

Decision 11-09-017 September 8, 2011

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the matter of the Application of the GOLDEN STATE WATER COMPANY (U133W) for an order authorizing it to increase rates for water service by \$2,911,400 or 29.9% in 2011 and by \$321,200 or 2.5% in 2012 in its Arden Cordova Service Area; to increase rates for water service by \$1,782,400 or 33.2% in 2011 and by -\$66,200 or -0.9% in 2012 in its Bay Point Service Area; to increase rates for water service by \$409,100 or 22.6% in 2011 and by \$23,300 or 1.0% in 2012 in its Clearlake Service Area; to increase rates for water service by \$1,467,000 or 48.5% in 2011 and by \$50,100 or 1.1% in 2012 in its Los Osos Service Area; to increase rates for water service by \$1,647,900 or 38.8% in 2011 and by \$343,200 or 5.9% in 2012 in its Ojai Service Area; to increase rates for water service by \$2,350,700 or 25.2% in 2011 and by \$363,200 or 3.1% in 2012 in its Santa Maria Service Area and; to increase rates for water service by \$799,500 or 6.5% in 2011 and by \$213,000 or 1.6% in 2012 in its Simi Valley Service Area.

Application 10-01-009
(Filed January 13, 2010)

(See Appendix A for List of Appearances.)

**DECISION ON THE RATEMAKING TREATMENT FOR THE
ABANDONED HILL STREET WATER TREATMENT FACILITY AND THE
AGREEMENT WITH THE CONTRA COSTA WATER DISTRICT TO ACQUIRE
REPLACEMENT WATER TO SERVE THE BAY POINT SERVICE AREA**

Summary

In Decision (D.) 10-06-031 the Commission found that a water purchase agreement between Golden State Water Company (Golden State) and Contra Costa Water District (Contra Costa) was the most viable option to replace the abandoned Hill Street Water Treatment Facility (Hill Street). Today's decision finds that Golden State must remove from rate base and amortize the undepreciated book value of its abandoned Hill Street facility over a six-year period, with interest, accrued at its 2011 incremental cost of debt from Golden State's Temporary Interest Rate Balancing Account adopted in its recent cost of capital proceeding, D.09-05-019. Additionally, Golden State must collect in rates the prepaid capacity cost for replacement water, acquired from Contra Costa, over a six-year period on the ratemaking presumption that Golden State made a single payment to Contra Costa.

This proceeding remains open to address an unrelated proposed settlement involving Golden State and the Commission's Division of Water and Audits.

Background

The ratemaking treatment for the abandonment of Hill Street Water Treatment Facility (Hill Street) and the replacement water agreement were both deferred to this proceeding in Decision (D.) 10-06-031 in Application (A.) 09-08-004. (See Procedural History.) The Commission otherwise approved the water purchase agreement between Golden State Water Company (Golden State) with Contra Costa Water District (Contra Costa), finding that the

replacement water agreement was the “preferred alternative.” (Findings of Facts (FOF) 4 and 5.) The reasons and need to abandon Hill Street have already been adjudicated and need not be repeated in full here. After determining Hill Street cannot provide drinkable water¹ (FOF 1 and 3), and must therefore be abandoned, D.10-06-031 found that, of the various replacement options, the preferred option is Golden State’s agreement to acquire excess capacity available from Contra Costa.² The approved agreement requires Golden State to prepay Contra Costa the full agreement cost of \$4.7 million in capacity charges in either a lump sum or over four years. (D.10-06-031 at 19.)³

Positions of Golden State and DRA

Golden State proposes that the undepreciated book value of Hill Street should remain in rate base and earn the full authorized rate of return over the remainder of its life forecast before it ceased being used and useful to provide safe and reliable potable water to Bay Point customers. Golden State also proposes that the cost of the Contra Costa agreement should be added to rate

¹ Specifically, the California Department of Public Health ordered Golden State to cease violating California Health and Safety Code § 11655 and California Code of Regulations § 64533. (See, Ex. G-1 at 5 in A.09-08-004.)

² Specifically, water would be provided by Contra Costa from its Randall Bold Plant (see, Ex. G-1 at 2-3 in A.09-08-004), however, the specifics of the plant are not germane: what is essential is that Golden State is buying water from Contra Costa pursuant to a negotiated long term agreement. It does not matter where or how treated water gets from Contra Costa; only that Contra Costa provides it to Golden State to replace the defunct Hill Street facility.

