Decision 03-05-078 May 22, 2003

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Suburban Water Systems (U 339-W) for authority to increase rates: In 2003 $9,919,002, or 27.2% above the revenues generated by present rates, in 2004 $1,447,692 or 3.1% above the revenue generated by the rates proposed for 2003, in 2005 $1,597,008 or 3.3% above the 2004 revenue requirements.	Application 02-05-033 (Filed May 13, 2002)

Lenard G. Weiss, Attorney at Law, Lori Anne Dolqueist, Attorney at Law, and Robert L. Kelly, for Suburban Water Systems, applicant.

Charlyn Hook, Attorney at Law, and Ishwar C. Garg, for the Commission's Office of Ratepayer Advocates, protestant.

OPINION RESOLVING GENERAL RATE CASE

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OPINION RESOLVING GENERAL RATE CASE

1. Summary

Suburban Water Systems (Suburban) is authorized a $6,345,200 (17.34%) general rate increase for test year 2003, $752,500 (1.75%) for test year 2004, and $737,300 (1.68%) for attrition year 2005. We authorize rates of return on rate base of 9.10% in 2003, 8.98% in 2004, and 8.89% in 2005.

2. Background and Procedural History

Suburban provides public utility water service to 74,000 customers in its San Jose Hills and Whittier/La Mirada service areas. Communities served include Glendora, Covina, West Covina, La Puente, Valinda, Industry, Hacienda Heights, Walnut, Whittier, La Mirada, La Habra and Buena Park, as well as unincorporated areas in Los Angeles and Orange counties.

Since the late 1960s, Suburban has grown little beyond its saturated areas of certification. It added 500 customers in its acquisition of Maple Water Company (Maple) in 1997. About 7,000 new customers were added in the year 2000 when Suburban took over the water system of the City of West Covina. Suburban is a California corporation and a wholly owned subsidiary of Southwest Water Company (Southwest), a holding company. In its last general rate case in 1996, Suburban was authorized to combine its San Jose Hills and Whittier/La Mirada districts into a single district for ratemaking and Commission reporting requirements, thus making Suburban a single-district utility.

Suburban's last general rate increase occurred in January 1998, as authorized in Decision (D.) 96-04-076. Pursuant to a Commission order in Resolution No. W-4271, Suburban filed this general rate case on May 13, 2002, subsequently amending it with four supplements. On June 7, 2002, the

Commission's Office of Ratepayer Advocates (ORA) protested the utility's request for increased rates. A Prehearing Conference was conducted on August 13, 2002, and Assigned Commissioner (now Commission President) Michael Peevey issued a Scoping Memo on August 19, 2002, concluding that a hearing was required. Two public participation hearings were conducted in West Covina on October 29, 2002, where the Commission heard from six ratepayers objecting primarily to what was then a proposed 45% increase in the San Jose Hills service area. By time of hearing, the company had reduced the size of the requested increase.

Four days of hearing were conducted in Los Angeles on December 3-6, 2002. The Commission heard from 11 witnesses and received 31 exhibits. A joint exhibit comparing the recommendations of Suburban and ORA was filed on January 10, 2003, and final briefs were filed on January 31, 2003, when the case was deemed submitted for Commission decision.

3. Suburban's Application

Suburban's initial request for overall rate increases is shown in Table 1, along with the utility's revised request following hearings and consultation with ORA. Also shown are ORA's initial recommendations and revised recommendations. The differences between Suburban and ORA estimates are dramatic, but they are due in large part to ORA's recommendations to defer (but not eliminate) major construction and maintenance projects to later years. Table 1 shows the adopted rate increases authorized by this decision.

The Commission is also asked to resolve a dispute involving the acquisition of Maple's water system, and we are asked to rule on issues that include recovery of 1996-2001 Department of Health Services (DHS) fees; uniform rates for the utility's two service areas; special provisions for low-income customers; a memorandum account for increased security costs; the method for accounting for reimbursement of contamination expenses; and whether to permit three test years instead of two for ratemaking purposes.

Table 1

Revenue Requirement Increases

	2003		2004		2005	
	$ (000)	%	$ (000)	%	$ (000)	%
Suburban						
Application Request	9,919.0	27.2	1,447.7	3.1	1,597.0	3.3
Revised Request	9,032.8	24.7	1,476.7	3.2	825.4	2.8
ORA						
Initial Recommendation	(895.9)	(2.4)	631.1	1.7	(357.8)	(1.5)
Revised Recommendation	(1,060.9)	(2.9)	626.2	1.7	(578.3)	(3.0)
Adopted	6,345.20	17.34	752.80	1.75	737.30	1.68

Suburban prepared its request using a 12% return on common equity, which resulted in a 10.27% rate of return in 2003; a 10.24% rate of return in 2004, and a 10.21% rate of return in 2005. ORA's recommendations used a 9.04% return on common equity. On that basis, ORA calculated a rate of return of 8.65% in 2003; 8.53% in 2004, and 8.45% in 2005. This decision adopts a 9.84% return on common equity, with rate of return set at 9.10% in 2003; 8.98% in 2004, and 8.89% in 2005.

In the discussion that follows, we will first address issues raised in the Assigned Commissioner's Scoping Memo. We then will deal with unresolved issues. Finally, we will turn to the parties' differences in calculating an appropriate return on equity.

SCOPING MEMO ISSUES

4.1 General Rates in 2003, 2004 and 2005

Through its testimony at hearing, Suburban maintains that the increases sought in this General Rate Case are intended to recover operating expenses as well as to provide a fair return on rate base. Suburban and ORA agree that Suburban's water system facilities are in good condition, and service complaints are few. Capital expenditures planned through 2005 consist largely of replacements in kind to maintain the condition of the water system and ensure water quality. The parties agree that Suburban faces water contamination problems in its San Jose Hills service area that are severe, and that the utility has managed to provide reliable water service while protecting ratepayers from most of the costs attributable to contamination. Suburban has submitted its current Urban Water Management Plan as part of this proceeding.

4.2 Department of Health Services Fees

ORA opposes recovery of certain of Suburban's DHS fees until resolution of Rulemaking (R.) 01-12-009, which deals with balancing account recovery. Suburban seeks recovery of DHS fees that it already has paid and will pay in test years 2003 and 2004. Suburban argues that historically it has booked DHS fees to a memorandum account for subsequent recovery through surcharges. It contends, however, that Resolution W-4327, dated March 6, 2002, authorized such memorandum accounts only for Class B, C, and D water utilities, urging that the larger Class A utilities (like Suburban) recover DHS fees in rates as part of their general rate cases.

We take official notice that the Commission in D.02-12-055, issued on December 17, 2002, adopted an interim decision in R.01-12-009 that leaves procedures in place for the recovery of balancing account costs existing prior to November 29, 2001. (*Interim Decision Addressing the Procedures for Recovery of*

Balancing Accounts Existing Prior to November 29, 2001 (2002) D.02-12-055.) A final decision in the case presumably will deal with costs booked on and after November 30, 2001.

Generally speaking, balancing accounts authorized by Pub. Util. Code § 792.5 track unforeseen increases or decreases in purchased power and purchased water. Upon Commission approval, increases are passed on to ratepayers through surcharges, while decreases are returned to ratepayers through credits. Memorandum accounts are authorized by the Commission to track particular expenses likely to occur, and these costs cannot be recovered until they are reviewed and approved by the Commission via an advice letter filing. Since the DHS fees have in the past been tracked in memorandum accounts (rather than balancing accounts), and since Resolution W-4327 encourages Class A water companies to recover DHS fees in rates rather than in memorandum accounts, we see no conflict in permitting recovery of DHS fees in rates in this proceeding.

ORA has confirmed the accuracy of Suburban's actual and estimated costs for DHS fees. We adopt Suburban's estimated costs for these fees.

4.3 Tariff Related to Fire Flow Meters

In September 2002, the Commission denied a complaint against Suburban by B.H. Properties, LLC (BH Properties) but directed Suburban to propose a new tariff for FMCT meters in this general rate case.[1] Suburban was told that it could either support or oppose the new tariff. (*B. H. Properties, LLC v. Suburban Water Systems* (2000) D.02-09-046.)

[1] FMCT stands for "Fire Meter Compound Train." Such meters are designed primarily for fire line use.

