10-10-019 (at 23), did not directly consider family relationships because the primary focus in the rulemaking was on corporate relationships and competitive behavior where those companies are related.

3. Prevent utilities from assisting their affiliates to unfairly compete against other firms; and
4. Avoid imposing rules which would cause excessive burdens on utilities, as compared to public interest benefits.

These rules may not sufficiently or clearly enough address commercial transactions involving Alco and the owners and/or senior employees related to the owners, where there is little or no structural or corporate separation in the form of affiliated companies. The affiliate rules in Rule II-E, for example, define an affiliate in terms of a corporate entity and the degree of ownership.[31] The adopted industry-wide rules do not prohibit related transactions; they impose reporting and disclosure requirements.[32]

Alco has a long history of "leasing" and "buying" equipment directly from the family who own and operate the regulated utility or other companies owned by the family. We find, as discussed below, these transactions are problematic and the cleanest course of action is to prohibit all future family commercial self-dealings and to closely examine any recent family transactions. Because the principal owner is the president's surviving parent there are absolutely no viable internal controls to preclude "sweetheart" self-dealing. Internal controls are

[31] Rule II-E: "Affiliate" means any entity whose outstanding voting securities are more than 10 percent owned, controlled, directly or indirectly, by a utility, by its parent company, or by any subsidiary of either that exerts substantial operational control." (2010 Cal. PUC LEXIS 400.) This definition doe not necessarily clearly encompass the person or persons who own the utility's stock and their family. Here, Mrs. Adcock owns the company stock and Thomas Adcock, her son, is the President of the company.

[32] Nothing in this brief discussion and description of the affiliate transaction rules should be viewed as modifying or expanding the application of those rules except for the specific commercial transaction ban solely applicable to Alco and the Adcock family adopted herein.

processes designed to ensure reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations. Internal controls in this instance are critical for safeguarding the utility's assets against theft and unauthorized use. Proper acquisition or disposal of assets is also a part of internal controls. As noted elsewhere, Alco has an independent certified public accountant for complete audits of the company on an ongoing basis. An integral part of such audits is an examination of the existing internal controls (or the lack thereof) which directly affects the accuracy and reliability of Alco's financial statements. We expect Alco to direct its auditor to carefully examine its internal controls to ensure that ratepayers are only burdened with fair and reasonable costs.

Alco is operated by the second generation of the Adcock family, with Thomas Adcock in the role of president whose mother controls the common stock of the company. In this proceeding one issue of dispute between Alco and DRA was the acquisition of equipment directly from Thomas Adcock personally, and another issue was the usage and acquisition of equipment leased from another company controlled by his mother, Mrs. Adcock. Possession of a public utility franchise, which entails an exclusive right to serve, also entails an obligation to provide safe and reliable service at the lowest reasonable cost. The existence of transactions involving the utility business and the individuals who own or operate the utility is problematic: are the prices paid for goods and services fair? Are the goods and services the best available or most suited? We should not have to address or search for the independence of the persons involved in every transaction.

Although the Commission imposes general affiliate transaction rules applicable to Class B companies in D.10-10-019, we hereby impose on Alco an additional clear and simple ban on any commercial transactions in the future between Alco and all Adcock family members and family-related persons.[33] We also understand that an absolute ban could in some unforeseeable circumstance also be unreasonable. Therefore we will allow that Alco may file a Tier 3 advice letter, for pre-approval by Commission Resolution, of any transaction with a related person, for good cause, when Alco can clearly demonstrate that the transaction is the most reasonable outcome for the ratepayers. There are, for example, numerous commercial equipment leasing companies, and we would therefore expect that Alco would not seek a waiver when there are viable independent options.

We further emphasize that this ban on family transactions does not apply to investment of equity capital where a ban would dilute the Adcock family ownership interest if the present owner(s) could not have the first chance to maintain their equity investment. Also, any member of the Adcock family with appropriate skills and qualifications may work for the company for reasonable compensation for the work that person performs.[34] Thus this ban applies to the acquisition of goods and services from related persons when there are independent provider options and does not prevent the Adcock family from investing any needed equity capital into the company. Alco must continue to comply with all requirements of the affiliate rules as adopted in D.10-10-019.

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[33] In modern California we respect all lifestyles – our concern is with any close personal relationship unreasonably crossing over to the regulated utility and unfairly burdening ratepayers with transactions that are not independent and market cost based.

[34] We note again that Thomas Adcock is the president of the company and this ban does not limit his ability or any other qualified family member from being paid a reasonable compensation for necessary work performed as a part of operating Alco.

8. Office Equipment

According to Alco, it has a total request of $945,600 for "Other Equipment - Plant Account" for years 2010 through 2012. (Alco Opening Brief at 17.) If Alco were authorized to acquire all the equipment and software it is seeking it would add $367,200 to rate base in test year 2010; $377,600 in escalation year 2011; and, $200,800 in escalation year 2012.