³ Golden State filed Advice Letter 1428-W which included an executed copy of the agreement with Contra Costa. Resolution W-4877 approved the advice letter. The Resolution noted that the ratemaking treatment of the agreement was deferred to this proceeding. On July 11, 2011 Golden State informed the Division of Water and Audits that the transaction was completed.

base and it should earn a full rate of return over the life of the agreement. (Transcript at 510: 26-27.)

Golden State characterizes the agreement (among other things) as a “lease.” Golden State’s Treasurer testified that the agreement is neither an operating nor a capital lease as defined in generally accepted accounting principles. (Transcript at 501: 7-10.) The agreement, according to Golden State’s Treasurer, is accounted for as a deferred asset because the company will have prepaid costs attributable to future periods.

Finally, Golden State characterizes a significant portion of the agreement’s cost as “water rights” which it proposes to place in rate base not subject to amortization. The agreement, for Golden State’s accounting and financial reporting purposes, is a prepayment which will be disclosed as a deferred asset on Golden State’s balance sheet and will be amortized (allocated to expense in the income statement) over the life of the agreement.⁴

The Commission’s Division of Ratepayer Advocates (DRA) investigated the two questions of abandoning Hill Street and the selection of the Contra Costa agreement in A.09-08-004. DRA filed opening and reply briefs again here. DRA opposes Golden State’s proposals and recommends alternative ratemaking treatments for both Hill Street and the agreement with Contra Costa. According to DRA, “Golden State... has a simple request for the... ratepayers living in its Bay Point customer service area. It wants those ratepayers to pay it a rate of return on two water treatment plants. But one of these plants does not work and

⁴ Testimony of Golden State’s Treasurer, purportedly relying on the codified generally accepted accounting principles that determines the financial reporting of this transaction. (Transcript at 501.)

the other plant is not owned by [Golden State].” Therefore, according to DRA, Golden State “is asking its customers to pay twice, but is only delivering water once.” (DRA Reply Brief at 1-2.)

DRA recommends the following ratemaking treatment for Hill Street and the Contra Costa agreement. First, the Commission should take the remaining undepreciated balance for Hill Street out of rate base, and amortize this amount in rates over 10 years,⁵ because Hill Street is no longer used or useful, provides no benefit to ratepayers, and therefore does not qualify for rate base treatment (including earning a full rate of return).⁶

DRA also argues the Contra Costa agreement is neither a true capitalized lease nor an intangible asset as the Commission has analyzed those concepts in prior decisions. (DRA Opening Brief at 8-9.) Thus, DRA argues the agreement should not be included in rate base but instead should be treated as a rental agreement, and as with any other rental agreement, Golden State should recover the cost as an operating expense. (*Id.* at 9-10.)

Discussion

We will allow Golden State to recover its undepreciated investment in Hill Street and allow as a reasonable carrying cost the company’s incremental cost of debt. We will also allow Golden State to amortize the prepayment of the capacity charge in the water purchase agreement and allow the same carrying cost. Golden State is not entitled to earn an equity return on either transaction.

⁵ Ex. D-25, at 3, Lines 7-9.

⁶ *Id.* at 2-3.

We reject Golden State's rate base proposal for both Hill Street and the Contra Costa agreement because it is unreasonable to burden ratepayers with a rate base treatment for two facilities performing or intended to perform the same function. Hill Street must be abandoned, and while it is reasonable to return the undepreciated balance, it is not reasonable for ratepayers to pay a return on equity as if Hill Street were still used and useful or capable of providing adequate service. Hill Street is neither.

Golden State's characterization of the Contra Costa agreement as an "intangible" asset, i.e., not a physical or tangible asset such as a truck or building, is not accurate either as accounting or as ratemaking. Golden State will have prepaid the whole cost for the capacity of a multi-year agreement, and thus Contra Costa owes Golden State water service in the future. Accountants call that a deferred asset for Golden State. As noted in the comments, the proposed decision did not distinguish that Golden State will annually pay commodity charges for the actual volumes of water delivered by Contra Costa. At issue in this decision is only the prepayment of capacity charges. Volumetric charges will be recovered as an expense when incurred.

Golden State makes a weak argument that the accounting practice is to "write-off" Hill Street's balance to the depreciation reserve, which for ratemaking treatment would result in the company being compensated as if nothing had happened and the plant were still working. "Write-off" is more appropriate (and frequently applied) to multi-unit assets like trucks or pumps, where some units fail early and others function longer, so the ratemaking treatment simply adjusts depreciation to correct for the difference between the forecast lives and the actual service lives of numerous like assets. "Write-off" is not suited to large single unit transactions. Moreover, the Commission treats

abandoned plant differently from adjustments to the forecasts of depreciable lives.