BH Properties owns Grand Creek Plaza, a mixed-use development of shops, offices and restaurants located on five acres in West Covina. In its complaint, it alleged that it was unfair for it to pay $525 per month for each of two FMCT 8-inch meters serving the property when it rarely exceeded the use of the FMCT's 2-inch meter connection. Monthly charge for each 2-inch meter would be $53.

The Commission found that Suburban was correctly applying its tariffs, but it agreed that BH Properties faced a Hobson's choice of paying a meter charge far higher than justified by use or of making a costly reconfiguration of water lines serving Grand Creek Plaza.

The new FMCT tariff provided by Suburban tracks the rationale of the Commission's decision, substituting a "peak monthly use" tariff for the fixed meter service charge that now prevails. BH Properties would save approximately $14,200 per year, but that amount would be recovered by a slight increase in the rates of Suburban's 74,000 other customers.

Suburban argues that BH Properties would be the only customer to benefit from the change, since it is the only customer with two FMCT meters. It states that the change would involve a major departure from the Commission's rate design policy for water utilities established in *Re Water Rate Design Policy* (1986) D.86-05-064, since it would rely on historical usage instead of meter size. Suburban states that would inject uncertainty in the monthly use calculation. It notes, as did the Commission in D.86-05-064, that BH Properties has benefited from its FMCT meter installation because it avoided the cost of separate onsite fire/domestic water systems.

ORA took no position at hearing on whether Suburban should change its fixed meter service charge, and no other party has come forward to address the issue. ORA changed its position in its brief, urging adoption of the proposed new tariff to remedy what it called an inequitable rate design. Its assertion in its brief, however, was untested by cross-examination. The evidence shows that BH Properties is the only customer that would benefit from the proposed change, and all other ratepayers would incur additional charges. Moreover, BH Properties does have the alternative, albeit a costly one, of reconfiguring its water lines to isolate fire service from domestic service. We conclude that a change in the FMCT tariff is not warranted.

4.4 Three Test Years

Suburban urges the Commission to establish adopted results of operations for three test years instead of two test years in this proceeding. ORA argues that for an early-year filer like Suburban, the Commission, with few exceptions, has established two test years and an attrition year for Class A water utilities. (*Rulemaking for Processing Rate Case Applications* (1990) D.90-08-045.) ORA's project manager testified that adding a third test year would mean an increase in rates relying, presumably, on more speculative cost estimates for the third year. We are not persuaded by Suburban's justification for a change in the normal attrition-year formula, and we adopt ORA's recommendation.

4.5 Memorandum Account for Security Costs

Suburban requests authorization to establish a memorandum account to track costs associated with any federal or state legislation requiring security measures to prevent acts of terrorism. ORA opposes the request at this time because Suburban has failed to provide any estimate of expenses.

ORA concedes that the purpose of a memorandum account is to be able to record expenses that are not predictable, and that recovery of those expenses cannot be made without subsequent Commission review and approval. Suburban concedes that there is uncertainty as to the costs that may be associated with federal or state legislation dealing with security.

We take official notice that, since Suburban filed this application, Congress has passed the Public Health Security and Bioterrorism Preparedness and Response Act of 2002. (Public Law 107-108 [H.R. 3448].) This legislation requires water utilities to undertake security risk analyses and make investments for improving security, especially in source water and distribution systems.

We believe (as does ORA) that utility expenses for security are inevitable. We will authorize establishment of the memorandum account.

4.6 Amortization of Balancing Accounts

Suburban sought amortization of an undercollection of $2.3 million in balancing accounts, including expense for pumped water and purchased water. ORA urged that this request be held in abeyance until the outcome of the pending balancing account proceeding, R.01-12-009. Suburban has now withdrawn its request for amortization because of the recent decision (D.02-12-055) in which the Commission ordered water utilities to recover certain of such accounts through advice letter filings. Suburban states that it will comply with the procedure set forth in that decision.

UNRESOLVED ISSUES

5. Summary of Earnings

The updated versions of Suburban's and ORA's competing summaries of earnings are shown in Appendix A, along with the summary of earnings that we adopt in this General Rate Case.

6. Operating Revenues

6.1 Environmental Claims

For its San Jose Hills service area, Suburban until recently derived much of its water – about 32,000 to 38,000 acre feet annually - from wells located in the Main San Gabriel Basin. However, contamination of the groundwater forced the decommissioning of all of its basin wells (the last of them during the hearing in this case), and Suburban now is required to purchase all of its San Jose Hills water from other purveyors, primarily the Metropolitan Water District (MWD).

Stephen B. Johnson, an engineer for the San Gabriel Basin Watermaster, testified that about 19 industrial companies believed to have contributed to the contamination last year signed the Baldwin Park Operable Unit Project Agreement, or BPOU Project Agreement,[2] to reimburse Suburban and other affected water companies for costs attributable to the contamination and cleanup. At time of hearing, Suburban had received more than $1 million in operations and maintenance reimbursements, and the industrial companies (called "cooperating respondents" or "CRs") had also contributed two new wells in a non-contaminated area that are expected to go into operation this year.

Johnson testified that the groundwater contamination is not stagnant, but rather is expanding and migrating. Moreover, the different contaminants discovered in the water, from volatile organic contaminants to perchlorate, require different methods of cleanup. According to the evidence, one cleanup facility has been built and is in operation and two more are under construction, with a total capital outlay of $100 million to be paid by the CRs.

Suburban accounts for all CR reimbursements of past costs as "below the line" since all costs related to CR environmental claims have been borne by shareholders and not reflected in rates. Two new wells paid for by the CRs are shown on Suburban's books as "contributions" that are not reflected in ratebase.

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[2] The agreement is dated March 29, 2002, and deals with the Baldwin Park Operable Unit of the San Gabriel Valley Superfund Sites in Los Angeles County. Industrial companies joining in the pact include the Aerojet-General Corporation; Azusa Land Reclamation Co., Inc.; Fairchild Holding Corporation; Hartwell Corporation; Huffy Corporation; the Oil & Solvent Process Company, and Reichhold, Inc.

ORA recommends that all costs and reimbursements attributable to contamination be recorded in a balancing or memorandum account so that the Commission can more readily verify their accuracy. Suburban maintains that since all operation and maintenance costs related to CR environmental claims have been borne by shareholders, reimbursements should be reflected as below-the-line credits to shareholders consistent with matching principles of accounting. It argues that a balancing account is inappropriate because the Public Utilities Code limits such accounts to situations in which the Commission has authorized changes in rates that are to be passed through to customers. (Pub. Util. Code § 792.5.) Similarly, a memorandum account would imply that Suburban could recover any unreimbursed amounts from ratepayers. As Suburban's chief financial officer testified at hearing:

> "If we were to enter these kinds of costs into a balancing account or a memorandum account, the implication would be that we are seeking relief from the ratepayer for these costs. It is not our intent, never has been. We have negotiated in good faith with the CRs that everyone must remain whole. So once again, none of these costs are reflected in any sort of balancing or memorandum account. They are the responsibility of the CRs." (Transcript, p. 251.)

ORA acknowledged at hearing that an audit of Suburban's books show that environmental expenses and CR reimbursements did not disclose inaccuracies. In view of this, we are reluctant to impose an accounting system on Suburban that would give the appearance of shifting to ratepayers the recovery of costs that now are the contractual responsibility of the CRs. However, recognizing the difficulty of tracking these diverse amounts in multiple accounts, our order today requires Suburban in the future, upon request of ORA, to prepare a pro forma exhibit showing all CR reimbursements and the contamination costs for which reimbursement has been made.

6.2 Water Service Revenues

The differences between Suburban's and ORA's water service revenues at recommended rates are a function of the issues discussed below. Suburban and ORA reached agreement on the figures for water use per customer and for customer growth.

7. Operations and Maintenance Expenses

7.1 Payroll

Suburban bases its operations and maintenance payroll estimate on all existing positions as well as four proposed new facility maintenance positions. ORA recommends eliminating the four facility maintenance positions as well as the existing Mechanic II position and Engineering Manager position for the Whittier / La Mirada service area.

ORA testified that it was not satisfied with Suburban's justification for these positions. It acknowledged, however, that the Mechanic II and Engineering Manager positions, while vacant for a time in 2002, had been authorized in Suburban's prior general rate case. The Mechanic II is responsible for inspecting every pump station each day and documenting each day's flows and chlorine residuals. The Engineering Manager supervises engineering, drafting and surveying functions for the utility's water facilities. Suburban last year filled both of these positions.