The first major addition is $578,400 worth of equipment that Alco argues it must acquire to replace existing equipment to meet its legal obligations under the California Air Resources Board rules. (Alco Opening Brief at 17.) The second major item in Alco's very large request is water infrastructure locating and mapping software and hardware (infrastructure mapping) at a cost of $100,000 (Transcript at 172 - 173, and Ex. A-13.) The third major component is $588,700 in 2010 and $30,000 in 2011 for office equipment.[35]

We are concerned by DRA's use of a trend when faced with such significant, unique, and severable items, which should be specifically examined. In fact we set aside submission in response to DRA's October 15, 2010 motion in order to consider further information and Alco's response on possible changes to the California Air Resources Board rules which might affect Alco's asserted need for new diesel equipment. Alco responded to DRA on October 28, 2010 and DRA was allowed to reply on November 2, 2010. We will consider these three major

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[35] The extensive list includes (19) Computers, Servers, Work Stations; (1) CDP 540 Backup; (1) NSA 5000 Firewall; (2) 48" Port Switches; (1) Digital Telephone System; (2) Server Cabinets; (3) Server Battery Backup; (1) Rack Hardware; (1) Electrical Hardware/Cable; (2) 60" HD Monitors; Installation Cost; (1) HP designerjet T1120 HD MFP; Customer Care/ Billing System (CIS); and Accounting System Upgrade. (Alco Opening Brief 18, citing to Ex. A-3, Schedule 26A, at 5 & 6.)

components separately, thus we implicitly reject DRA's use of a five-year trend in this instance.

8.1. New Diesel Equipment

To comply with California Air Resources Board regulations, Alco argues that it must acquire a new portable air compressor, two backhoe loaders and a wheel loader at a total cost of $578,400. (Alco Opening Brief at 15.) Alco requested, and we grant, judicial notice of Title 13, Art. 4.8, Chap. 9, §§ 2449 through 2449.3 which Alco asserts to mandate acquiring this new equipment. This new equipment is "cleaner" than Alco's existing equipment and Alco believes that the California Air Resources Board would otherwise impose significant fines for the use of its older, non-compliant equipment.

DRA filed a motion to reopen the record to admit new information: that the California Air Resources Board was likely to revise the rules cited by, and relied upon by Alco. The motion was granted and Alco filed a timely response. Alco argues that there is uncertainty over the whether the California Air Resources Board will adopt different regulations.

We are very concerned about the significant rate impact this new equipment would engender in addition to the already substantial increases granted elsewhere in this decision and in the settlement agreement also adopted herein. Alco makes further argument that the new equipment is necessary to support the construction and maintenance programs adopted elsewhere in this decision and in the settlement agreement also adopted herein. We are not persuaded the new equipment is necessary solely for the construction and maintenance programs and we therefore will not adopt the proposed equipment budget at this time.

We are equally concerned that the California Air Resources Board could subsequently enforce Title 13, Art. 4.8, Chap. 9, §§ 2449 through 2449.3 or some new regulation, and Alco could then be subject to large fines for using its then non-compliant equipment. We therefore will allow Alco to timely file a motion to reopen this proceeding for the sole purpose of seeking rate recovery for this new cleaner diesel equipment when it can demonstrate that it must in fact replace the existing equipment in order to comply with California Air Resources Board rules. This will be an expeditious means to avoid the expense and time of a new application, allow the use of the existing record, supplemented with any additional information on California Air Resources Board enforcement, and allow DRA an opportunity to examine Alco's up dated justification for acquiring the new equipment.

8.2. Infrastructure Mapping

Alco advances two arguments for its proposed infrastructure mapping system: first, that California Government Code Sections 4216 through 4216.9 require Alco to be able to identify and promptly disclose the location of its facilities so that other construction, for example, will not accidently damage the water system; and secondly, Alco's Monterey County Franchise Agreement creates the need for Alco to accurately map and identify its system and individual elements of its system. (Alco Opening Brief at 16 – 17.) DRA argues it does not oppose the system per se, only that Alco should acquire it within the forecast non-specific budget proposed by DRA. (DRA Reply Brief at 19.) We have already indicated that we reject DRA's blanket forecast given the detailed specific requests proposed by Alco. We therefore find Alco was persuasive and we will adopt the forecast of $100,000 for an infrastructure mapping system. We will allow Alco to file an advice letter to put the revenue requirement associated with the infrastructure mapping system into rates only upon its actual purchase and installation and when its becomes used and useful, subject to a cap of the forecast cost of $100,000.

8.3. Office Equipment- Special Request # 5

DRA does not address specific allowances of these and other items but instead proposes an annual budget of $45,156 in 2010, $46,150 in 2011, and $47,304 in 2012 for the Office Equipment Plant Account which is equal to two times Alco's escalated five-year historical average expenditure, and a total of $138,610. (DRA Opening Brief at 22, and Ex. D-1, Table 7-L.) We find DRA's approach to be unreasonable because it substitutes a mathematical trend for an analysis of the specific request. If we were examining a relatively unchanging, ongoing task such as meter testing, trending may be a reasonable approach. But in this instance, Alco has cited numerous specific changes involving large equipment purchases, new software, etc., and a trend does not adequately answer the basic questions of "what is new" and "why is it needed?"

The rate case plan for water companies requires the utility to specifically identify any large or new requests so that parties may be readily aware and the Commission will specifically consider them. Alco's special request # 5 is a substantial request for new computers, software, a telephone system, and a substantial new customer information system. (Alco Opening Brief at 18 - 19.) Alco points out the current computer equipment is quite old and runs on an out-of-date operating system, and the current customer information system software cannot be supported because its vendor is out of business. Alco further notes the old phone system is no longer supported either and will not work with a new customer information system to digitally record calls.

We agree with Alco that it needs new equipment. We will therefore allow Alco to spend up to $618,700 (the sum of $588,700 forecast in 2010 and $30,000 in 2011) and recover in rate the related revenue requirement on the actual amount spent. Alco may file an advice letter quarterly to adjust rates to reflect the actual plant additions to date, up to the $618,700 cap.

