Decision 06-01-025 January 12, 2006

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of the Southern California Water Company (U 133 W) for an order authorizing it to increase rates for water service by $18,972,300 or 24.17% in 2006; by $1,534,500 or 1.57% in 2007; and by $1,493,900 or 1.50% in 2008 in its Region III Service Area.	Application 05-02-004 (Filed February 1, 2005)

(See Appendix A for List of Appearances.)

OPINION AUTHORIZING RATE INCREASES

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1. Summary

Southern California Water Company (SCWC)[1] is authorized to increase its Region III service area rates as follows:

	Amount	Percentage
2006	$5,351,700	6.69
2007 (estimated)	$1,878,400	2.19
2008 (estimated)	$2,333,700	2.66

As we discuss in more detail below, SCWC and our Office of Ratepayer Advocates (ORA) were able to reach agreements that resolve some issues in this proceeding. The bulk of the requested rate increase remains in dispute. This decision addresses each of the disputed issues.

On some issues, we find that SCWC has demonstrated that its costs are reasonable. On many issues, however, we find that SCWC inadequately documented its position. As noted below, we have accepted SCWC's inadequate documentation, in two instances locating record evidence on our own initiative, in furtherance of long-term customer interests. On other issues, we must disallow costs where SCWC presented superseded, inconsistent, or no documentation.

2. Background

This proceeding involved both an evidentiary phase, including formal hearings and briefs, and public participation hearings. Although the comments received during the public participation hearings are not technically evidence, we find that the themes raised in those hearings are revealing, as shown by our

[1] Effective October 1, 2005, SCWC changed its name to Golden State Water Company. As the record was developed before the name change, we will continue to use SCWC.

resolution of this disputed issues in today's decision. We also appreciate the participation of various cities on behalf of their residents and businesses.

2.1. Procedural History

SCWC seeks rate increases for its Region III service area based on increased costs for, among other things, plant investment, capital, operation and maintenance, and administrative and general. SCWC states that absent a change in rates, its return on rate base would be 4.62% for 2006, which it asserts would be an unjust and unreasonable return. SCWC also requested authorization for escalation increases, based on the escalation year methodology adopted in Decision (D.) 04-06-018. ORA protested SCWC's application as unreasonable or insufficiently justified.

The Assigned Commissioner and Administrative Law Judge (ALJ) convened a prehearing conference on April 26, 2005. Prior to the prehearing conference, the ALJ noted by ruling that the Commission had previously found deficiencies in SCWC's cost allocation to unregulated operations and had ordered SCWC to conduct a cost study and analysis to demonstrate compliance with SCWC's holding company decision.[2] The Commission had further directed SCWC to address capital costs and management polices and accounting practices for unregulated operations. The ALJ noted that SCWC's testimony on unregulated operations relied on a cost allocation methodology previously rejected by the Commission, and that it did not address capital costs or management policies and accounting practices.

At the prehearing conference, the Assigned Commissioner, ALJ, and the parties discussed the following:

1. The state of the record on the issue of unregulated operations;

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[2] See D.04-03-039, SCWC's last Region III general rate case.

2. Whether a reasonableness review was needed for the Calipatria Niland Upgrade project in this proceeding;
3. Using the Construction Work in Progress Account to add projects to rate base; and
4. The accuracy of SCWC's lists of primary cost increases and contentious issues in the application.

Based on the prehearing conference discussion, SCWC filed and served supplemental information on May 11, 2005. SCWC substantially revised its list of primary cost increases and contentious issues. The revised primary cost increases are:

	Dollar Amount of Increase
Income taxes	$3,826,400
Purchased Water	$3,590,500
Increased Rate Base	$3,126,600
Allocated General Office Expense	$2,312,400
Increased Cost of Capital	$1,860,700

With this new information, SCWC also modified its list of contentious issues to include its proposed return on equity of 11.65%, which is an increase from the previously authorized rate of 9.90%.

Also in its May 11 filing, SCWC explained that it had reviewed the Commission's treatment of the Calipatria Niland Upgrade project in D.04-03-039 and determined that the Commission had not found that the plant was a prudent investment. SCWC stated that it was reviewing its direct testimony for compliance with the Commission's directive in that decision to justify the recorded expenditures and consider project alternatives in SCWC's subsequent prudence showing.

The ALJ convened a second prehearing conference on May 31, 2005, where the City of Claremont appeared as a party. ORA and SCWC stated that they had reached an agreement in principle to reschedule consideration of SCWC's general office from this GRC to the Region II filing, expected next year. On August 3, 2005, ORA and SCWC filed a stipulation which defers full review of general office to SCWC's 2006 Region II general rate case and sets specific amounts for general office capital and expenses for this rate case. The stipulation is Appendix B to today's decision.

SCWC stated that it wished to offer additional testimony on the Calipatria Niland Upgrade project, and that all the information in the proposed additional testimony had been provided to ORA in a data response in April. A schedule was set for distributing the testimony, and for ORA to set forth any objections.

At the second prehearing conference, the parties also discussed SCWC's increase in rate base, including the comparison report of authorized versus actual investment and the nearly $60 million of construction work in progress forecasted to be closed and booked to plant in service in 2005. SCWC stated that it would file and serve supplemental information on these topics as well.

Evidentiary hearings were held on August 10, 11, 12, and 15, 2005. SCWC, ORA, and the City of Claremont cross examined witnesses. Apart from the evidentiary hearings, the ALJ also held three public participation hearings; these are discussed in the next section.

During the hearing process, ORA and SCWC were able to resolve some issues, which they memorialized in an overall stipulation. On September 16, 2005, ORA and SCWC jointly filed this stipulation, with supporting comparison exhibit, and a second comparison exhibit setting out all the issues that remained in dispute. The overall stipulation is Appendix C to today's decision.

The overall stipulation showed ORA's agreement to $770,000 increase in 2006 test year revenue requirement, but the issues with the greatest revenue impact, accounting for $10.7 million of the requested increase, remained in dispute. Agreed-upon and not disputed plant comprises the most significant component of the stipulation. The stipulation also contains agreed-upon forecasts for average commercial and residential customer sales for test years 2006 and 2007 in each of the customer service areas in Region III. The parties were also able to resolve most administrative and general cost forecasts, typically settling on an amount between the two initial recommendations. The stipulation includes agreed-upon sources of water supply, i.e., wells and purchases, for each customer service area. The prices for purchased water supply and energy shall be updated to the latest available at the time the decision tables are prepared.