Suburban presented evidence in its Results of Operations Report showing that the four facility maintenance positions (two for San Jose Hills and two for Whittier / La Mirada) are necessary for routine painting and repair of the company's well and reservoir sites. Suburban acknowledged an error detected by ORA in double counting salary escalation costs, and the error has been corrected in the parties' Joint Comparison Exhibit filed on January 10, 2003.

Suburban has made a reasonable showing that the requested positions are necessary, and that they contribute to quality of service. The fact that the utility operated in the past with two of the positions unfilled is insufficient to disallow them. We adopt Suburban's estimate for this payroll category.

7.2 Water Loss

Suburban estimates a 7.34% annual water loss based on the most recent losses in the year 2001. ORA notes that water loss has ranged from 5.46% in the year 2000 to 7.34% in 2001 and recommends a 6.6% factor based on the average over six years. We accept ORA's estimate as the more reasonable measure.

7.3 Source of Supply

ORA calculated source of supply expenses based on Suburban's estimate for pumped water and purchased water, multiplied by ratios of the estimated quantities of each source of water. Suburban's workpapers reflect the actual quantities available from each source of water, and they offset reduced reimbursement for contamination based on production of two new wells. ORA acknowledged at hearing that its calculation of pumped water costs was understated by $700,000. Suburban's estimates are supported by reliable data, and we adopt them.

7.4 Water Treatment Expenses

Suburban and ORA are relatively close in estimating water treatment expenses. Both calculated amortization of preliminary design cost estimates based on past Commission authorization to amortize the cost over 12 years ending in 2007. ORA, however, included no escalation in its calculations. Suburban estimated its costs for such maintenance based on a six-year average. Similarly, Suburban based its estimate on quantity of total water supply and water treatment costs on a six-year average. We will adopt Suburban's estimates as the more reliable.

7.5 Transmission and Distribution Expenses

ORA based its transmission and distribution expenses estimate on a five-year average. Suburban used a six-year average, resulting in slightly higher estimates. Suburban's estimates are more reliable and are adopted.

7.6 Customer Account Expenses

Suburban proposes to reduce the interest rate it pays on deposits from 7% to the average monthly 90-day commercial paper rate. ORA notes that interest is paid only on deposits that are held for one year or more. Since deposits are taken to establish credit where credit cannot otherwise be established, ORA argues that the 7% rate encourages Suburban to monitor customers' credit standing and return deposits promptly. We adopt ORA's position on this issue.

7.7 Uncollectibles

The differences between Suburban's and ORA's estimates are due to their different estimates of operating revenues, and these are reconciled in the adopted revenue requirements.

8. Administrative and General Expenses

8.1 Payroll

Suburban based its administrative and general payroll expenses estimate on all existing positions, as well as three proposed new positions: corporate counsel, vice president of quality assurance, and regulatory analyst. ORA recommends eliminating an existing district manager position, as well as the three proposed new positions.

a. District Manager

Suburban has a district manager for each of its two service areas. ORA recommends eliminating one of these positions on grounds that Suburban is a single-district company. Suburban argues that the position ORA seeks to eliminate has existed for at least 12 years and was only temporarily vacant for part of 2001.

Although the Commission in 1996 combined the San Jose Hills and Whittier/La Mirada districts into a single district for ratemaking purposes, Suburban continued to have a manager for each of these service areas. The two service areas are geographically distinct, with a mountain and valley between them, and in total serve 74,000 customers. The evidence shows that no other Class A water utility has a single district manager for a system with 74,000 customers. The testimony showed that San Jose Hills faces contamination and supply problems far different from those of Whittier/La Mirada. Our order adopts Suburban's expense recommendation in retaining district managers for each of these two service areas.

b. Corporate Counsel

Suburban said it proposed the corporate counsel position to deal with accelerating legal costs and intensifying water quality issues. ORA argues that Suburban has failed to show a particular need for in-house counsel, nor has it estimated any savings attributable to the new position. Suburban acknowledged that even with the new position, it expects to require substantial outside counsel for various specialties. We agree with ORA that the position has not been justified, and we disallow this expense.

c. Vice President of Quality Assurance

Although this is a proposed position, Suburban hired a vice president of quality assurance in May 2002, maintaining that increasingly stringent regulatory requirements to which Suburban is subject require an executive level position. The company states that the vice president of quality assurance supervises and directs all quality assurance efforts, as well as all emergency planning and preparedness activities, and coordinates all dealings with county, state and federal water quality regulators. ORA maintains that Suburban has functioned well without an executive level position of this nature, and that justification is lacking. The record establishes Suburban's need to constantly address water quality assurance at an executive level. We will authorize the expense for this position.

d. Regulatory Analyst

Suburban states that it proposed the addition of a regulatory analyst to cope with the demands of rapidly evolving regulatory requirements of this Commission. ORA argues that the new position has not been justified. We are aware of no regulatory requirements of this Commission that Suburban has not been able to effectively address through its existing personnel. We disallow expenses requested for the new position.

8.2 Pension and Benefits

The differences between Suburban's and ORA's pension and benefit estimates are due to different payroll estimates and are reconciled in the adopted revenue requirements.

8.3 Insurance

In estimating insurance, ORA used recorded amounts from 1997 to 2001, then trended to 2003 and 2004 and increased premiums by 15% for each test year. However, uncontested testimony by Suburban's insurance agent showed that the cost of current policies had increased by 35%, even with steeply increased deductibles. The agent attributed this to an increasingly restrictive insurance market exacerbated by the September 11 attacks. The agent estimated that premiums at the next renewal are likely to increase by another 35% to 50%. Based on this testimony and the exhibits supporting it, ORA agreed that it would increase its estimate of property and casualty insurance costs for the current period. For the same reason, we will adopt Suburban's estimates of insurance costs for the test years.

There was little disagreement on allocation of insurance costs. Southwest, Suburban's parent company, purchases insurance for its various subsidiaries, including Suburban. The cost of premiums are allocated to the subsidiaries based on various factors, including risk, payroll and capitalization. We accept Southwest's allocation formula as reflecting industry practice.

8.4 Water Conservation

Suburban estimated expenses for advertising to encourage water conservation at $38,000 for test year 2003 and $36,000 for test year 2004. ORA disallowed these amounts, noting that there had been no expense in this category in the last five years. However, testimony at hearing showed that Suburban faces seriously diminished groundwater supply because of contamination. In view of this, Suburban's plans through advertising to encourage conservation and reduce the amount of expensive purchased water seem prudent and desirable. We will adopt Suburban's estimates.

8.5 Regulatory Commission Expenses

Suburban's recorded expenses for this rate case were $55,000 at the beginning of last year, but the company expects that to increase to more than $100,000 because of unanticipated issues that have been added to this proceeding (Maple acquisition, BH Properties matter, reduction in revenue requirement because of the BPOU Project Agreement). Based on the only recorded amount, ORA estimated a total of $60,000 for this proceeding. Because at least two of the issues added to this proceeding were essentially uncontested at hearing (BH Properties and BPOU adjustment), and because the Maple acquisition issue could have been dealt with earlier by Suburban, we discount Suburban's estimate and allot $80,000 for regulatory expense.

8.6 Extraordinary Legal Fees

ORA excluded expenses for extraordinary legal fees on the basis that Suburban failed to justify such expenses. However, Suburban showed that the expenses (an $800,000 legal cost recorded in 1993 and amortized over a subsequent 12 years) had been authorized by the Commission in Suburban's last general rate case. (*In re Suburban Water Systems* (1996) 66 CPUC2d 59; *see also* Ex. 15, Attachment 5.) As of the beginning of the first test year, 2003, Suburban will only have recovered eight years of the 12-year amortization. We will allow the recovery of the remaining legal expense.