9. Trucks

9.1. Summary – Equipment from G&L Leasing, Trucks from T.R. Adcock, and Three New Trucks

As noted already, there are problematic self-dealing transactions which we proscribe in the future, prohibiting any further family transactions. Alco would have us adopt its fair market valuations for the trucks and equipment acquired from G&L Leasing (owned by Mrs. Adcock) and trucks and equipment (not everything is a truck but "truck" is an adequate generic term) acquired from her son who is the company's current president, T.R. Adcock. We find these valuations to be tainted by self-interest and not independently verified.[36] We therefore adopt DRA's valuation for ratemaking. We adopt Alco's forecast for the purchase of three new trucks but we condition rate recovery on Alco demonstrating to the Commission's Division of Audits and Water that the trucks were purchased in an arms-length transaction from a commercial seller of trucks not related to the Adcock family.

[36] Any such equipment valuation would be beyond the typical scope of Alco's independent audit by a certified public accountant; it would be done instead by an equipment broker or evaluator.

9.2. Trucks from G&L Leasing

Alco has previously used equipment owned by G&L Leasing, which was owned by Mrs. Adcock, an Alco shareholder and Mother of the current president, T.R. Adcock. There is no dispute the equipment was used by Alco and title is now held by Alco. (Alco Opening Brief at 24-25.)

Alco proposes to use a "fair market value" of $109,390[37] for numerous items previously leased from G&L Leasing. DRA argues that the transaction is inherently unreasonable between related parties and proposes instead that ratepayers should only pay for the net book value of $32,350[38] remaining on the books of G&L Leasing. If G&L Leasing could actually sell this equipment on the open market at the alleged fair market value it would have a gain of $77,040 over its remaining book value.

Ratepayers have been paying the lease charges on this equipment and should not pay an inflated valuation on the residual use of this equipment. A basic tenet of regulation of a public utility is that rate base cannot be inflated by reselling assets (or even whole companies) simply to reflect a new "market" value in excess of the remaining book value. We adopt DRA's valuation of $32,350.

9.3. Trucks From T.R. Adcock

In a second example of self-dealing the applicant would have us adopt a fair market valuation, not independently verified in the record, of $201,530.[39] DRA proposes instead the net book value remaining on this equipment of

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[37] Ex. D-1 at Table 14-B on at 14-8. ($36,000 + $73,390 = $109,390.)

[38] Id. ($15,220 + $17,130 = $32,350.

[39] Ex. D-1 at table 14-A on at 14-6.

$109,540. Ratepayers have been paying the lease charges on this equipment and should not pay an inflated valuation on the residual use of this equipment. We adopt DRA's valuation of $109,540.

9.4. New Trucks

Alco proposes to acquire three new large work trucks to support its capital improvements and ongoing maintenance. DRA opposes the $177,464 cost of the acquisition of the new trucks arguing the current fleet is sufficient in size to meet Alco's needs. At $59,154 each, these are clearly large specialized trucks and for a company the size of Alco reflect a major acquisition. Elsewhere, we authorize the construction of three of the six proposed new wells (three previously approved in Resolution W-4577), as well as the various items in the settlement agreement.[40] We therefore find that Alco is persuasive that it has need of these three trucks. As with all disputed capital acquisitions, we are conditioning rate recovery so that Alco must file an advice letter to recover the revenue requirement only after acquiring the trucks with a cap of $177,464. Additionally, Alco must document for the advice letter that the trucks were obtained at a fair commercial price in an arms-length transaction from an unrelated business entity.

10. Cost of Capital

10.1. Summary

[40] "Alco and DRA have reached agreement that Alco will install approximately one mile of various sized new water mains in years 2010, 2011 and 2012, approximately 80 service line replacements during those years, and approximately 12 sample tap/blow-off assemblies, as well as the 5 million gallon storage tank required by federal court order." (Alco Opening Brief at 23.)

As discussed below, we adopt a capital structure for Alco which is 70% long term debt and 30% equity. Alco has no preferred stock, but it does have long term debt and common stock and therefore we do not impute a capital structure. As noted in briefs, Alco and DRA agree to a 70/30 ratio.[41] We therefore adopt, as discussed below, the following cost of capital:

2010 - 2012 Alco Cost of Capital			
	Percentage	Cost	Weighted Cost
Debt	70%	8.00%	5.60%
Equity	30%	10.70%	3.21%
Total	100%		8.81%

10.2. Legal Standard

The legal standard for setting the fair rate of return has been established by the United States Supreme Court in the Bluefield and Hope cases.[42] The Bluefield decision states that a public utility is entitled to earn a return upon the value of its property employed for the convenience of the public, and sets forth parameters to assess a reasonable return. Such return should be equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings attended by corresponding risks and uncertainties. That return should also be reasonably sufficient to ensure confidence in the financial soundness of the utility, and adequate, under efficient management, to maintain and support its credit and to

[41] Alco Opening Brief at 26 and DRA Opening Brief at 38 - 39: "DRA uses a 69.38% debt and 30.62% equity breakdown in deriving its recommended [rate of return]."

[42] *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944).

enable it to raise the money necessary for the proper discharge of its public duties.

Hope held that the value of a utility's property could be calculated based on the amount of prudent investment minus depreciation, which we call rate base. Hope reinforces the Bluefield decision and emphasizes that the returns should be sufficient to cover operating expenses and capital costs of the business. The capital cost of business includes debt service and stock dividends. The return should also be commensurate with returns available on alternative investments of comparable risks. However, in applying these parameters, we must not lose sight of our duty to utility ratepayers to protect them from unreasonable risks including risks of imprudent management.