As noted above, the second comparison exhibit sets out the remaining disputed issues. These are the issues we resolve in today's decision.

The parties filed initial briefs on September 19, 2005, and participated in oral argument before the assigned Commissioner and ALJ on September 20, 2005. Final briefs were scheduled to be filed on September 28, 2005, but due to the illness of SCWC's counsel were rescheduled to October 17, 2005, which became the submission date. ORA's briefs included a comprehensive discussion of the issues with its recommendations. SCWC limited its brief to a discussion of the Calipatria Niland Upgrade project and return on equity.

2.2. Public Participation Hearings and Written Comment Submitted to the Commission

Public Participation Hearings were held in Apple Valley (July 11), San Dimas (July 14), and Placentia (July 13), with day and evening hearings at each location. No customers attended either hearing in Apple Valley. The Commission received 156 written communications, via postal and electronic mail. Residents of Claremont submitted the largest number of written comments, 48, with San Dimas residents adding 27.

The Cities of Acacia, Walnut, and San Dimas all submitted written comments on behalf of their residents, with representatives of several cities also offering testimony at the hearings. The City of Claremont formally appeared and actively participated in the evidentiary hearings.

The message from the comments was straightforward: SCWC's requested rate increase was too high, and SCWC had not done enough to control its costs. As shown in other parts of today's decision, we find that the evidentiary record bears out many of these comments.

Monthly service fee increases, including those for multi-family housing and businesses, drew many objections. One speaker prepared an analysis of his home bills from the last seven years, and calculated that SCWC's service fee had increased by 89%, from $113 to $214.60 for each two-month period. An apartment owner reported that the fixed charges for her apartment building have gone up 70% in seven years. Conservation also suffers because the very high monthly service fee offers no incentive to conserve.

Several speakers criticized SCWC for seeking such a large rate increase, and alleged that SCWC's per share corporate earnings had increased substantially.

The need for cost cutting and efficiency improvements was a theme of several comments. Cost reduction, as well as efficiency and effectiveness improvements must precede any rate increase. Executive compensation was challenged; one speaker suggested that SCWC should "cut some of their fat," and he nominated a "couple of vice presidents" as a good place to start.

SCWC's requested increase in its rate of return was also criticized. One speaker contended that monopoly companies face little if any market risk, which SCWC says justifies its requested rate of return.

Business leaders opposed the rate increase proposal because it would dramatically decrease the revenue of all business members either directly or indirectly, and was "unconscionable" at a time when the cost of doing business in California was soaring.

SCWC's practice of making exorbitant rate increase proposals and then "accepting" a small fraction was called a "trap" that the Commission should avoid. SCWC was accused of making "high-ball" requests, based on "gamed" cost estimates, fully expecting substantial "reductions" and knowing that this result will be acceptable.

3. Rate Case Plan

SCWC's general rate case (GRC) application for its Region III is made pursuant to the new three-year GRC cycle requirements for Class A water utilities set forth in § 455.2[3] and implemented by the Commission under its new rate case plan in D.04-06-018.[4] The plan provides for each utility to file a GRC application every three years, complete with specified documentation and supporting material, and for the Commission to process each application under a 12-month schedule. For the 2005 transitional first year filings under the plan, D.04-06-018 adopted an expedited schedule, allowing a February 1 rather than January 1 filing date while retaining a projected completion date by the end of the calendar year; SCWC's Region III is included in the February 2005 filing

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[3] All citations are to the Public Utilities Code unless otherwise indicated.

[4] Class A utilities are investor owned water utilities with greater than 10,000 service connections. All Section (§) references are to the Public Utilities Code.

schedule. Thus, this GRC application was scheduled to be processed in 11 months, rather than 12, so Commission staff could start work punctually on the next GRCs in the cycle. At the prehearing conference, the Assigned Commissioner indicated that completing this case in a "timely fashion" would be a high priority.

Adhering to the 11-month schedule for processing this GRC has been challenging primarily due to SCWC's failure to present issues and evidence early in the process. The critical first step in the GRC process is the utility presenting a complete application with all significant issues clearly identified and supporting evidence included. However, this GRC is SCWC's first experience with the new rate case plan, which places new and exacting obligations on the utility, ORA, and principal hearing officer. To the extent this GRC was a learning experience, we hope it was a successful one.

As well, we note that under the plan, ORA is responsible for reviewing the proposed application of each utility and identifying all deficiencies, which the utility must remedy prior to the application being accepted for filing. In the case of SCWC's proposed application, ORA did not take the opportunity to point out obvious deficiencies, e.g., SCWC's list of most significant cost increases not corresponding to the total requested increase, the lack of justification for the unprecedented amount of construction work in progress to be added to rate base, and the absence of any testimony on the prudency of the Calipatria Niland Upgrade project.

4. Recommendations of the City of Claremont

The City of Claremont participated as a formal party and presented its Mayor, who testified that Claremont is a community of about 37,000 residents located in east Los Angeles County that is exclusively served by SCWC. The City has been actively participating in SCWC's rate cases since 1995 to protect the interests of its businesses, residents, and non-profit community organizations, including its many colleges. The City of Claremont criticized SCWC for charging rates that were shown in 2001 to be 60% higher than surrounding water purveyors, and 40% higher in 2002, and opposed the requested 24% increase as unwarranted and burdensome for its residents and businesses.

In its brief, the City of Claremont addressed the burden of proof, and attacked SCWC's use of three across-the-board adders to its capital budgets. It also questioned SCWC proposal to include capital projects in rate case regardless of whether the project had been built, and opposed the requested rate of return. Each of these substantive contentions is addressed in the discussion section of today's decision.

In response to the assigned Commissioner's invitation, the City offered several suggestions for encouraging ratepayer participation in water rate cases. The suggestions focus on making information about the proposed rate increase available to ratepayers. We have forwarded these suggestions to our Public Advisor for consideration and implementation as appropriate.

Substantively, the City also recommended that the Commission include in the hearing process a comparative rate survey and analysis of other water purveyors in the region. Such a comparison would begin with systematic operational comparisons with other purveyors, i.e., leakage rates, and efficiency assessments for personnel and resources. We direct our staff to fully consider this proposal.

5. Discussion

5.1. Burden of Proof under Statutes and Rate Case Plan

The applicant, SCWC, bears the burden of proving that its proposed rate increases are "justified." Pursuant to § 454(a), before implementing a rate increase, SCWC must make a "showing before the Commission," and the Commission must find that the proposed increase is "justified."