In A. 09-08-004 Golden State used a 20-year life for its comparison of modifying Hill Street or entering into the water purchase agreement. (D.09-06-031 at 8.) Any attempt to forecast the hypothetical remaining useful life of Hill Street is pointless for our needs. We need to avoid the rate shock to rate payers if Golden State recovered its costs immediately and the burden to Golden State of an overly-long amortization. We will compromise on six years; it is not as long as any arbitrary forecast of useful life for a modified Hill Street plant, and it eases the immediate impact on rates.

It is equally inappropriate to place the prepaid costs of the Contra Costa replacement water agreement in rate base. Golden State has no operational control over the facility, has made no investment, and does not acquire any ownership interest under the agreement with Contra Costa. Golden State is simply buying water, and water purchases are usually recovered in a purchased water balancing account. Golden State has negotiated with Contra Costa to prepay \$4.7 million, but prepayments are not entitled to rate base treatment simply by virtue of being paid upfront.

Not only is Golden State's proposed treatment of its water purchase costs at odds with Commission precedent, it would also result in rate shock to Bay Point customers who are faced with amortizing Hill Street as well as prepaying Contra Costa for many years' worth of water. Golden State proposes to place the cost in rate base (including a significant portion classified as a non-amortizing water right) and to recover the full amount as well as earn a return on the balance at its full cost of capital, as if the purchase agreement were a productive asset. This rate base treatment would greatly increase the amount to be collected

from Bay Point customers. Further increasing the cost to ratepayers, Golden State has indicated that it would select an option offered by Contra Costa to pay the amount in full rather than elect a four year installment option.

In short, Golden State has elected at every turn to select the option most beneficial to itself in the face of abandoning its Hill Street plant and limited options to replace the lost potable water needed to serve Bay Point.

Consistent with law and Commission policy, we will allow Golden State a reasonable interest cost to reflect the prompt write-off of the purchase agreement's capacity costs. We will allow Golden State to recover this cost over a six year timeframe, which is longer than the time that Golden State could have used to pay Contra Costa under the initial terms of the agreement. We add these two years to ease the rate shock to ratepayers. There will be no allowance for a return on equity. We will instead amortize the cost over six years using Golden State's 2011 incremental embedded cost of debt in the Temporary Interest Rate Balancing Account from its last cost of capital proceeding. (D.09-05-019, at Ordering Paragraph (OP) 3.) This is a compromise between the full 13.06% cost of capital proposed by Golden State and DRA's proposal to treat the payments as an operating expense.

Golden State has consistently mischaracterized the Contra Costa agreement in numerous ways, and by its ratemaking proposals has endeavored to unfairly enrich itself even in the face of the water quality violations of its Hill Street plant. The agreement is a long-term water purchase agreement. The proposed decision required Golden State to delete section 4.2.1 of the agreement because impinged on the Commission's discretion and would have appeared to impose a specific ratemaking treatment. On August 8, 2011 Golden State filed a motion to reopen the record to admit the second amendment to the agreement.

That amendment replaced section 4.2.1 and we grant the motion for that limited purpose which eliminates the need for a further revision.

Procedural History

On January 13, 2010, Golden State filed its general rate case for Region I. By Resolution ALJ 176-3247 dated January 21, 2010. There was a pre-hearing conference on March 3, 2010 (Rule 7.2), and an assigned Commissioner's Scoping Memorandum and Ruling (Rule 7.3), dated March 11, 2010, adopted a preliminary schedule and defined the scope of the proceeding.

Decision 10-12-059 adopted a settlement on most of the issues for the test year revenue requirement, as proposed, and resolved all litigated or otherwise contested issues, except for those issues that we address today, i.e., the ratemaking treatment for the abandonment of Hill Street and the replacement water agreement with Contra Costa. The agreement with Contra Costa was otherwise conditionally approved. (OP 1.) Regarding the ratemaking issues deferred to today's decision, opening Briefs were filed by Golden State and DRA on September 17, and replies on September 23, 2010. There were no further hearings.

Comments on Proposed Decision

The proposed decision of the Administrative Law Judge (ALJ) 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. Timely comments and reply comments were filed by Golden State and DRA.

Both parties' opening comments express concern that the proposed decision did not clearly distinguish the prepayment as a capacity charge, distinct from a volumetric commodity charge for water. It is true that the payment is for

capacity and not production, but both comments ignore the principal concern in the proposed decision which is the cost is prepaid for multiple years and not paid annually. Nothing in the record justified the need to prepay and burden ratepayers with a rate base treatment for a prepayment of capacity costs as a part of the water purchase agreement.