We attempt to set the return on equity at a level of return commensurate with market returns on investments having corresponding risks, and adequate to enable a utility to attract investors to finance the replacement and expansion of a utility's facilities to fulfill its public utility service obligation. To accomplish this objective, we have consistently evaluated analytical financial models as a starting point to arrive at a fair return on equity.

10.3. Capital Structure

Ratemaking capital structure is long-term debt, preferred stock, and common equity.[43] Because the level of financial risk that a utility faces is determined in part by the proportion of its debt to equity capital, or the degree of financial leverage, we must generally ensure that the utility's adopted equity ratio is sufficient to maintain a reasonable credit rating and to attract capital

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43 Short-term debt due within one year is excluded.

without incurring unnecessary costs for an excessive amount of expensive equity.

Generally, long-term debt is the least expensive form of capital but the utility must ensure that it timely meets every interest payment and maintains any required terms or conditions of the loan agreements or mortgage indentures, and that it can refinance or refund the debt when it matures. Preferred stock is generally more expensive than debt (at the time it is originally issued) and may or may not have a maturity or refund provision. Interest may usually be deferred but it then accumulates and takes preference over payment of dividends to common equity owners. Thus, equity owners assume more risk than either debt holders or preferred stock owners, including the risk of losing their entire investment, and therefore equity investors require the highest return over the long run.

We believe that the company does have a significant control over the mix of debt and equity and thus ratepayers should not bear unnecessary costs as a result of management discretion—the equity return is a market return for the assumption of like-risk in comparable investment choices. Thus, even if, for the sake of argument, a smaller water company as a matter of course has a higher transaction cost and even a higher interest cost for debt, debt is almost always cheaper than equity and does not carry the added loading of an income tax allowance in rates. Therefore, if a company carries a high equity ratio, for ratemaking purposes we should necessarily consider adjusting either the return on equity or the capital structure.

The company and DRA agree upon a 70% debt and 30% equity ratio and we will adopt this ratio for all 2010--2012 cost of capital calculations.

10.4. Cost of Long-Term Debt

Long-term debt costs are almost always based on actual, or embedded, costs. Future interest rates must be anticipated to reflect projected changes in a utility's cost caused by the issuance and retirement of long-term debt during the year. This is because the rate of return is established on a forecast basis.

We recognize that actual interest rates do vary and that our task is to determine "reasonable" debt cost rather than actual cost based on an arbitrary selection of a past figure.[44] In this regard, we conclude that the latest available interest rate forecast should be used to determine the forecast of additional debt included in the embedded debt for the forecast period. (See recently, D.07-12-049, and 38 CPUC2d 233, where 18 years ago, the Commission definitively discussed the need for, and use of, a reliable forecast of future interest costs.)

10.4.1. Positions of the Parties

The company and DRA disagree significantly on the cost and availability of debt. DRA further expresses a concern that Alco should not issue debt in excess of the amounts recently authorized in D. 08-11-035. We can address this briefly: Alco cannot issue long-term debt without specific authority by the Commission pursuant to Pub. Util. Code §§ 816-830. Should Alco choose or need to issue debt in excess of its current authority it must first obtain authority to do so.

Alco assumes that, based on the current market conditions and other factors specific to Alco, its future cost of debt will be approximately 9.5% to 10.0% (Ex.A-5, at 93). Alco argues that (1) its last cost in 2007 was 7.85% and

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[44] 38 CPUC2d 233 at 242 and 243 (1990).

(2) there has been a 200 basis point increase in the market "spread" between 2007 and 2010 for 20-Year – BB rated bonds, and that Alco on this alone should be allowed a debt cost of 9.85% (7.85% + 2.00%). (Alco Opening Brief at 33-34.)

DRA disagrees with Alco's forecast of new long term debt costs, and argues instead that the Commission should adopt a cost which is 400 basis points above the 10-Year U.S. Treasury note. This results in a recommended cost of 7.85%, and the general belief that Alco can borrow at less than 8%. (Ex. D-1 at 13-11 through 13-14.) DRA also argues that Alco has made expensive choices or recommendations, for example, by using capital leases with 4M Development Corporation, and should instead deal with banks and insurance companies as it did in prior loans with Allstate. DRA is also concerned that the leases contain hidden interest costs which significantly drive-up the actual cost to ratepayers. (DRA Opening Brief at 39 – 42.)

10.4.2. Discussion

If we look at current 10-Year Treasury Note yields for November 2010, we find that rates are around 2.60%.[45] If we refer back to July (when we held evidentiary hearings) rates were slightly higher at 2.90% to 3.0%. (Id.) Thus, DRA's 400 point premium, above, would result in a forecast rate of between 6.60% to 7.00%. By comparison, the Federal Reserve's Statistical Release H.15 reports that corporate bonds (rated at Baa) yielded approximately 6.0% in July 2010 and 5.70% to 5.80% for November 2010. Thus Alco's 200 point premium would result in a forecast of between 7.70% and 8.0% before considering any further differential between Alco's proposed – BB benchmark rating and the Baa reported by the Federal Reserve. Essentially, a rating at Baa is considered to be an adequate lower-grade investment grading whereas a rating of – BB (more commonly BB-) is a tier lower and generally considered less than investment grade or somewhat speculative. (There is a slight difference too in that Baa is a term generally used by Moody's Investor Service, whereas BB- is a term used by Standard and Poor's.)