In adopting the revised Rate Case Plan, the Commission further articulated the required showing for a water utility's GRC: "The utility's application for a rate increase must identify, explain, and justify the proposed increase." Specifically, the application must include testimony, with supporting analysis and documentation, describing the components of the utility's proposed increase, e.g., results of operations, plant in service. All significant changes from the last adopted and record amounts must be explained, and all forecasted amounts must include an explanation of the forecasting method.

As discussed above, SCWC's initial showing was deficient in many respects. Some of these deficiencies have been remedied, and some have not. In considering each remaining disputed issue, we evaluate whether SCWC's showing meets our standards for justifying a rate increase.

As set out in detail below, we resolve the $10.7 million of issues that remain in dispute between SCWC and ORA and allow SCWC to increase its operating revenues by $4.65 million.

5.2. Calipatria Niland Upgrade Project

5.2.1. Summary and Background

SCWC serves, among many other areas, the Imperial Valley communities of Calipatria and Niland. In 1997, SCWC realized that its then-existing water treatment plants in Calipatria and Niland had inadequate long-term capacity and that they used technology not approved by the Department of Health Services. SCWC commissioned a study by the Kennedy Jenks consulting firm to evaluate three alternatives to improve the water supply to these communities: (1) building a regional water pipeline to a water treatment plant in the City of Brawley; (2) improving the water treatment plants in both Niland and Calipatria;

or (3) constructing a new water treatment plant to serve both communities. The study dismissed Alternative 1 as too expensive. By 1999, SCWC decided that Alternative 3 was the best approach, and SCWC began designing a water treatment plant for Calipatria with a transmission main and pump station to the Niland system.

SCWC included this project in its test year 2000 general rate case, where the Commission adopted the parties' stipulation that the costs be recovered through an advice letter. In SCWC's next general rate case, test years 2003 and 2004, the Commission observed that the previously contemplated project "was apparently not done." The Commission directed SCWC to either file a separate application for this project, or include the project in its next general rate case. In either case, the Commission required SCWC to "justify the recorded expenditures and, given the disparate cost estimates, address its consideration of alternatives to the proposed project, or aspects of the project, in order to mitigate financial impacts." (D.04-03-039, *mimeo.*, at page 12.) The referenced "disparate cost estimates" are SCWC's contractor bids of $13.2 million and $18.9 million, which far exceeded SCWC's original cost estimate of $9.2 million.

When SCWC filed this application in February 2005, the Calipatria Niland Upgrade project was nearly complete. As discussed earlier, SCWC did not include its full presentation on the project in its initial testimony, but rather distributed supplemental direct testimony in June 2005.

In today's decision, we allow $11,946,854 in rate base as the total cost for this project. We disallow certain costs, discussed in detail below.

5.2.2. Total Plant Cost

According to SCWC's rebuttal testimony, in 2002, SCWC projected the cost of the project to total $9,303,900. During the course of this proceeding, SCWC offered the following total cost estimates, all of which include 22.5% in overheads[5]:

[5] A key issue in today's decision is the amount of capital overheads to be added to each capital project. (See 5.3-5.3.2 below.) All amounts in SCWC initial filing include 22.5% of project costs for capital "overheads," which are largely engineering administration and management performed at the general office level. In today's decision, we will indicate whether the overhead rate is included or not.

February 1, 2005	$16.02 million
Date Response	$16.33 million
May 2005 Supplemental Testimony	$16.9 million
June 29, 2005 Rebuttal Testimony	$17.19 million[6]

These data show that the projected plant cost has increased by 7.3% during the five-month period from February to June. Between the 2002 initial estimate and the final estimate, cost increased by 85%, if the 2002 estimate includes overheads, and by 51%, if it does not. The speed and size of these cost increases suggest faulty management oversight, as discussed below.

Planning and constructing major plant additions is a management challenge. Objectives of the plant must be identified and thoroughly understood, and options for meeting those objectives brought forward and critically evaluated. Once an option is selected, sound project planning requires detailed understanding of critical systems, construction sequencing, and anticipation of problems.

Any infirmities in project planning and construction come sharply into focus with budget. Cost plays a critical role in selecting a particular project option. Consequently, option costs must be carefully estimated so that management will have a sound basis for selecting a particular option. Well

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[6] In SCWC's last GRC decision, D.04-03-039, the Commission approved a memorandum account for the Calipatria Niland Upgrade project. SCWC, however, has not included any documentation of such an account, but its presentation has addressed all components of the project and indicated that some costs were recorded as construction work in progress. ORA has requested that any costs recorded in a memorandum account be reviewed. For today's decision, we will assume that all project costs are included in the 2005 capital budget or as construction work in progress, and that there is no project memorandum account.

thought out project budgets, absent unforeseeable events, should closely track actual costs. In the final stages of planning and construction, the final cost estimates should have little variance with actuals.

The Calipatria Niland Upgrade project cost forecasting history shows a substantially evolving design, with resultant and on-going cost increases. Major changes occurred from the original plan put forward in the 1999 rate case; they were considered during the two-year CEQA review period, and resubmitted in the 2002 rate case. For example, the initially proposed 7.5 MG raw water storage reservoir became two 4.5 MG reservoirs, and a building was added to house the treatment equipment.

In this GRC, the Calipatria Niland Upgrade project makes its third appearance at the Commission. Despite the previous two submittals and six-year period for design refinements, the final cost of the upgrades has increased by over 7%, more than $1 million, in five months. In support of the project, SCWC submitted a 14-inch high stack of bid documentation. Despite this volume of documents, and three sets of testimony, ORA argues, and we find, that SCWC has not presented sufficient documentation for many of 26 budget line items. In short, this project shows poor advance planning and implementation by SCWC management.

We are mindful of the water industry's need to improve its infrastructure. However, in a capital intensive industry, the need to spend wisely is greater, not less. Our goal is to encourage prudent investment in water utility infrastructure to ensure long-term safe and reliable water supplies for California's ever-growing population. We do not write a blank check, however. SCWC's revenue requirement includes substantial salaries for expert management, which must thoroughly understand a proposed capital project, especially its cost, to be in a position to evaluate whether it economically meets customers' needs. While projects will understandably evolve at the design stage, when a project is presented for inclusion in rate base it should fully designed and ready for construction. A series of major revisions requiring three appearances at the Commission, and then rapid costs increases, suggests that, at a minimum, this project was substantially in flux.