DRA comments that the proposed decision used an “out-of-date” interest cost and that issue is addressed in changes to the decision. The proposed decision used the interim forecast interest rate for the balancing account. For 2011 interest on the amortization Golden State must use the actual incremental cost of borrowing during the life of the company’s Temporary Interest Rate Balancing Account that will be determined in the balancing account’s reasonableness review in A. 11-05-004, which is Golden State’s pending cost of capital application for a base year 2012. Thereafter the Company must use the adopted incremental cost of debt in A. 11-05-004 until subsequently modified by the Commission.

Based on the comments the decision is modified to eliminate the requirement that Golden State re-file the water purchase agreement with Contra Costa to eliminate the term “lease.” What matters is our ratemaking treatment, not the internal characterization of the transaction. The core of the transaction is that Golden State prepaid an expense and did not made a rate base investment, therefore our ratemaking reflects that basic truth.

To the extent that any comments only reargue litigation positions they have been given no weight. Other minor changes have been made based on our review and consideration of the comments.

Assignment of Proceeding

Michael R. Peevey is the assigned Commissioner and Douglas M. Long is the assigned ALJ in this proceeding.

Findings of Fact

1. The Commission has already determined that Golden State must abandon Hill Street.
2. The Commission has already approved the water purchase agreement in D.10-06-031, finding the agreement the most viable option to replace the water from Hill Street, in that purchasing water from Contra Costa was the best of the limited available alternatives.
3. The Commission's practice is to allow the recovery of the undepreciated investment balance on abandoned plant. It is reasonable to use Golden State's 2011 incremental cost of debt in the Temporary Interest Rate Balancing Account as the carrying costs for amortization purposes.
4. Six year amortization is a compromise between immediate recovery of the undepreciated investment balance on the abandoned plant, and a theoretical forecast of useful life on a modified plant. It will mitigate rate shock to ratepayers and not delay Golden State's recovery of its investment.
5. Depreciation is not the appropriate recovery mechanism for abandoned large plant.
6. The water purchase agreement with Contra Costa is a long term water purchase agreement, not a lease of the facility.
7. The two payment options for the water purchase agreement with Contra Costa are both a prepaid expense.

8. The 2011 incremental cost of debt in the Temporary Interest Rate Balancing Account reasonably compensates Golden State while amortizing the water purchase agreement prepayments of capacity charges.

9. A six-year amortization of the water purchase agreement's prepayment is a compromise between full recovery immediately and amortizing the capacity charge payment over the life of the agreement. It will lessen rate shock to customers and timely reimburse Golden State.

10. The original Section 4.2.1 of the agreement with Contra Cost reflects Golden State's preferred ratemaking treatment for prepayments under the agreement. Under Commission precedent regarding such agreements, payments by the utility are treated as an expense, not an investment by the utility.

11. Section 4.2.1 has been amended.

Conclusions of Law

1. It is reasonable to allow Golden State the undepreciated investment balance for Hill Street without a return on equity because the investment is no longer used and useful.

2. It is reasonable for Golden State to recover its incremental cost of debt on the undepreciated investment balance for the Hill Street facility while the balance is subject to amortization. The same incremental cost of debt should be used to compensate Golden State while amortizing the water purchase agreement capacity charge prepayments.

3. It is not reasonable to capitalize the water purchase agreement because it is not an investment suitable for inclusion in rate base.

4. It is reasonable to amortize in rates the capacity charge prepayments under the water purchase agreement and the amortization of the undepreciated Hill Street investment balance to avoid rate shock.

5. Section 4.2.1 of the Contra Costa water purchase agreement was reasonably amended.

6. The water purchase agreement with Contra Costa should have correctly characterized the agreement as a purchase agreement and not a lease.

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

O R D E R

Therefore **IT IS ORDERED** that:

1. Golden State Water Company must amortize the prepayment of the water purchase agreement capacity charges with Contra Costa Water District over six years and may only accrue interest using its incremental cost of debt in its Temporary Interest Rate Balancing Account on the unamortized balance. Golden State must file a Tier 1 advice letter to implement this amortization within 14 days of the effective date of this decision.

2. Golden State Water Company must amortize the undepreciated Hill Street Water Treatment Facility investment over six years and may only accrue interest using its incremental cost of debt in its Temporary Interest Rate Balancing Account on the unamortized balance. Golden State must file a Tier 1 advice letter to implement this amortization within 14 days of the effective date of this decision.

3. Application 10-01-009 remains open for another matter.

This order is effective today.

Dated September 8, 2011, at San Francisco, California.

MICHAEL R. PEEVEY

President

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Commissioners

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