The use of "investment grade" versus "speculative" is problematic when dealing with small investor-owned, regulated public utilities. First, the existence of rate regulation specifically because the company provides a monopoly service, significantly alters the dynamics when assessing the likelihood of a company having the cash flow and continuity of business necessary to assure repayment of principal and timely debt service. In a far-less regulated environment, i.e., a company not subject to rate regulation by any agency such as this Commission, investors would be more likely to find a family-owned company the size of Alco to be risky and perhaps a "speculative" investment and not likely an investment grade opportunity.

We believe utility rate regulation substantially alters the risk profile of a public utility because it provides substantial assurances or enhancements that make debt service and repayment far more likely. The one problem that even regulation doesn't address is finding corporate or institutional lenders interested in the relatively small size of the principal amounts borrowed by companies like Alco. For example, D.08-11-035 granted Alco authority to borrow $8 million. We routinely authorize the large gas and electric utilities authority in the

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[45] http://www.federalreserve.gov/releases/h15/Current/.

many-hundreds of millions of dollars where debt is issued to a national or world-wide market of investors.

Although DRA objects to the inclusion of certain costs added into the 4M Development Corporation loan we do not have in the record the detailed breakdown of the embedded costs of debt (with or without these additional costs). We therefore adopt a market forecast which subsumes any underlying embedded costs.

Based upon all of the above considerations of market yields, risk and regulation, and size of the company, we find that a long term debt cost of 8.00% is a reasonable forecast for the rate case cycle 2010 - 2012.

10.5. The Cost of Equity

In competitive markets for goods, the return on common equity is determined by the relative risks of alternative investments and the willingness of individual investors to accept varying degrees of risk. In a closely regulated market regulation substitutes for competition and the regulator, acting as a substitute for the market, provides investors an opportunity to earn a fair and reasonable return for accepting the degree of risk presented by the regulated business.

Thus, the Commission must, as always, exercise extreme caution and critically review the wide range of results seemingly rendered from the same models held in different hands. Recently we noted:

> What stands out in a comparison of the testimony of the experts is the inevitable and pervasive use of [their] judgment, which colors all results. (D.07-04-046 at 58.)

We also noted at that time:

> Although the parties agree that the models are objective, the results are dependent on subjective inputs. For example, each party used different proxy groups, growth rates, and calculations of market returns. (Id. at 57.)

10.5.1. Positions of the Parties

Alco proposes a return on equity of 13.20% based upon a comparison of itself with the California large multi-district Class A water companies. (Alco Opening Brief at 30 citing to Ex. A-5, at 84-92.) Essentially Alco begins with the recently authorized 10.20% return on equity adopted in D.09-05-019 and derives an additional risk premium of 300 basis points (100 basis points = 1.0%) for a 13.20% requested return on equity.

Rate of return for Class B water companies is not as rigorously reviewed and tested as is the return for a Class A company. For example, Resolution W-4760, dated July 9, 2009, for Del Oro Water Company, adopted an overall rate of return of 10.80%. No further detail or analysis was provided to explain or distinguish this adopted return. (Resolution W-4760 at 4.) DRA asserts that this included a return on equity of 10.96%. (Ex. D-1 at 13-7.) DRA provides very little other analysis and we necessarily accord DRA's recommendation little weight.

10.5.2. Discussion

Alco derives its 300 basis point adder to the 10.2% return on equity recently adopted for the large Class-A companies in two parts: 200 points from a bond yield curve differential for BBB and BB- publicly traded utility bonds (Ex. A-5 at 87-88) and another 50-100 points to compensate for Alco's "limited financial flexibility" due essentially to its smaller size when compared to the

Class-A companies. (Id. at 89 - 90.) Neither argument is rigorous, precise or particularly apposite.

The comparison of BB bonds, (at the low-end of speculative in Standard and Poor's lexicon) and BBB- (at its low-end of investment grade) is problematic as presented by Alco. First, the company presents a one-time snapshot without context or continuity. Secondly, the comparison is at most relevant to measuring a point-in-time interest rate differential for debt and is not indicative of investor risk perceptions for an equity investment. We therefore accord no weight to Alco's 200-point proposal.

We are again very concerned that the second component, a small-size adjustment factor that is based on a long-term debt cost comparison is imprecise for adjusting equity returns. The typical cost of equity models measure, or at least forecast, a differential for the risk assumed by an equity holder above a risk-free alternative. (D.09-05-019 at 17 and footnote 22 at 19.)[46] So the question we decide in adopting a return on equity is what reward is required for the ownership risk of the utility compared to a risk-free investment such as a government bond.

We are not convinced that Alco has demonstrated with any precision that a small-size adder of 50-100 basis points is warranted. We do not like the exercise of judgment to be confused with or tainted by seemingly arbitrary choices. But we agree at a fundamental level that Class B companies are smaller

[46] A risk premium is a return in excess of the risk-free rate of return that an investment is expected to yield. An asset's risk premium is a form of compensation for investors to tolerate the extra risk compared to that of a risk-free asset. The risk-free rate represents the interest an investor would expect from an absolutely risk-free investment over a specified period of time.

than Class A companies; they have a less-rigorous regulatory oversight (which could be seen as a two-edged sword of risk and opportunity); and small fluctuations in operations can have a disproportionate impact on financial results. We therefore will exercise our judgment and provide a 50 basis point adder to the 10.20% return we have so recently found to be applicable to the Class A water companies. We therefore adopt a return on equity of 10.70% for 2010 – 2012.