Turning to SCWC's specific requests, SCWC sought rate base treatment for $16.02 million (including 22.5% overheads) as the total cost of the Calipatria Niland Upgrade project. SCWC subsequently updated that amount to $17.19 million. In its rebuttal testimony, SCWC confirmed that it now seeks rate base treatment for the full $17.19 million. ORA implicitly opposed the $1.17 million increase in the request by ignoring it and analyzing only the components of the original amount.

In adopting the new water rate case plan, we recognized the temptation to "update," i.e., include more recent data in developing the test year analysis, but we also recognized the practical limitation that data collection must have an end point or the rate case would not. We settled on a general rule that precludes updates after the filing of the application. We also adopted two exceptions to this rule.

First, more recent <u>recorded</u> data may be provided by the utility up to 45 days after the application is filed. Such data are utility plant or expense account balances showing actual historical amounts. New or additional items or <u>forecasted</u> costs are not updates to recorded data.

Second, updating is permitted under extraordinary circumstances, with the authorization of the Principal Hearing Officer.

SCWC's post-application updates to the total cost for the Calipatria Niland Upgrade project do not meet either exception. SCWC did not provide the data within 45 days of filing the application and has not shown that the costs were recorded, not forecasted, costs. Similarly, SCWC has not made the required showing of extraordinary circumstances.[7]

Consequently, we deny SCWC's request to consider $1.18 in additional costs for the project. We limit our consideration to SCWC's request in the application for a total of $16.02 million, including overheads.

5.2.3. Grading, Paving, SCADA

Amount Requested by SCWC	$500,000[8]
ORA Allowance	$0
Documentation	None

In its initial application, SCWC included $500,000 for "grading, paving, and SCADA."[9] ORA stated in its report that SCWC provided "no documentation" for this estimate and recommended that no amount be included in rate base.

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[7] As discussed elsewhere in today's decision, we do find the requisite extraordinary circumstances to allow SCWC to update its construction work in progress account to the balance included in its rebuttal testimony. Unlike the additional amount SCWC sought for this project, SCWC did include the 2005 construction work in progress amount in its application. Commission practice, however, prevented including the amount in revenue requirement, absent the update allowance.

[8] Includes 22.5% overheads.

[9] SCADA (supervisory control and data acquisition): An industrial measurement and control system consisting of a central host or master (usually called a master station, master terminal unit or MTU); one or more field data gathering and control units or remotes (usually called remote stations, remote terminal units, or RTU's); and a collection of standard and/or custom software used to monitor and control remotely located field data elements. See "SCADA Primer" at http://members.iinet.net.au/~ianw/primer.html. (Web site includes a water treatment SCADA simulator).

SCWC addressed these three cost items in its rebuttal testimony with three paragraphs that describe the grading, paving, and SCADA. SCWC estimated $150,000 for grading, $175,000 for paving, and $175,000 for SCADA, all including overheads. SCWC provided no documentation whatsoever to support these cost estimates.

In its rebuttal testimony, SCWC included $408,163 as the "total cost without overheads" for these three items. Again, SCWC provided no supporting documentation for this precise number. We observe, however, that $408,163 plus the overhead adder of 22.5% equals $500,000, which strongly suggests that rather than "building up" from specific item cost estimates, and applying the overhead adder to achieve a total cost estimate, SCWC "worked backward" from its original $500,000 estimate to create an after-the-fact justification.[10] This mathematical exercise does nothing to support the original estimate.

Turning first to the estimates for grading and paving, ORA stated that the 1999 cost study estimated $27,000 for this line item. SCWC's intervening 1999 and 2002 GRC filings for the project contained no budget for these items.

In its supplemental testimony, SCWC explained that several modifications had been made to the 1999 design. Among the "miscellaneous" changes was the addition of SCADA and telemetry equipment. SCWC stated that the purpose of this equipment was to enable communication between the Niland and Calipatria systems and the in-line booster system.

SCWC offered no explanation for grouping the SCADA system with grading and paving. The logistical and project sequencing relationship of grading and paving is apparent – both would occur at the end of the project, and grading and paving often would be done by the same contractor.

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[10] This is also why we address this issue using the amount including overheads.

The SCADA system, however, has no such relationship and would appear to require accommodation as part of plant design. SCWC's explanation of the purpose of the system - "to increase/decrease the water production in Calipatria based on water usage throughout the two distribution systems and also start and stop the in-line pump station based upon the water level in the Niland reservoirs" - suggests that the SCADA system will serve a control function at the plant. If so, then a functioning SCADA system would seem essential to plant testing and certainly to operation. At a minimum, the plant control instrumentation and data collection systems would need to be designed and installed with the SCADA system in mind. However, SCWC states that the SCADA system has not been bid yet, much less installed, but the plant is nearly operational. This suggests that the SCADA system either is not, in fact, necessary, or SCWC has done a poor job of planning for its installation.

In sum, SCWC's presentation on the SCADA system raises more questions than it answers. Most puzzling, however, is SCWC's decision not to provide documentation to support its cost estimates, especially after ORA proposed to disallow the entire amount. A preliminary quote, vendor price list, or extrapolation from another similar project, would have added some credibility to these estimates. The record in this proceeding contains only SCWC's conclusory assertions of likely cost, with no objective support in any form.

SCWC bears the burden of justifying the costs of its proposed upgrade. As to the $500,000 for paving, grading, and SCADA, SCWC has not met this burden. This amount will be excluded from the plant costs.

5.2.4. Electrical and Instrumentation and Chemical Feeding Equipment

Electrical Equipment	
Amount Requested by SCWC	$767,200 (without overheads)
ORA Allowance	$572,000 (without overheads)
Chemical Feeding Equipment	
Amount Requested by SCWC	$336,000 (without overheads)
ORA Allowance	$309,000 (without overheads)
Documentation	Bid evaluation sheet showing lower of two bids not accepted by SCWC. Cross-examination testimony explaining that lowest bidder was not qualified, leaving only higher bid which SCWC used.

In its report, ORA first noted that the price for electrical and instrumentation equipment as well as chemical feeding equipment varied substantially among the three previous cost estimates submitted by SCWC. ORA then identified and corrected what ORA thought were errors by SCWC in its application.

In its rebuttal testimony, SCWC explained that it had not erred in its application. Instead, ORA had not been aware of all the components to total for each of these two items. When ORA's mistakenly omitted components were added to ORA's amount for each item, the sum was the same amount SCWC included in its application. SCWC concluded that it had fully justified the original amount for this equipment.