8.7 BPOU Litigation

ORA's estimate for BPOU Litigation is zero for test years 2003 and 2004, while Suburban estimates $181,587 and $186,417 for those years, respectively. ORA notes that the BPOU Project Agreement was signed last year and further litigation in that proceeding is unlikely. Suburban offered evidence showing that it is involved in two other San Gabriel Basin contamination inquiries unrelated to the BPOU. Its estimates for litigation are not for defense-related costs (which we disfavored in *In re San Gabriel Valley Water Company* (2001) D.02-10-058), but instead anticipate plaintiff costs in the event Suburban joins in litigation against parties alleged to be responsible for groundwater contamination. The BPOU Project Agreement was an outgrowth of litigation brought by water agencies, including Suburban. In view of the agreement's dramatic benefits to water purveyors and their customers, we want to encourage Suburban in its efforts to require responsible parties to help pay for past pollution. We will accept these plaintiff litigation estimates.

8.8 Office Supplies and Other Expenses

ORA estimates for office supplies and other office expenses are based on recorded year costs escalated to 2001, with the resulting average escalated to the test years. Suburban has accepted ORA's estimates, as do we.

8.9 Miscellaneous General Expenses

In the category of Miscellaneous General Expenses, dealing primarily with fiduciary insurance and professional dues for organizations like the California Water Association, Suburban bases its estimate on actual insurance costs after allocation by its parent company and escalated costs of dues, including announced increases. ORA's estimates are based on a five-year average. We deem Suburban's estimates more reliable. For test year 2003, we authorize $82,284. For test year 2004, we authorize $86,016.

8.10 Miscellaneous Expenses

The Miscellaneous Expenses account deals with car and truck expenses. ORA's estimates are based on a five-year average, with insurance based on the 2001 recorded expense escalated by 15%. Suburban's estimates are based on an internal analysis and Commission escalation factors. We adopt ORA's estimates, except that we adjust them to reflect Suburban's auto insurance forecasts for the reasons discussed earlier in our analysis of insurance costs. For test year 2003, we authorize $256,712. For test year 2004, we authorized $286,940.

9. Parent Company Allocation

Suburban's estimate of expenses allocated to Suburban from its parent company, Southwest, is $1,965,315 for test year 2003 and $2,017,591 for test year 2004. ORA's estimate is $439,728 for test year 2003, and $455,128 for test year

2004. There are three principal issues that account for the difference. First, ORA excluded certain Southwest expenses that it claimed were of little or no benefit to Suburban. Second, ORA excluded Suburban's share of certain Southwest officer salaries that it alleged are duplicative of officer functions at Suburban. Finally, ORA used a three-factor analysis in allocating Suburban's share of its parent's expenses, while Suburban used a more common four-factor analysis.

We adopt Suburban's estimates of expenses, including officer salaries, because we believe ORA has failed to make a persuasive case for altering those estimates. We adopt ORA's three-factor allocation because Suburban has not convinced us that Southwest subsidiaries that have "clients" instead of "customers" should receive a preference in the allocation of parent company costs.

As to expenses, ORA excluded items it deemed not directly related to Suburban, including Southwest's franchise fees for its Delaware registration, quarterly and annual shareholder reports, Securities and Exchange Commission (SEC) filings, and costs of shareholder meetings. Suburban also excluded certain parent company costs, such as consultant expenses, but it included costs associated with Southwest's status as a public company. Suburban argues that it receives many benefits as a subsidiary of a larger entity, including greater purchasing power for insurance, greater access to capital markets at lower interest rates, and streamlined cash management functions. ORA presents us with no supporting authority or precedent for excluding what appear to be normal cost items shared by a parent company with its subsidiaries.

Similarly, ORA excludes certain Southwest officer positions that appear to duplicate the titles of officer positions at Suburban, including chief financial officer, corporate controller, vice president of human resources, and director of communications. At hearing, Suburban presented evidence showing that the functions of these Southwest officers are different from the functions of Suburban officers with similar titles. For example, Southwest's chief financial officer deals with the SEC and the equities markets, allowing Southwest and Suburban to attract less expensive capital. The corporate controller directs all accounting personnel and prepares reports to the SEC. The corporate accountant is responsible for the consolidated financial reporting of all subsidiaries to management, the board of directors, stockholders and the SEC. These are functions not performed by Suburban's officers but necessary to corporate governance. Again, ORA presents us with no supporting authority or precedent for excluding these parent company officer positions, and its argument that their function is unnecessary because their titles duplicate titles at Suburban is unpersuasive. We will accept Suburban's estimates of the parent company expenses.

We come to a different conclusion as to allocation. Southwest is a holding company. It has four rate-regulated utilities: Suburban; New Mexico Utilities, Inc.; Windermere Utility Company, and Hornsby Bend Utility Company. Non-utility subsidiaries include ECO Resources Inc.(ECO); Operations Technologies, Inc.(OpTech), and Master Tek International (Master Tek). ECO and OpTech provide contract operation and management of wastewater and water systems owned by municipalities, while Master Tek provides utility submetering, billing and collection services for multi-family properties.

In allocating parent company expenses to subsidiaries, the Commission generally follows a four-factor approach, measuring each subsidiary's (1) direct operating expenses, (2) end-of-year gross plant, (3) total customers, and (4) payroll. The results are applied to determine a subsidiary's share of its parent company expenses. Suburban applied these four factors to its allocation. ORA applied a three-factor test, eliminating "customers" of each subsidiary because non-regulated subsidiaries like ECO reported that they had clients rather than customers. By entering "0" for ECO customers, ECO's share of parent company costs was reduced, and Suburban's share was increased, despite ECO's annual revenue of $62 million or more.

ORA notes that it has used two- or three-factor analyses for other Class A water companies where appropriate, most recently in dealing with Park Water Company. ORA's analysis is persuasive, and we adopt the ORA allocation formula in this proceeding. Suburban thus is allocated 32.6% of the parent company costs, rather than the 45.2% recommended by Suburban.

10. Taxes

Suburban and ORA agree on the tax rates and methods used to determine payroll taxes, ad valorem taxes and income taxes. Similarly, they agree on methods for calculating depreciation expense and income taxes. The remaining differences in their figures result from differing estimates in other areas, and these are reconciled in our adopted revenue requirements.

11. Purchase of Maple Water Company

Suburban in 1997 acquired Maple, a 155-customer mutual water company that occupied a few blocks within Suburban's service territory. Suburban seeks to include the assets of Maple in its rate base and to begin cost recovery of and a rate of return on those assets. ORA investigated the transaction. While ORA does not object to inclusion of the Maple assets in rate base, it contends that irregularities in the purchase warrant fines of $25,000 under Pub. Util. Code § 2107.

The facts are not in dispute. On May 5, 1997, Suburban and Maple filed a joint application requesting Commission authorization for Suburban's acquisition of Maple. Two months later, on July 7, 1997, Suburban and Maple filed for withdrawal of their application. On September 2, 1997, Suburban purchased

Maple's assets without prior approval by the Commission. It did so under that provision of Pub. Util. Code § 1001 that provides that Commission approval is not required for an extension into territory contiguous to its service area where the territory has "not [been] theretofore served by a public utility of like character." In such circumstances, "[a]ll that is required…is that the public utility, before commencing service, file revised tariff service area maps pursuant to the requirements of General Order 96-A, Section 1-E." (*In re Alisal Water Corporation* (1994) 53 CPUC2d 154, 157.) There is no question that Maple, a mutual water company, was not a public utility, and there is no question that it was contiguous to Suburban's service territory.

Three weeks after the sale, on September 24, 1997, the Commission issued D.97-09-094 granting the applicants' request to withdraw the application for approval of the acquisition. However, the second ordering paragraph of the decision stated: "Southwest Suburban Water System shall seek Commission approval prior to acquisition of the assets of Maple Water Company."

Suburban states that it called the director of the Commission's Water Division at that time and was assured that D.97-09-094 would be corrected so as not to require Commission approval of a purchase that had already taken place. A correction was never issued. Suburban admits that it did not file an advice letter and new service map showing the acquisition, but it argues that the map would have been the same as the one on file, since Maple's customers already are shown within Suburban's service area.

Asked why Suburban filed an application to acquire Maple if it was free to acquire a contiguous mutual water company, Suburban's witness stated that the company originally sought the Commission's prior approval of the purchase price ($188,902). He stated that Maple's water quality problems were so severe that Suburban felt it could not wait for the application to be processed, and it proceeded with the acquisition knowing that the purchase price could be challenged in this General Rate Case.