11. Next General Rate Case

Alco is a Class B company and typically Class B general rate cases are filed by advice letter. The Commission directed Alco to file this general rate case as an application and DRA actively and fully litigated the proceeding. The litigated issues were significant in this proceeding, but were based on genuine differences of opinion and we have no reason to doubt Alco's good faith in its filing. Nevertheless, we believe that Alco should file its next rate case as a full application and not as an advice letter. This is a discretionary choice on our part: Alco is a very large Class B company and is a sophisticated water operation. We therefore find it prudent to examine Alco's next general rate case for a test year no earlier than 2013 under the full scrutiny applied to an application. Therefore, there will be no increase in base rates beyond the 2012 attrition allowance until Alco files subsequent general rate case. This requirement should be revisited in the next proceeding and should not automatically result in the continued use of the application process over the advice letter process beyond the next proceeding (unless Alco were to become a Class A company through continued growth). The Commission should make an appropriate finding in the next proceeding.

12. Procedural History

Alco filed A.10-02-006 on February 1, 2010 as required by D.08-11-035, in lieu of an advice letter process. In Resolution ALJ 176-3249 the Commission determined that this proceeding was a ratesetting proceeding and required evidentiary hearings. On March 3, 2010 there was a timely protest by DRA and the City of Salinas was permitted to late-file a protest on March 10, 2010. On March 26, 2010, there was an unreported (no transcript) telephonic prehearing conference. This telephonic conference was held with the agreement of all parties and saved time and money by avoiding unnecessary travel. An assigned Commissioner's Scoping memorandum and Ruling was issued on April 2, 2010. Public Participation hearings were held in Salinas, California, on June 3, 2010. Evidentiary hearings were held on July 8 and 9, 2010. Opening briefs were filed on August 9 and 10, 2010 by DRA and Alco, respectively, and Reply briefs on August 23, 2010. On September 15, 2010 a joint motion was filed for approval of a settlement between Alco and DRA. The assigned ALJ granted DRA's September 15, 2010 motion to set aside submission to consider additional information, Alco filed a response on October 28, 2010, and DRA replied on November 2, 2010. On January 20, 2011, the California Water Association was granted party status after a late filed motion on January 18, 2011.

12. Comments on Proposed Decision

The proposed decision of ALJ Long in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code, and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were filed on January 18, 2011 by Aloc, DRA and the California Water Association, and reply comments were filed on January 24, 2010 by Alco and DRA.

The California Water Association was allowed party status after a late filed motion on January 18, 2011. Its comments were limited to the limitation imposed on family transactions. California Water Association showed in its comments that it had a limited knowledge of the record in this proceeding and we accord those comments no weight. We otherwise have made significant revisions to this decision based upon the comments of Alco and DRA to correct errors in the proposed decision or to provide greater clarity.

14. Assignment of Proceeding

John A. Bohn is the assigned Commissioner and Douglas M. Long is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

Record

1. There is a full and complete record composed of testimony, work papers, examination of witnesses, as well as full and complete opening and reply briefs.

Settlements – Generally

2. The parties to the settlement adopted in this decision had a sound and thorough understanding of the application, and all of the underlying assumptions and data included in the record and could make informed decisions in the settlement process.

3. The adopted settlement is between competent and well-prepared parties who were able to make informed choices in the settlement process.

Test Year Settlement

4. The intervening party, DRA, which settled with Alco, represents a broad range of customers.

5. The test year revenue requirement settlement for Alco is a balance of the positions advocated by the applicant and DRA.

Unresolved Issues

6. The test year settlement's revenue requirement is unaffected by resolving open disputes between applicant and the primary intervenor, DRA.

7. The unresolved issues include issues litigated by Alco and DRA outside the test year revenue requirement settlement.

Wells & Pumps

8. Alco needs new energy efficient pumps as a part of meeting its water supply requirements.

9. Three new wells are already authorized by Resolution W-4577 and the Verona and Bardon Wells are partially completed. The East Laurel Well has only minor expenditures.

10. The total forecast cost for the three wells are $953,505 for the Verona Well which includes $778,905 of construction work in progress incurred through 2009; $1,689,130 for the Bardin Well which includes $750,345 of construction work in progress incurred through 2009; and $1,802,235 for East Laurel Heights which includes $57,000 of construction work in progress incurred through 2009.

11. Based on the record the estimated cost to complete the Verona, Bardon, and East Laurel Heights wells is reasonable.

12. Alco can meet its water demand for safe water with its largest one well off-line.

13. Public Health Code requirements in § 64554(c) apply continuously and Alco must be able to meet its water demand with the largest source off line.

14. Alco needs none of the three new wells proposed in the rate case to have sufficient supply to meet maximum daily demand after including three previously approved new wells and the new pump for an existing well.

15. Alco needs only three new wells already authorized by Resolution W-4577 as a part of its supply to meet its fire flow requirement pursuant to Public Health Code § 64554(a).

16. Alco needs 9,575 gpm which includes 1.5 times its maximum daily demand to meet its fire flow requirement.

17. Alco need only have an adequate fire flow supply with its single largest water supply offline.

18. Alco will have sufficient margin to meet its maximum daily demand, plus a fire flow allowance, even with one of its largest wells offline.

19. Alco must blend water sources and needs 5 new wells to meet arsenic contamination limits.

Audit

20. Alco does have its financial statements audited by an independent Certified Public Accountant.

Family Transactions

21. The Commission's water affiliate transaction rules adopted in D.10-10-019 do not clearly address family transactions; they are focused on related company dealings and anti-competitive behavior.