However, the bid evaluation sheet included with the rebuttal testimony raised additional questions. This bid evaluation sheet showed bids for the entire microfloc systems from RSH Construction, $3,480,000 and Pacific Hydrotech,

$4,352,800. (The electrical and instrumentation, and chemical feeding equipment are elements of this total bid.) ORA contended that the lowest bid, from RSH Construction, should be allowed as the reasonable cost. The RSH Construction amounts are the basis for ORA's recommendations above.

During cross-examination, SCWC stated that the RSH Construction bid had been rejected because RSH could not supply the required bond. ORA's counsel asked the SCWC witness to compare copies of two bid evaluation sheets for the microfloc systems: one that was attached to the rebuttal testimony, and a second bid evaluation sheet that was provided earlier to ORA as a data response. The data response bid evaluation sheet had hand-written notes on it (which ORA's witness later described as a "scribble"). The notes, however, suggested that the lowest bidder was not qualified. The cost information for each bidder on both the rebuttal testimony bid evaluation and the data response bid evaluation were identical. Other than to suggest that the two inconsistent documents might have come from two different files, SCWC provided no explanation for the discrepancy in presenting two different versions of purportedly the same bid evaluation sheet.

Due to the inconsistency in documentation presented, ORA concluded that SCWC had not met its burden of justifying its use of the higher cost bid.

SCWC bears the burden of justifying its proposal. Its inattention to the documentation on these issues in this rate case is disturbing. However, in contrast to the complete lack of documentation on grading, paving, and SCADA costs, there is some record support for the costs claims for these equipment categories. Thus, we will accept SCWC's documentation and belated explanatory testimony and allow SCWC's requested amounts.

5.2.5. Pump Station (Calipatria)

Amount Requested by SCWC	$676,739 (without overheads)
ORA Allowance	$477,900 (without overheads)
Documentation	None, beyond $477,900

ORA does not dispute SCWC's request for $477,900 for installation of the Calipatria pump station. SCWC, however, seeks $198,839 (before overheads) for two additional elements of the pump station: electrical gear, $124,525, and finished water pumps, $74,314. ORA opposes including these elements because SCWC has provided no documentation supporting these amounts.

In rebuttal, SCWC lists the additional amounts but provides neither new documentation nor cross-references to previously filed documents. On cross-examination, SCWC's witness referred to Exhibit 17 as containing the "information" on these amounts.

Review of Exhibit 17, however, reveals only the contract documents and specifications for the New 480 Volt Switchboard, 480 Volt Control Center, and Programmable Logic Controller. No bid information is included, despite the specification documents being dated March 2004, with a bid submission deadline of March 30, 2004. Exhibit 17 is dated December 2004.

We conclude that SCWC has provided no documentation to support its request for $198,839 in additional costs.

In its report, ORA first agreed that Variable Frequency Drives (VFD) were necessary for the pumps within the treatment plant. ORA then questioned whether these expensive drives were necessary for the pumps on the finished water reservoir. ORA explained that the purpose of the reservoir was the same as that of the VFDs, namely, flexibility to match finished water flow to demand. ORA observed that SCWC has operated with neither reservoirs nor VFDs at this plant for years, and that SCWC has not identified any current operational problems.

In its rebuttal testimony, SCWC did not respond to ORA's VFD argument. On cross-examination, SCWC admitted that the $477,900 included all the VFDs.

We are left with a very close question about whether to disallow the (uncertain) cost of the VFDs from the documented $477,900 overall costs. On the one hand, SCWC has not quantified the incremental effect of the VFDs on plant flexibility. On the other hand, the purpose of the project was in large part to enhance plant flexibility. We will allow the entire $477,900, but with a further admonition to SCWC that weak justification for major project components is a disservice to all concerned.

5.2.6. Two 1.1 MG Reservoirs (Calipatria)

Amount Requested by SCWC	$1,108,436 (without overheads)
ORA Allowance	$ 985,218 (without overheads)
Documentation	Change orders for all disputed amounts

ORA disputed $117,918 of change orders. In its rebuttal testimony, SCWC provided documentation breaking the total down into two components and showing that $74,634 was the additional costs associated with accelerating the construction schedule to have a tank in service by November 2003, and $43,284 for "design changes." SCWC stated in its testimony that the design of the reservoirs' foundations was changed based on the pre-construction soils report.

SCWC has provided sufficient documentation to meet its burden of justifying the additional change orders. We, therefore, approve for inclusion in rate base $1,103,236 for two 1.1 MG reservoirs at Calipatria. The parties have not provided any explanation for the deviation of about $5,000 from the total of ORA's allowed costs plus the disputed amount and SCWC's original request.

5.2.7. In-line Pump Station

Amount Requested by SCWC	$555,102 (without overheads)
ORA Allowance	$426,100 (without overheads)
Documentation	Change order for $31,000 General Work Order for $477,935 Bid: $426,100

In its application, SCWC sought $555,102 for the in-line pump station to serve the prison. In an ensuing data request, ORA sought documentation for this amount, but SCWC could only provide a General Work Order showing a total of $477,935 comprised of a vendor bid for $426,100 and $51,835 in SCWC direct services. SCWC was unable to account for the remaining $77,167 it included in its application.

In its report, ORA pointed out that the SCWC General Work Order predated the GRC application by about 4 months and that SCWC "increased its actual costs without reason" in the application.

SCWC's rebuttal testimony included an Authorization for Additional Expenditures for an easement for the pump, "reimbursement to farmer", and "transaction costs" totaling $31,000, dated April 28, 2005.

ORA was not persuaded by this new document, contending that it lacked any explanation or support, and ORA recommended that the Commission authorize only the amount of the bid, $426,100.

The record shows no explanation for the amount SCWC included in its application, and SCWC's own General Work Order undermines the reasonableness of the amount SCWC choose to seek authorization to include in rate base. SCWC's after-the-fact Authorization for Additional Expenditures does little to bolster SCWC's request. ORA's recommendation, however, is too punitive. SCWC's General Work Order supports $477,935, which we will allow.

Therefore, SCWC is authorized to include in the costs for the Calipatria Water Treatment Plant an in-line pump station in the amount of $477,935, reflecting a disallowance of $77,167 to SCWC's request.