We cannot fault Suburban for failure to comply with the ordering paragraph of D.97-09-094 and seek prior Commission approval of a purchase that had taken place three weeks earlier. Moreover, we conclude that the acquisition of a contiguous water entity was permissible under § 1001 without prior Commission approval. However, we do fault the company for failure to pursue a change to D.97-09-094 so that it would not be in technical noncompliance with a Commission order. Suburban could have filed an application for rehearing within 30 days of the decision (Rule 85 of the Rules of Practice and Procedure), or it could have filed a petition to modify the decision within a year of its issuance (Rule 47). It did neither, choosing instead to wait five years before formally addressing this issue. Suburban also failed to comply with General Order 96-A in filing a revised service map after it acquired Maple. While the map would have shown an identical service area, testimony at hearing showed that a new map would have eliminated a small shaded area that signified homes served by Maple instead of Suburban. All parties agree that the principal purpose of the service map is to enable the public and the Commission to identify customers served by a particular utility.

Therefore, we agree with ORA that a penalty is warranted, but we also believe that any fine should be mitigated by the fact that the acquisition was permissible without Commission approval (a proposition with which ORA does not disagree) and by the fact that Suburban acted promptly on behalf of Maple and its customers to resolve serious water quality problems. Further, we believe the rates Suburban has charged Maple customers since that system was acquired in 1997, which are the same rates charged the adjacent San Jose Hills Service Area customers, have been lawfully charged.

Under Pub. Util. Code § 2107, the statutory range of Commission penalties is from $500 to $2,000 for each offense. Under *Re Standards of Conduct* (1998) D.98-12-075, we have discretion to consider the severity of the offense, the conduct of the utility and the totality of the circumstances in assessing a fine. On the record before us, we will assess the minimum fine of $500 for each of what we regard as two infractions by Suburban: (1) failure to formally seek correction of its technical noncompliance with a Commission order, and (2) failure to file an advice letter and new service area map after the Maple acquisition. We grant Suburban's request to include in ratebase the recorded purchase cost of Maple. We agree with ORA that Suburban should amend its annual report to reflect the purchase amount, closing costs and depreciation of the Maple acquisition.

We note that the facts in this case are markedly different from those that we are investigating in R*e California Water Service Company*, D.03-01-081. In the latter case, the utility acquired two water systems without the notice and prior approval specifically required by the Commission in an earlier decision (D.97-03-028) directed only at California Water Service Company. Suburban was under no such requirement at the time of its acquisition of Maple, and its sole violation was the failure to file a new service map. The tariffs under which Suburban provided service to the Maple customers are those previously approved by this Commission and, in any event, have not been challenged by ORA.

12 Purchase of Maple Water Rights

As part of the Maple acquisition, Suburban's parent company (Southwest) purchased Maple's 118.5 acre feet of prescriptive pumping rights in the Main San Gabriel Basin for $330,889. Suburban has leased those rights as needed at the prevailing market rate. ORA contends that Suburban should be ordered to acquire these rights directly because, in the long run, that would be less costly to ratepayers than leasing the rights. Suburban's witness testified that it was prudent to lease instead of to buy the pumping rights, since the rights are not needed every year. Indeed, no lease costs for these pumping rights are included in this rate case. According to Suburban's testimony, had Suburban bought the pumping rights in addition to the other Maple assets, the cost of the transaction would have gone from about $1,000 per new customer to about $4,000, an amount that Suburban argues is unreasonable and would likely have been disapproved by the Commission.

In *Joint Application of Southern California Water Company and Peerless Water Co.* (2002) D.01-11-064, we denied a proposed merger in part because the price of pumping rights in the transaction would have meant a significant increase in ratebase and rates. We believe the same principle applies here. Had Suburban acquired pumping rights as well as other Maple assets, the purchase price would have gone from $189,000 to about $520,000, with a concomitant increase in Suburban's ratebase and rates. By leasing the rights as needed, Suburban avoids so substantial an increase in ratebase, and its ratepayers benefit. In the absence of a showing by ORA that long-term savings would have accrued, we decline to direct Suburban to acquire the prescriptive pumping rights from its parent company.

RATE BASE

12.1 Capital Expenditures

Suburban testified that its proposed capital additions are primarily for replacement of facilities that are at the end of their useful life. It argues that its estimates are conservative, and it presented evidence to show that since 1996 its actual capital expenditures and depreciation expense have exceeded the amount authorized by the Commission.

ORA conducted a field investigation of Suburban's water system, and it recommends postponement to later years of certain capital expenditures.

a. Plant 235 Booster Pump Station

ORA recommends deferral of an additional booster pump station at Plant 235 and a reduction of the proposed expenditure from $600,000 to $237,991. Suburban's witness testified that in the past three years, the existing pump station (built in 1966) has shown signs of increased deterioration. The new pump station will include three vertical turbine pumps, each capable of delivering 1,500 gallons per minute. Two pumps will operate to meet maximum-day demands in an adjacent pressure zone, and the third pump will be a standby pump to be used if one of the other pumps is taken out of service. Suburban presented uncontradicted evidence to show that the difference in cost estimates by Suburban and ORA is attributable to use of some of the funds budgeted for this project to deal with higher priority capital repairs. We will adopt Suburban's actual expenditures for Plant 235 for 2002 ($74,948) and its estimate of additional funds for completion of the project in test year 2003 ($145,085).

b. PVC Pipe Additions

Suburban requested $270,000 for installation of 8-inch PVC pipe between Maplegrove and Lark Ellen for 2002. ORA recommends allowing only the amount that Suburban budgeted, or $220,000. The installation has been completed and put into service at an actual construction cost of $229,049. That is the amount that we will adopt.

ORA recommended $416,858 for test year 2003 for installation of 12-inch PVC pipe between Carmenita and Laurel. Suburban requested $660,000 for inclusion in the year 2002. By the time of hearing, Suburban showed that the work had been completed at a cost of $555,919. We will authorize that amount for the year 2002.

c. Transmission and Distribution Mains

ORA proposed $400,000 for miscellaneous transmission and distribution mains in 2002, as compared to Suburban's proposed $588,000. ORA testified that its recommendation was based on the last five years of Suburban's recorded information. We will adopt ORA's estimate.

d. Service Lines

ORA proposed $250,000 per year for 2002, 2003 and 2004 for service line replacement based on average expenses over a three-year period. Suburban requests $370,000 for 2002 and $350,000 per year for 2003 and 2004. Suburban testified that after the acquisition of the West Covina service area, it discovered that many of the service lines were polybuylene plastic that had to be replaced because of numerous failures. Cost of replacement to date has been $371,501. We will adopt Suburban's 2002 actual expenditures and its proposed budget for test years 2003 and 2004.

e. New Well

Suburban requested $1,000,000 in test year 2004 for construction of a new well in the Plant 201 Bartolo well field. ORA presented evidence to show that approvals of various government and court agencies will take 12 to 18 months before construction can begin. It recommends that the requested amount for 2004 be excluded. Suburban's witness testified that it began the approval process in late 2002 and anticipates completion in late 2003 or early 2004, with construction of the well to be completed in 2004. ORA does not contest the necessity for the new well. We will adopt Suburban's estimate.

12.2 Advice Letter Filings for Major Projects

Suburban has requested more than $4 million for four major projects, each of them estimated to cost more than $1 million. The projects include:

- San Jose Hills Service Area. Replacement of existing 2-million gallon concrete tank at Plant 121 at a cost of $1.352 million.
- Whittier/La Mirada Service Area. Replacement of the existing pump station at Plant 235 at a cost of $1.045 million.
- Plant 410. Construction of an iron and manganese removal treatment facility at a cost of $1.4 million.
- Plant 235. Replacement of an existing steel tank at a cost of $1.014 million.

Because of the uncertainties of the costs in projects this substantial, ORA recommends that Suburban file advice letters and supporting work papers to recover actual costs once each project is completed and placed into service. Suburban argues that it must have the flexibility to manage its portfolio of construction projects, and that the advice letter process limits that flexibility.

We are reluctant to authorize recovery at this time of more than $4 million in costs that are likely to be less (or more) than estimated. We agree with ORA that the advice letter process provides accuracy in accounting for these major expenditures and does not burden ratepayers unnecessarily. We will disallow these costs in this rate case and direct Suburban to proceed by way of advice letter filings. Our order authorizes the filing of advice letters for each of these four capital projects at costs not to exceed Suburban's estimates.