22. Prohibiting transactions involving Alco and the family that owns the company, one of whom is the president of the company, will avoid the risk of unfair transactions.

23. Alco has had commercial transactions between the regulated utility and the family members that control the ownership of Alco's common stock.

24. Alco purchased equipment from a company, G&L Leasing controlled by a shareholder, Mrs. Adcock, who is also the mother of the utility's president.

25. Alco purchased equipment from T.R. Adcock who is the president and whose family controls the ownership of Alco's common stock.

26. The equipment acquired from G&L Leasing is fairly valued for ratemaking purposes at remaining book value.

27. The assets acquired from T.R. Adcock are fairly valued for ratemaking purposes at remaining book value.

New Equipment Purchases

28. Alco should defer purchase of equipment intended to comply with California Air Resources Board Rules until Alco can demonstrate the California Air Resources Board will enforce new emission standards. Reopening the record would be efficient and timely.

29. Alco needs an infrastructure mapping system.

30. Alco needs new office systems including computers, operating systems, customer service software, and telephone equipment.

31. Alco needs three new large service trucks.

Advice Letters for New Equipment and Wells

32. Deferring rate recovery until new equipment or new wells are built and used and useful, protects customers from paying in rates for items not actually built or acquired.

33. Advice letters can enable Alco to recover in rates the revenue requirements of new equipment and wells after the wells or equipment are actually built or acquired and are used and useful.

Cost of Capital

34. Alco and DRA agree to use a 70% debt and 30% equity capital structure.

35. Alco forecasts debt cost at 9.5% to 10.5% by adding a 200 basis points to its last debt cost because the cost of bonds has risen by 200 points between 2007 and 2010 on corporate bonds yielded rated at Baa.

36. 200 points above current rates reported in the Federal Reserve's Statistical Release H.15 on corporate bonds yields rated at Baa results in a forecast of 7.70% to 8.00%.

37. DRA recommends 400 points adder to the 10-year Treasury Bond which would be a forecast of 6.60% to 7.00%.

38. The most reasonable forecast cost of debt for Alco is 8.0%.

39. The Commission has recently authorized 10.20% on equity for Class A water companies.

40. Alco is much smaller than the smallest Class A companies.

41. Alco does not justify its 200 basis point adder for greater risk and smaller size compared to the Class A water companies. It used an out-of-date bond yield curve.

42. DRA could not demonstrate how it derived an estimate of 10.96% from Resolution W-4760 which was Del Oro Water Company's recent general rate case.

43. We believe that 50 basis points is a sufficient allowance for Alco's smaller size and the less rigorous regulatory oversight of Class B water companies.

Other

44. Alco is a sophisticated operation. DRA found many issues to litigate in this proceeding.

45. A rate case application is usually more thoroughly examined than an advice letter rate case.

Conclusions of Law

1. This decision reasonably relies on the entire record of the proceeding and accords weight based upon the evidence's relevance and the persuasiveness of the parties' arguments.

Settlements Generally

2. The existing framework of regulatory proceedings sets just and reasonable rates for Alco to provide safe and reliable service pursuant to Pub. Util. Code § 107.10.

3. Applicant alone bears the burden of proof to show that its forecasts are reasonable.

Test Year Settlement

4. The Test Year revenue requirements settlement is reasonable because it fairly balances intervenor interests and provides sufficient revenue to safely provide reliable service.

5. The Commission has the discretion and authority to resolve open disputes which were not addressed in the settlement and were part of the litigated positions of parties.

6. The adopted settlement provides sufficient information for the Commission to discharge its future regulatory obligations.

Unresolved Issues

7. The Commission has the discretion and authority to craft a regulatory solution which differs from the applicant's proposal and the intervenor's recommendations in order to adopt just and reasonable rates which allow the applicant a reasonable opportunity to recover its costs to provide safe and reliable service.

8. Public Health Code requirements in § 64554(c) apply to Alco on an ongoing basis.

9. Public Health Code § 64554(a) for fire flow requires Alco to have a supply of 1.5 times its maximum daily demand.

10. Equipment purchased from G&L Leasing should be included in rate base at its net book value at the time of transfer.

11. Equipment purchased from T.R. Adock should be included in rate base at net book value at the time of transfer.

12. The Pre-2009 CWIP and 2009 CWIP which totals $778,905 for the Verona Well should be included in rate base as Plant Held for Future Use.

13. The 2009 CWIP of $750,345 for the Bardin Well should be included in rate base as Plant Held for Future Use.

14. The construction work in progress balance of $57,000 should be included in rate base as plant held for future use.

15. It is reasonable to cap the cost to complete the Verona, Bardon and East Laurel Heights wells at the current forecast.

16. Alco must file Tier 2 Advice Letters to recover any additional costs of the three wells up to the individual cost caps.

Family Transactions

17. The Commission's adopted affiliate transaction rules in D.10.10-019 apply to Alco. These rules do not prohibit family transactions with the regulated utility.

18. The Commission has the authority to apply additional or more specific restrictions on Alco prohibiting specific types of transactions with members of the ownership family.

Advice Letters

19. Advice letter rate recovery when new wells and other equipment acquisitions actually occur, and are used and useful, is reasonable to protect ratepayers from paying for major forecast expenditures which do not occur.

Cost of Capital

20. The legal standard for setting the fair return on equity has been established by the United States Supreme Court in the *Bluefield* and *Hope* cases. (*Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944).)