5.2.8. 32,000 Foot 12-inch Water Transmission Main

Amount Requested by SCWC	$1,230,870 (vendor contract only)
ORA Allowance	$1,129,910 (vendor contract only
Documentation	Bids from Roland (x2) and Broughton

In its application, SCWC included $1,621,932 for this item, comprised of a bid from Broughton Construction for $1,230,870, plus $90,155 in company direct costs and 22.5% or $297,906 in overheads. In support of this amount, SCWC included a General Work Order for that total amount (which included SCWC direct costs and 22.5% overheads) and a vendor bid for $1,230,870.00 from Broughton Construction.

In a data response, SCWC presented a bid tabulation sheet which showed a lower bid, $1,129,910.70, from Roland Construction. ORA adopted this lower bid as its recommendation for the water transmission main.

SCWC's rebuttal testimony explained the complicated history of this bidding. SCWC initially bid the project in June 2003, and Roland Construction submitted the lowest bid (ORA's amount). Delays, however, prevented SCWC from awarding the contract in a timely manner, and required SCWC to rebid the project in February 2004. Broughton Construction submitted the lowest bid in the second bidding. Based on this bid, SCWC prepared the General Work Order which it used in the application. Unfortunately, prior to filing the application, SCWC cancelled the contract with Broughton when Broughton refused to perform according to the terms. SCWC had then turned to the second lowest bidder in the second bid, which was a bid of $1,326,636, from Roland Construction.

Date of Bid	Bidder	Amount ($)	Outcome
June 2003	Roland	$1,129,910.70	Delay prevents awarding contract
February 2004	Broughton	1,230,870.00	Contract cancelled but mistakenly used in GRC
February 20004	Roland	1,326,636.00	Contract awarded but no Work Order in GRC

Based on this history, ORA recommended that the Commission give no weight to the General Work Order based on the cancelled Broughton bid and contract. ORA similarly argued that the February 2004 bid from Roland Construction was not reliable as the record does not contain an implementing General Work Order for the Roland contract. ORA also opposed using the second Roland bid as it represented a substantial price increase (17%) in eight months. ORA concluded that the first Roland bid, the lowest of all, should be used for this item.

The record shows at least two mishaps. First, SCWC was unable to timely award the contract in the initial bidding. SCWC has offered no explanation for this delay, or its failure to anticipate it. Second, SCWC used an invalid and superseded bid as the basis for its GRC showing justifying the cost of this element of the plant upgrade. While SCWC did include Roland's final bid, SCWC failed to include a General Work Order showing its proposed revised total for the work. These two events led to increased costs and a muddled record.

Constructing six miles of water transmission main from Calipatria to Niland is a substantial component of the Calipatria Niland Upgrade project, comprising about 10% of the total costs. SCWC has not presented any justification for its delay in awarding the contract resulting from the initial bid. SCWC's preparation of its GRC based on an invalid and superseded bid for a million dollar plus item does not reflect well on SCWC's record-keeping or internal coordination.

Of the three bids included in the record, SCWC justified rejecting the Broughton bid, leaving the two bids from Roland Construction. Of those two bids, ORA recommends that we adopt the lower. Absent countervailing justification from SCWC, we agree with ORA. Therefore, we will adopt $1,129,910 as the vendor cost for the Calipatria Niland transmission main. ORA has not provided us with an amount for SCWC's direct costs, other than the estimate included in the cancelled Broughton General Work Order. We will substitute Roland's June 2003 bid amount in that General Work Order to calculate the total direct costs as $1,223,066, without overheads, and allow this amount.

5.2.9. Engineering and Other Professional Services

Amount Requested by SCWC	$1,677,027 (without overheads)
ORA Allowance	$0
Documentation	No documents, one page of text.

Neither SCWC's application, or accompanying testimony, nor its supplemental testimony mentions this component of the costs for the plant upgrade. In its table setting out its position on the various cost components for plant upgrade, ORA summarily disallows this cost by substituting a "0" in place of what it identified as SCWC's request of $1,405,000.

This item appears as an articulated issue for the first time in SCWC's rebuttal testimony. There, SCWC explains that engineering costs are "critical" and "must be incorporated." SCWC also noted that the actual final cost had increased by $272,027, or 19%, to $1,677,027 from the original amount. SCWC disaggregated the total into four components representing four firms hired to perform various services and draft reports. The largest component is for design and construction management services from an engineering firm, $1,350,000. This one page of text is the only support SCWC provides for this line item.

ORA contended that engineering and consulting costs are already included in each cost component. ORA stated that General Work Orders include both costs for outside vendors and direct billing for SCWC labor at the regional, district, and customer service area levels.[11] Contract inspection, permits, and miscellaneous are also provided for on the General Work Order. ORA stated that it requested additional information on the amounts paid under the engineering contracts, and how they related to the General Work Orders, but received no response. ORA concluded that SCWC had not rebutted ORA's contention that cost of capitalized labor is included in each General Work Order and any additional amount would be double counting. ORA, therefore, recommended that no separate amount for engineering be added to the capital costs of the project.

We agree with SCWC that engineering and construction management are critical to this project, or indeed any similar project of such complexity. Prior to including such costs in rates, however, the Public Utilities Code requires that the cost be "justified" with clear evidence. SCWC has presented us with four conclusory paragraphs to justify $1.6 million in expenditures.

We know that as a practical matter water treatment plants must be designed and engineered, and SCWC would not be likely to have sufficient

[11] "IT&T" is also included at 35% of direct labor billing. "IT&T" is not defined.

engineering staff to accomplish this task. The record contains evidence, discussed below, that significant engineering and consulting services were performed. We have also made other substantial disallowances to SCWC's requested costs for this project. We find, therefore, that some allowance should be made for this cost of engineering and consulting services, and we reject ORA's recommendation that this line item be "0."

Our independent review of the record finds support for SCWC's assertions that engineering and consulting services were provided. SCWC requests $39,627 for soils reports and compaction testing services from Southland Geotechnical. This report is found in Exhibit 12. SCWC states that Albert A. Webb Associates performed the majority of engineering work for the project. Exhibits 14, 15, 16, 17, 18, 19, and 22 all contain contract documents and specifications for various components of the project. Each of these exhibits shows that the documents and specifications were prepared by Albert A. Webb Associates. SCWC requests $60,000 for a water quality and disinfection alternatives study by Montgomery Watson Harya, and the study is found in Exhibit 11. This record evidence provides some justification for SCWC's request.