13. Working Cash

The difference between Suburban's and ORA's estimates of working cash is due to differing average lag days for expenses. Suburban computed its estimate in accordance with Commission Standard Practice U-16. In the case of other operating expenses, for example, ORA's recommendation of a 45-day lag period is unsupported by the cases it cites. We will adopt Suburban's estimates for all working cash items.

14. Rate Design

14.1 Single District Rates

Rates for customers in the Whittier/La Mirada service area are higher than the rates in the San Jose Hills service area. ORA recommends a uniform rate for customers in both service areas. Suburban opposes a uniform rate, citing a long-standing policy of the Commission stating that districts should not be combined for the express purpose of having one district subsidize another.[3]

Suburban points out that the two service areas are not geographically connected and cannot share their supplies of water. The settlement approved by the Commission in Suburban's last rate case addressed this issue:

> Due to complexities of the computations of the cost of water from different sources for the existing two districts and the complexity of the rules affecting these costs, which complexities can be expected to continue, the Parties agree that respective rates for the San Jose Hills and Whittier/La Mirada Districts will reflect the cost differences in source of supply, and that production cost balancing accounts will be maintained separately by district. (*In re Suburban Water Systems* (1996) 66 CPUC2d 59, 97-98.)

ORA has not presented evidence that would justify a change in the Commission's position on permitting separate rates for the San Jose Hills and Whittier/La Mirada service areas. We decline to adopt a uniform rate for these two service areas.

14.2 Low-Income Assistance

Noting that Pub. Util. Code § 739.8 requires the Commission to consider programs to provide relief for low-income water customers, ORA recommends

[3] Policy letter, Division of Ratepayer Advocates, August 20, 1992.

that Suburban amend its tariffs to offer a 50% service charge reduction to customers currently receiving low-income assistance from other utilities. Suburban responds that because of a preponderance of low-income families in much of Suburban's service areas, establishing a low-income assistance program would unfairly burden customers who do not qualify. Moreover, according to Suburban, occupants of apartments and other multi-family housing would be ineligible for the discount under the approach recommended by ORA and could actually wind up paying more for their service. Suburban notes that a similar reduction in service charge for low-income customers was rejected by the Commission last year in *In re San Gabriel Valley Water Company, supra.*.

Because of the unusual demographics of Suburban's customer base, we decline at this time to direct the proposed change in tariff.

15. Rate of Return

For a regulated utility, rate of return on rate base is the ratio of earnings to total rate base. Essentially, rate of return is the compensation paid to investors for the capital they have provided for public utility service. A fair rate of return is acknowledged to be no less than the company's cost of capital (so that the utility can maintain its credit rating and attract additional investment). Cost of capital is determined as a weighed average of the cost of debt, the cost of preferred stock, and the cost of common stock. The cost of each capital component is weighted on the basis of the company's capital structure (that is, the relative amounts of equity and long-term debt that constitute the company's long-term financing).

Suburban and ORA agree on most of the elements of Suburban's capital structure. For test year 2003, capital structure consists of long-term debt, 37.90%; preferred equity, 6.50%, and common equity, 55.60%. For test year 2004, the respective ratios are 38.30%; 6.00%, and 55.70%. For 2005, the respective ratios are 38.90%; 5.70% and 55.40%. Suburban adopted ORA's more current projections of common equity ratios. The parties have slight differences on their estimates of embedded costs of long-term debt. Suburban relied on historical data, while ORA relied on a forecasted interest rate. The latter approach is more appropriate in determining the future cost of long-term debt. We will accept ORA's calculations of 8.83% for 2003; 8.45% for 2004, and 8.23% for 2005.

Cost of equity is typically the most contested component of rate of return in water general rate cases. It is a direct measure of the company's after-tax return on equity (ROE) investment, and its determination is by necessity somewhat subjective and not susceptible to direct measurement in the same way as capital structure and embedded cost of debt.

Both Suburban and ORA acknowledge the established legal standard for determining a fair ROE, and we have many times cited that same legal standard. In the *Bluefield Water Works* case,[4] the Supreme Court stated that a public utility is entitled to earn a return on the value of its property employed for the convenience of the public, and set forth parameters to assess a reasonable return. That return should be "...reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economic management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."

As the Supreme Court also noted in that case, a utility has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. In 1944, the Court again considered the rate of return

[4] *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia* (1923) 262 US 679.

issue in the *Hope Natural Gas Company* case,[5] stating, "[T]he return to the equity owner should be commensurate with returns on investments in other enterprises sharing corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." The Court went on to affirm the general principle that, in establishing a just and reasonable rate of return, consideration must be given to the interests of both consumers and investors.

With these principles in mind, we examine ORA's recommended rate of return and return on equity, and then Suburban's.

15.1 ORA's Recommended Return on Equity

To determine the appropriate return on equity for Suburban, ORA performed a quantitative analysis and then assessed the level of business and financial risk Suburban faced. In its quantitative analysis, ORA used two financial models, DCF (discounted cash flow) and RP (risk premium), to estimate investors' expected return on equity.[6] ORA applied both models to a group of comparable water utilities selected based on two criteria: (1) water operations

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[5] *Federal Power Commission v. Hope Natural Gas Company* (1944) 320 US 591.

[6] The DCF model is a financial market value technique based on the premise that the current market price of a share of common stock equals the present value of the expected future stream of dividends and the future sale price of a share of stock, discounted at the investor's discount rate. By translating this premise into a mathematical equation, the investor's expected rate of return can be found as the expected dividend yield (the next expected dividend divided by the current market price) plus the future dividend growth rate.

The RP model is a risk-oriented financial market value technique which recognizes that there are differences in the risk and return requirements for investors holding common stock as compared to bonds. An RP analysis determines the extent to which the historical return received by equity investors in utilities comparable to the utility at issue exceeds the historical return earned by investors in stable, long-term bonds. This difference, or "risk premium," is then added as a premium to the estimated cost of long term debt to derive average expected return on equity for the test period.

account for at least 70% of the utilities' revenues, and (2) the utilities' stocks are publicly traded. The comparable group was comprised of seven companies: American States Water, American Water Works, California Water Service, Connecticut Water Service, Middlesex Water, Philadelphia Suburban, and San Jose Water.[7] ORA used this comparable group for both its DCF and RP analyses.

ORA's DCF analysis yielded an average expected ROE of 7.87%. Its RP analysis produced an initial result of 10.21%. It averaged the two results to produce a composite model return of 9.04%.

In addition to its DCF and RP quantitative analyses, ORA assessed the level of financial and business risk Suburban faces. In concluding that Suburban's business risk is low, ORA cited the Commission's many risk-reducing mechanisms available to water utilities, including balancing accounts for purchased water, purchased power, and pump taxes, memorandum accounts for Safe Drinking Water Act compliance, 50% fixed cost recovery, and Construction Work in Progress in rate base.

15.2 Suburban's Recommended Return on Equity

Suburban used five market-oriented methods, including the DCF and RP models,[8] to arrive at a market cost rate of common equity of 10.82%, and three conversion methods to arrive at its recommended 12% return on equity. Suburban's financial consultant, Henry G. Mülle, stated that his 12% ROE

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[7] Because acquisition of American Water Works by RWE/Thames Water was announced in September 2001, and because this announcement could affect the stock price, ORA used stock price data from the period prior to September 2001 in the DCF model.

[8] The other financial models used were the capital asset pricing model (CAPM), the Ibbotson Buildup Method (BM), and the Fama-French Three-Factor Model (FFM).

recommendation includes a 25 basis-point (1/4 of 1%) allowance for increased risk.

Suburban's DCF calculation, including a growth rate calculated from various market indices, was 10.46%. Suburban's RP calculation, including a beta-adjusted risk premium, showed a market cost of common equity for an A rated water utility of 11.08%.

Mülle said that he tested his findings by comparing them to the Value Line quarterly estimates of prospective ROEs to be achieved by the water utility industry. Value Line looks at four of the industry's largest water utilities and, as of November 2002, projected what Mülle interpolated as an average 10.60% ROE for 2003; 11.10% ROE for 2004, and 11.60% ROE for 2007.

In contrast to ORA's assessment of risk, Suburban regards its risk as high because of the contamination in much of its source of water supply. To maintain its bond quality rating between A and AA, Suburban cites one of the Standard & Poor's interest coverage benchmarks as requiring an ROE of between 11.5% and 12%.