21. It is reasonable to impute a cost of debt based on the historical interest rate spread above the return on corporate bonds rated at Baa.

22. It is reasonable to allow an additional 50 basis points to the cost of equity to compensate for the smaller size of a Class B water company compared to a Class A.

Other

23. The Commission has the authority to order Alco to file its next general rate case by application no sooner than a 2013 test year to increase base rates beyond the 2012 attrition rates.

24. All rulings by the assigned judge were lawful and are affirmed.

25. Application 10-02-006 should remain open to address the proposed advanced metering infrastructure proposal.

O R D E R

IT IS ORDERED that:

1. The September 15, 2010 Joint Motion of Alisal Water Corporation, dba Alco Water Service and the Division of Ratepayer Advocates to Approve a Settlement in Application 10-02-006 is granted and the settlement is approved. (The settlement is available at http://docs.cpuc.ca.gov/efile/MOTION/123510.pdf).

2. The disputed issues regarding construction of six wells in Application 10-02-006, which are not included in the proposed settlement between Alisal Water Corporation, dba Alco Water Service (Alco) and the Division of Ratepayer Advocates, are resolved as follows:

   a. Alco may record $778,905 in construction work in progress for the Verona Well in rate base as Plant held for Future Use.

   b. Alco may record $750,345 in construction work in progress for the Bardin Well in rate base as Plant held for Future Use.

   c. Alco may record the $57,000 in construction work in progress for the East Laurel Heights Well in rate base as Plant held for Future Use.

   d. Upon completion and becoming used and useful Alco must file a Tier 2 Advice Letter to recover actual cost up to a cost cap total of $953,505 for the Verona Well which includes the amount of $778,905 recorded in Plant Held for Future Use.

   e. Upon completion and becoming used and useful Alco must file a Tier 2 Advice Letter to recover actual cost up to a cost cap total of $1,689,130 for the Bardin Well which includes the amount of $750,345 recorded in Plant Held for Future Use.

f. Upon completion and becoming used and useful Alco must file a Tier 2 Advice Letter to recover actual cost up to a cost cap total of $1,802,235 for the East Laurel Heights Well which includes the amount of $57,000 recorded in Plant Held for Future Use.

g. Alco may not construct any of the three wells proposed in this application.

3. The disputed installation of new energy efficient pumps is approved and Alisal Water Corporation, dba Alco Water Service is authorized to file a Tier 2 Advice Letter upon installation and the pumps becoming used and useful.

4. The disputed purchase of an infrastructure mapping system is resolved as follows: Alisal Water Corporation, dba Alco Water Service (Alco) may purchase the office equipment at a capped cost of $100,000. Alco must file a Tier 2 Advice Letter to put the actual costs of the infrastructure mapping system in rate base and recover the revenue requirement but only if and when the system is purchased and becomes used and useful.

5. The disputed purchase of office equipment is resolved as follows: Alisal Water Corporation, dba Alco Water Service (Alco) may purchase the office equipment at a capped cost of $618,700. Alco must file a Tier 2 Advice Letter to put the actual costs of the office equipment in rate base and recover the revenue requirement but only if and when the office equipment is purchased and becomes used and useful.

6. The disputed purchase of three new service trucks is resolved as follows: Alisal Water Corporation, dba Alco Water Service (Alco) may purchase the three trucks at a capped cost of $177,464. Alco must file a Tier 2 Advice Letter to put

the actual costs of the trucks in rate base and recover the revenue requirement but only if and when the trucks are purchased and become used and useful.

7. The equipment acquired from G&L Leasing is valued at $33,350 for inclusion in rate base.

8. The equipment acquired from T.R. Adcock is valued at $109,540 for inclusion in rate base.

9. Alisal Water Corporation dba Alco Water Service must cease all commercial transactions between the utility and any member of the Adcock family. The Adcock family may continue to invest equity capital as needed pursuant to a Commission decision authorizing the company to issue common stock. Qualified members of the Adcock family may work for Alco and be paid reasonable compensation for the necessary work they perform to operate the utility.

10. Alisal Water Corporation dba Alco Water Service (Alco) may file a Tier 3 Advice Letter for a waiver of the ban on commercial transactions with related parties. Alco must fully justify why the transaction would be reasonable and in the ratepayer's interest.

11. Alisal Water Corporation dba Alco Water Service must continue to have annual independent audits by a Certified Public Accountant.

12. Alisal Water Corporation dba Alco Water Service must submit its annual audited financial statements, the related disclosures and the attest opinion of the Certified Public Accountant to the Division of Water and Audits (or successor organization) within 90-days of filing the Annual Report required by General Order 104-A.

13. Within 30 days of today's date, Alisal Water Corporation, dba Alco Water Service must file a Tier 1 Advice Letter with tariff changes and new rates in the

attached Tables. The tariffs shall become effective on January 1, 2011, subject to the Division of Water and Audits' determination that they are in compliance with this decision.

14. Alisal Water Corporation dba Alco Water Service (Alco) must file its next general rate case by application and not by advice letter for no earlier than a test year 2013. Until Alco files this rate application the 2102 attrition allowance will be the last adjustment to base rates.

15. Application 10-02-006 remains open.

This order is effective today.

Dated March 10, 2011, at San Francisco, California.

MICHAEL R. PEEVEY
President
TIMOTHY ALAN SIMON
MICHEL PETER FLORIO
CATHERINE J.K. SANDOVAL
Commissioners

ATTACHMENTS

D1103005/A1002006 Attachments Long