Missing, however, is any evidence showing that these costs are reasonable. SCWC has presented no evidence that the engineering contract was competitively bid, or that the hourly rates and time billed are reasonable. Also missing is any analysis of engineering services that could have been provided by SCWC's in-house engineers.

Our review of the record failed to find support for the $227,400 contract with the Holt Group for surveying, construction staking, and part-time construction inspection. We disallow this amount.

We will allow SCWC to include in its plant accounts the cost of engineering and consulting it included in its original application, $1,405,000, less

$227,400 for the unsupported Holt Group contract. The final amount is $1,177,600.

5.2.10. Office/Lab/Electrical Building

Amount Requested by SCWC	$491,429 (without overheads)
ORA Allowance	$281,747 (without overheads)
Documentation	General Work Orders in Data Response

ORA and SCWC reference bid records in their testimony and on cross-examination. However, these bid records do not appear to be part of the record.

ORA accepts "SCWC records" as showing a bid for this building of $281,747. ORA did not accept SCWC's explanation that another contractor performed preliminary work on the building and was paid $192,714, bringing the total up to $491,429. ORA contended that SCWC provided neither documents supporting the second contract nor any explanation of the need for two contractors.

In rebuttal, SCWC stated that "the preliminary work on the Operations Center was done by another contractor who was retained based on their experience constructing another similar operations center for the Company in the past and on their ability to begin the work expeditiously. The contract was awarded on a time and materials basis and a General Work Order totaling $192,714 for the work performed was submitted in that response."

ORA found this rebuttal unpersuasive for the second General Work Order because it did not explain the scope of the work, the actual costs, or why the building construction was not completed.

SCWC has not presented a comprehensive description of the construction of this building. A better explanation of SCWC's decision to contract for "preliminary work" on a time and materials basis would have been helpful, especially in light of the need for a subsequent contractor. However, SCWC has presented some justification for the two amounts, so we will accept the two General Work Orders as sufficient support for SCWC's total of $491,429.

5.2.11. Backwash Decant Basins

Amount Requested by SCWC	$200,000 (without overheads)
ORA Allowance	$0
Documentation	Unsigned, Undated, General Work Order for $269,194.

SCWC provided ORA a General Work Order that was unsigned and undated and for an amount in excess of that claimed for backwash decant basins. SCWC explained that the contract for Backwash Sludge Basins was on a time and materials basis with a contractor that had previously constructed a similar sludge basin for SCWC. The purpose of the backwash water reclamation system is to minimize water waste as part of the treatment process. SCWC asserted that $200,000 of the total $269,194 contract was for the backwash decant basins.

SCWC has failed to meet its burden of proof. SCWC's General Work Orders carry exact instructions for multiple management level approvals; absent such approvals the General Work Order is invalid.[12] In addition, ORA contends that the invalid General Work Order includes work beyond a backwash decant basin as well as costs in excess of those claimed by SCWC. In rebuttal, SCWC asserts, without any documentation or analysis, that exactly $200,000 of the total contract is for backwash decant basins. We observe that such exactitude in a

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[12] Either SCWC relied on the unapproved General Work Order to construct the backwash decant basins, or SCWC used a General Work Order not in record for this item.

time and materials contract that was not competitively bid is implausible. Accordingly, SCWC has not justified its proposed cost, and we adopt ORA's recommendation that the adopted amount be "0."

5.2.12. Summary of Calipatria Niland Upgrade Project

SCWC's application requested $13,072,320, without overheads. Our disallowances total $1,212,366:

Paving, grading, and SCADA	$408,000
Pump Station, Calipatria	$198,839
Inline Pump Station	$ 77,167
Water Transmission Main	$100,960
Engineering and Consulting	$227,400
Backwash Decant Basins	$200,000
TOTAL DISALLOWANCES	**$1,212,366**

The Calipatria Niland Upgrade project total allowed costs are therefore $11,859,954, without overheads. This represents a disallowance of 8.6% of costs requested in the application. Given the weaknesses in SCWC's presentation, we consider this disallowance to be towards the low end of a reasonable disallowance.

5.3. Capital Overheads

The purpose of the overhead allocation is to distribute <u>indirect</u> costs of capital projects among those projects. Actual incurred costs for a capital project, i.e., in-house engineering design, are assigned to directly to the project. Indirect costs, such as engineering management, legal, and insurance (most of which are done at the General Office level) must be similarly assigned to actual capital projects among the three regions.

5.3.1. SCWC's Allocation Factor

In SCWC's last Region III general rate case, it proposed an overhead allocation factor of 25%, but stipulated with ORA to 22.5%. See D.04-03-039, mimeo at page 9. Thus, the parties agreed that annual indirect capital overheads for Region III were about 22.5% of the annual capital project budget. In effect, by adding 22.5% to the annual project costs, SCWC could properly include in capital accounts these indirect costs. SCWC kept track of the unallocated indirect amounts to be capitalized, and allocated these amounts to particular projects via the 22.5% adder. As SCWC stated, its goal is to keep the unallocated total at about zero; that is, all indirect costs should be allocated to a project.

This allocation methodology is appropriate where annual capital budgets and indirect costs are relatively stable. Significant changes in either component could lead to under- or over-allocation. For example, if the capital budget for a certain year is substantially less than that assumed when calculating the 22.5%, then the utility will not allocate enough indirect capital costs to capital projects for inclusion in rate base. Conversely, if the utility's capital budget for a year represents a dramatic increase, then the utility will attribute more indirect costs than it has incurred to capital projects.

The current balance is negative several million dollars; SCWC presented conflicting amounts for the record. SCWC's work papers show balance to be a negative $4.5 million but SCWC's witness testified that is was actually $3 million. The substantial negative balance shows that SCWC has allocated indirect costs to capital costs that it has not incurred. ORA and the City of Claremont might refer to this as allocating "phantom" costs.