15.3 Return on Equity Discussion

ORA and Suburban each attack perceived shortcomings in the other's ROE showing. Suburban argues that ORA's use of only two market-oriented methods results in widely divergent results of 7.87% and 10.21% that are too far apart to be averaged in arriving at a recommended ROE of 9.04%. Moreover, according to Suburban, ORA's market-oriented methods estimate investors' expected market return on their market-valued investments (ROM), rather than expected return on book value common equity (ROE) for Suburban. Suburban argues that ORA should have used conversion methods to translate ROM into ROE.

ORA argues that Suburban's analyses are contrary to Commission policy in that its CAPM, as well as its small co-premium adjustment, consider non-regulated and non-water company market factors in arriving at an ROE. ORA states that the Commission discourages comparisons to non-regulated companies because the non-regulated companies do not benefit from such regulatory tools as fixed cost recovery, balancing accounts and memorandum accounts.[9] ORA also rejects Suburban's analysis of market value and book value of stock prices for water utilities, arguing that the authority upon which the analysis is based[10] does not recommend any one method of utilizing the DCF model.

Ultimately, the choice of factors used to measure an appropriate return on investors' equity is a matter of judgment. Both parties rely on DCF and RP analyses that we have consistently accepted in the past for water companies. In ORA's analysis, however, we are troubled by the unusually large disparity (234 basis points) between the DCF and RP results. ORA has not adequately explained the reasons for the disparity, nor the logic of averaging two such differing results to arrive at an ROE of 9.04%. This is significantly lower than ROE results either endorsed by ORA or adopted by this Commission in recent water company cases.[11] Results of a third ROE model, even one with acknowledged shortcomings, would have been useful in weighing ORA's recommendations.

By the same token, Suburban's use of data including non-regulated and non-water companies affects the results of some of its data since, as ORA notes, the Commission has consistently resisted using non-utility data to gauge a water

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[9] ORA cites *In re Southern California Water Company* (1992) D.92-01-025.

[10] Citing *The Cost of Capital – A Practitioner's Guide,* David C. Parcell (1997).

[11] San Gabriel Valley Water Company, 9.83%; Apple Valley Water Company, 9.53%; Valencia Water Company, 9.72%. (Transcript, at 97.) *See also* California-America Water Company, 10.25% (D.03-02-030 (February 13, 2003)).

company's risk analysis or ROE. Suburban's use of regulatory mechanisms available in Pennsylvania and Florida to deal with utility risk is meaningless without a thorough review of programs already in place in each state to deal with risk. When asked to explain how Suburban would justify a 12% ROE in the face of the lower returns anticipated for other California water companies, Suburban's witness pointed to his five market-oriented analyses and emphasized the utility's risk. While we agree that sitting atop a Superfund Site is risk enough for any water company, the evidence also shows that Suburban has in fact alleviated its risk through the CR reimbursements and contributions of the BPOU Project Agreement.

Suburban points out that what it calls the inconsistency between ORA's DCF model (7.87% ROE) and its RP model (10.21% ROE) can be alleviated by taking a more traditional approach in the model. In its DCF model, ORA included a comparable company (American Water Works) for yield purposes but excluded that company for growth purposes. When asked on cross-examination about the exclusion of American Water Works for earnings growth rate purposes, ORA's witness explained that she felt at the time that an acquisition announcement involving the company was likely to have influenced its earnings growth rates. In fact, recent Standard & Poor's Earnings Guide data show post–announcement earnings growth expectations ranged from a low of 6% to a high of 9.5%, while pre-announcement earnings growth expectations ranged from 6% to 9%. Since the acquisition announcement in fact appears to have had little effect on forecasts of earnings growth rate, the American Water Works data could have been used in ORA's model for both yield and growth purposes, as would normally be the practice. By doing so, ORA's DCF model would have shown an ROE range of between 9.21% and 9.72%. When averaged with the RP method, a more plausible average return on equity between 9.71% and 9.97% would have been obtained, and criticism of the diverse results in the two approaches would have been eliminated.

In the absence of more compelling alternatives, we will adopt an ROE of 9.84% for Years 2003, 2004 and 2005. We choose the midpoint of the adjusted averages because we believe that this strikes a reasonable balance of the data that ORA and Suburban have presented to us.

15.4 Rate of Return

With the capital structure, cost of debt, and cost of equity components determined, the calculation in Table 3 derives the rate of return on rate base:

Table 3

Cost of Capital

	Adopted		
	Capital Structure	Cost	Rate of Return
Test Year 2003			
Long-Term Debt	37.90 %	8.83 %	3.35 %
Preferred Equity	6.50%	4.25 %	0.28 %
Common Equity	55.60%	9.84%	5.47%
Total	100.00%		9.10%
Test Year 2004			
Long-Term Debt	38.30 %	8.45%	3.24%
Preferred Equity	6.00%	4.25%	0.26%
Common Equity	55.70%	9.84%	5.48%
Total	100.00%		8.98%
Attrition Year 2005			
Long-Term Debt	38.90%	8.23%	3.20%
Preferred Equity	5.70%	4.25%	0.24%
Common Equity	55.40%	9.84%	5.45%
Total	100.00%		8.89%

16. Comments on Proposed Decision

The principal hearing officer's proposed decision was filed with the Commission and served on all parties in accordance with Section 311(d) of the Public Utilities Code and Rule 77.1 of the Rules of Practice and Procedure.

Comments were filed on May 13, 2003, and reply comments were filed on May 19, 2003.

ORA objects to language in Ordering Paragraph 2 in the Proposed Decision, dealing with step rates for the years 2004 and 2005. ORA argues that the language proposed would permit the water company to automatically recover the requested rates until such time as the Water Division determines that the rates are accurate, and would place the burden on Water Division staff to disprove the justification for the water company's requested increase. ORA states that it has long been Commission practice to require the utility to prepare a pro forma earnings test exhibit that must be reviewed and approved by the Water Division before allowing the utility to recover the requested rate increase.

ORA notes that this change in practice was not raised by any party in this proceeding. Such a change, ORA argues, should only be made after all affected parties have been given notice and an opportunity to be heard, pursuant to Pub. Util. Code § 1708.

While we question whether a change in the Commission's internal procedure for processing step rate requests requires § 1708 perusal, we agree with ORA that the record in this case is silent as to the manner in which step rates are processed. There may be legitimate concerns that should be addressed before we make such a change. Accordingly, we have changed Ordering Paragraph 2 to more traditional language, providing that the rate changes "shall go into effect upon Water Division's determination of compliance, not earlier than January 1 of the year for which the increase is authorized, or 30 days after filing, whichever is later."

ORA also raises a factual objection related to the testimony of ORA witness Ishwar Garg, and we have corrected that reference in the decision.

Suburban notes a number of corrections in dollar amounts recorded in Appendix A and reflected in the text of the decision, and we have made those corrections where appropriate. We also have corrected the number of Maple customers (155 instead of 500) and deleted a reference to a Commission acquisition decision (D.99-10-064) that does not apply retroactively to the 1997 acquisition of Maple. Suburban also urges a correction to Appendix E, Attrition Calculations for 2005. The section calculating operational attrition uses the adopted rates of return for 2003 and 2004. Rather, based on current Commission practice, this calculation should use the return at present rates for 2003 and 2004. We agree.

In order to be clear in the decision about the method of calculation, Suburban suggests that text be added similar to that approved by the Commission in the recent Valencia Water Company General Rate Case, D.03-05-030. We agree, and we add the following text to this decision:

Attrition is a change in the earning (rate of return on rate base) of a utility from the first test year to the second test year when the utility's existing (present) tariff rates stay the same. The attrition consists of two components: operational and financial. They are calculated as follows:

<u>Operational attrition</u>. Calculate the rate of return on rate base (ROR) for the first test year using the present (existing) tariff rates. Calculate the ROR for the second test year using the same present tariff rates as used for the first test year. Compute the difference by subtracting the second test year ROR from the first test year ROR. Multiply the difference by the net-to-gross multiplier and the second test year rate base to arrive at the operational attrition allowance.

<u>Financial Attrition</u>. The financial attrition is calculated by subtracting the second test year's total weighted cost of debt and equity from the attrition year's total weighted cost of debt and equity. Multiply the difference by the

net-to-gross multiplier and the second test year rate base to arrive at the financial attrition allowance.

The attrition allowance is computed by adding the operational and financial attrition amounts. The attrition allowance could be positive or negative.

17. Assignment of Proceeding

Michael Peevey is the Assigned Commissioner and Glen Walker is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. Suburban provides public utility water service to 74,000 customers in its San Jose Hills and Whittier/LaMirada service areas.

2. Suburban's last general rate increase occurred in January 1998, as authorized in D.96-04-076.

3. ORA has confirmed the accuracy of Suburban's actual and estimated costs for DHS fees.

4. A proposed new FMCT tariff would save BH Properties approximately $14,200 per year, and this amount would be recovered by increasing the rates of Suburban's other customers.

5. The capital structure, cost of debt, rate of return on equity, and rate of return on rate base shown in Table 3 are reasonable for ratemaking.

6. The Public Health Security and Bioterrorism Preparedness and Response Act of 2002 requires Suburban and other water companies to make investments for improving security.

7. All of Suburban's wells serving the San Jose Hills service area have been decommissioned because of contamination.

8. The BPOU Project Agreement requires CRs to reimburse Suburban for costs attributable to groundwater contamination.

9. An audit of Suburban's books show that environmental expenses and CR reimbursements have been accurately recorded.

10. No Class A water utility has a single district manager for a system with 74,000 customers.

11. The cost of Suburban's current insurance policies has increased by 35% because of an increasingly restrictive insurance market.

12. Recovery of extraordinary legal fees was authorized by the Commission in Suburban's last general rate case.

13. Suburban did not file a revised service map following its acquisition of Maple Water Company.

14. Suburban's water system facilities are in good condition, and service complaints are few.

15. Suburban faces severe water contamination problems in its San Jose Hills service area.

Conclusions of Law

1. The adopted summaries of earnings presented in Appendix A, and the quantities and calculations included as Appendix D that underlie them, are reasonable for ratemaking purposes and should be adopted.

2. A change in the FMCT tariff is not warranted on this record.

3. Suburban should be authorized to establish a memorandum account to track costs associated with federal and state legislation requiring security measures to prevent acts of terrorism.

4. Suburban should not be required to establish a balancing account or memorandum account for CR reimbursements, but it should be required to prepare a pro forma exhibit showing contamination costs and reimbursements if so requested by ORA.

5. Suburban's request for three test years in this General Rate Case should be denied.

6. A minimum fine of $500 for each of two infractions should be assessed with respect to the acquisition of Maple Water Company.

7. The revised rates and step increases set forth in Appendix B are justified.

8. Suburban should be authorized to implement the rate changes set forth in this order.

9. This decision should be made effective immediately to allow Suburban opportunity to earn the return found reasonable for it in test year 2003.

O R D E R

IT IS ORDERED that:

1. Suburban Water Systems (Suburban) is authorized to file in accordance with General Order 96, and make effective on not less than five days' notice, the revised tariff schedules for 2003 included as Appendix B to this order. The revised tariff schedules shall apply to service rendered on and after their effective date.

2. Advice letters for authorized rate increases for 2004 and 2005 may be filed in accordance with General Order 96-A no earlier than November 1 of the preceding year. The filing shall include appropriate work papers. The increase shall be the amount authorized herein, or a proportionate lesser increase if Applicant's rate of return on rate base, adjusted to reflect rates then in effect, normal ratemaking adjustments, and the adopted change to this pro forma test, for the 12 months ending September 30 of the preceding year, exceeds the lower of (a) the rate of return on rate base found reasonable by the Commission for Applicant for the preceding year in the then most recent rate decision, or (b) the return on rate base authorized herein for the preceding year. The advice letters

shall be reviewed by the Commission's Water Division for conformity with this decision, and shall go into effect upon Water Division's determination of compliance, not earlier than January 1 of the year for which the increase is authorized, or 30 days after filing, whichever is later. The tariffs shall be applicable to service rendered on or after the effective date. The Water Division shall inform the Commission if it finds the proposed increase does not comply with this decision or other Commission requirements.

3. Suburban is authorized to file advice letters seeking Commission authorization for rate offsets for the following capital projects when each has been completed and placed in service, with costs not to exceed those indicated:

- San Jose Hills Service Area. Replacement of existing 2-million gallon concrete tank at Plant 121 at a cost of $1,352,000.
- Whittier/La Mirada Service Area. Replacement of the existing pump station at Plant 235 at a cost of $1,045,000.
- Plant 410. Construction of an iron and manganese removal treatment facility at a cost of $1,400,000.
- Plant 235. Replacement of an existing steel tank at a cost of $1,014,000.

The advice letters shall be effective on filing. If the Water Division finds that the proposed rate offsets do not conform with this order, the Water Division shall prepare a Resolution that adjusts the rates as of the effective date.

4. Suburban is authorized to establish a memorandum account to track costs associated with any federal or state legislation requiring security measures to prevent acts of terrorism.

5. Suburban is authorized to include in rates the requested value of acquired Maple Water Company (Maple) assets.

6. Suburban shall within 60 days pay a fine of $1,000 for two filing infractions involved in its acquisition of Maple; the fine shall be payable to the state's General Fund.

7. In the future, upon request of the Office of Ratepayer Advocates, Suburban shall prepare a pro forma exhibit showing all reimbursements by Cooperating Respondents and the contamination costs for which reimbursement has been made.

8. The summaries of earnings presented in Appendix A, and the quantities and calculations included as Appendix D which underlie them, are adopted.

9. Suburban's requests in Application (A.) 02-05-033 are granted as set forth above, and in all other respects are denied.

10. A.02-05-033 is closed.

This order is effective today.

Dated May 22, 2003, at San Francisco, California.

MICHAEL R. PEEVEY
President
CARL W. WOOD
LORETTA M. LYNCH
GEOFFREY F. BROWN
SUSAN P. KENNEDY
Commissioners

I will file a concurrence.

/s/ MICHAEL R. PEEVEY
President

D.03-05-078
A.02-05-033 (Suburban Water Systems)

President Peevey, concurring:

I voted for this decision today, and I would like to express my opinion about one aspect of it. In Ordering Paragraph #2, the process of how step increases become effective on January 1st 2004 and 2005 respectively is described. The current system is that the rates do not become effective until Water Division has completed its review of the advice letter for compliance with the decision. We have had several orders recently that deal with the effective dates of tariffs because of delays in processing utility applications for one reason or another. [e.g. the general rate cases for Pacific Gas and Electric Company (D.02-12-073) and Apple Valley Ranchos Water Company (D.02-12-063)]. We issued those orders because we could not meet the effective date of a test period otherwise. We need not be in that situation. I prefer prevention rather than remediation.

Even though we do not have an instance of where Water Division has been tardy with its review of step increases, that possibility is much more likely now with the adoption of Assembly Bill 2838 (Chapter 1147; September 30, 2002), which requires Class A water companies to file a general rate application every three years. The work-load of Water Division will increase significantly. The utility may be in jeopardy of not having timely relief if Water Division does not complete its review on time, and Water Division should not be placed in such an untenable position. It would be unfair to put unnecessary pressure on staff to complete their review during a period of the year when many staff would rather spend extra time with their families during the holiday season. I would prefer that rates be made effective the 1st of the year or test period. I prefer a process that sets rates on a date certain. If, after a more reasoned review period, Water Division staff found that the utility made an error, rates would be changed back to the effective date of the 1st of the year. I would also add that if utilities were less than diligent in submitting sufficient documentation for the advice letters, I would be the first to seek sanctions for such behavior.

This change is not new. It works. The Energy Division has it in place now. In one instance, San Diego Gas & Electric Company found an error in the ratepayers' favor, informed the staff, and the customers received a credit for the error effective back to the 1st of the year.

My preferred method of handling these filing would result in an efficient processing of water utility general rate case applications, support the regulatory compact of timely rate relief, and not place undue pressure on staff. In order to implement AB 2838, we need to have a decision. I understand that we have an OIR in the wings. I am concerned that we need to expedite this effort. I am requesting here today that the issue of effective dates for step increases be considered in that OIR.

/s/ MICHAEL R. PEEVEY
MICHAEL R. PEEVEY
President

San Francisco, California
May 22, 2003