The record does not include annual totals of indirect capital attributed to projects, or actual totals of the indirect costs to be allocated. The record does include gross capital additions for five recorded years (2000 to 2004[13]) and forecast years 2005, 2006, and 2007. Assuming that each additional project included an overhead adder of 22.5% of project costs, then an estimate of the amount attributed to capital projects on a year-by-year basis can be obtained by multiplying the gross additions total by 18.4%:[14]

	2000	2001	2002	2003	2004	2005	2006	2007
Gross Additions ($000)	11,279.1	9,384.2	13,682.7	12,352.8	15,171.2	73,028.9	17,832.1	21,008.5
Overhead Costs Allocated	2,075.3	1,726.6	2,517.6	2,272.9	2,791.5	13,437.3	3,281.1	3,865.5

This table shows that over the eight-year period SCWC's indirect capital cost allocations varied from a low of $1.7 million to a high of $13.4 million. The indirect overhead amount quadruples between recorded 2004 and forecast 2005. Setting aside 2005, the amount increases 18% from 2004 to 2006. This table illustrates that the set percentage adder for allocating capital overhead costs is not appropriate where capital additions fluctuate significantly. The record does not contain a convenient summary of overhead capital costs to be allocated, so a similar analysis cannot be performed for the cost side of the methodology. However, similar results are expected for widely fluctuating costs.

As the gross additions table shows, SCWC's capital expenditures for 2005 are anomalously high, as compared to recorded and forecast years, so SCWC's

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[13] The data are found on Schedule 2 to Exhibit 9 (McDonald). Data for 2004 have been updated for plant added in December 2004 as provided in the Joint Comparison Exhibit on unresolved issues, page 13.

[14] SCWC points out that 22.5% of project costs is 18.4% of total costs. For example, if a project costs $100,000, then the overhead adder is $22,500, for a total of $122,500. The overhead allocation, $22,500, is 18.4% of total costs. See Exhibit 50.

allocation of capital overheads will be equally high. The record shows that SCWC's overhead pool is currently over-allocated. Allowing SCWC to continue allocating capital overhead costs using 22.5% of project costs will substantially exacerbate this over-allocation, resulting in plant in service accounts which reflect costs that have not been incurred. This is not reasonable. We, therefore, decline to adopt SCWC's proposed 22.5% overhead allocation factor for 2005, 2006, and 2007 projects.

ORA, however, has not provided us with a comprehensive proposal to replace the across-the-boards adder in circumstances where the annual capital budget fluctuates significantly. A replacement methodology must link the allocation factor with the total costs to be allocated to ensure that the utility is not under/or over-recovering indirect capital costs. Of course, where capital budgets and indirect costs are relatively stable, the pre-set adder may still be an appropriate ratemaking tool.

Today's decision requires a solution for years 2005, 2006, and 2007 in Region III. We find that the proposed 22.5% adder is inappropriate and should not be used. To calculate an appropriate rate, we will use the 2004 recorded indirect costs, $2.79 million, as shown above. This amount will be escalated by 3% to approximate inflation to obtain an indirect cost estimate for 2005, 2006, and 2007. Using SCWC's gross capital additions for those years results in the following indirect capital cost allocation percentages:

	2005	2006	2007
Gross Additions	31,670.0[15]	14,550.9	17,142.9
Indirect Cost Estimate	2,870.0	2,950.0	3,050.0
Allocation Factor	9.1%	20.3%	17.8%

[15] This number has been corrected to remove work performed in 2004 or prior years.

For all capital projects recorded in 2005, SCWC shall use an indirect capital adder of the project costs. For 2006, the adder will be 20.3%, and for 2007, the adder will be 17.8%.

5.3.2. Further Requirements for SCWC's Capital Overheads

SCWC's proposed overhead allocation factor, 22.5%, shows that SCWC's capital overhead expense, e.g., engineering administration and management, requires that more than one out of every five dollars spent on capital projects (and included in rate base) be attributable solely to "overheads." The record shows that private engineering businesses assess overhead rates of about 15%. In fact, SCWC's own "overhead" rate in 1990 was only 12%, and that included its direct billings, as shown by the contract with the Department of Corrections for facilities to serve the prison discussed in detail below.

The vendor rates differ substantially from SCWC's current rate because they include the vendor company's profit, as well as administration and management. SCWC's overhead rates do not include profit. This difference strongly suggests that SCWC's overhead expenses are high, a conclusion also supported by SCWC's 1990 rate, and giving credibility to customers' allegations of corporate "fat."

SCWC provided a copy of its 1990 contract with the California Department of Corrections. Pursuant to that contract, SCWC, among other things, constructed certain facilities at the Department's expense. Section II-2 of the contract provides that the Department of Corrections will pay to SCWC:

> Upon presentation to CDC of Company's billings and four (4) sets of the plans, specifications and all other contract documents identified in the contracts referred to in Section III-3 below, the amounts paid by the Company to its competitively bid material and construction contractors for construction of the facilities included in the design

identified in Section III-3, plus engineering, inspection, legal and administrative costs equal to 12% of the total project cost.

From this section of the contract, we learn that prior to reimbursing SCWC for its costs, SCWC's largest customer required the following:

a. a binding, not-to-exceed budget amount;

b. full sets of billings, plans, contracts and all related documents;

c. all vendor contracts to be competitively bid; and

d. SCWC internal costs (direct and overhead) limited to 12%.

SCWC's presentation in this general rate case, most particularly its presentation on the Calipatria Niland Upgrade project, fails to meet any of these commercially reasonable requirements. Moreover, the fact that SCWC's direct and overhead was 12% in 1990 suggests that these costs have grown disproportionately.

Capital overheads are largely incurred at the general office level. Due to the stipulation with ORA, we will not be reviewing SCWC's general office in this proceeding, but rather with SCWC's Region II GRC in 2006. SCWC is directed to make a comprehensive study of the items it charges to capital overheads, and to present this study with its 2006 application. The study must identify all line items allocated to capital overheads, and provide a concise explanation for this allocation. References to past practices will not be sufficient justification.

In addition to the thorough review of SCWC's internal practices, the study must include a detailed comparison of SCWC's overhead amounts to other reasonably comparable entities. To the extent such information is available, investor-owned and municipally-owned water utilities should be included in the comparison group. Finally, SCWC must justify its continued use of this complicated approach to allocating engineering overhead, or propose alternatives.

5.4. Ten Percent Contingency Adder on Capital Budget

SCWC included a 10% adder in its capital budgets for "contingency." ORA opposed adding this amount because SCWC had not provided ORA with sufficient justification.

In rebuttal, SCWC explained that the contingency budget is used where actual costs exceed budgeted costs for a capital project. On cross-examination, SCWC's witness explained that in addition to cost overruns, the contingency budget is used for unanticipated projects. SCWC also stated that in 2004, actual capital expenditures were $29.1 million, while the budgeted amount was only $20.7 million, including the contingency budget. SCWC pointed out that this line item had been in its capital budgets for at least 20 years.

The record in this proceeding shows that SCWC often overruns its budget for a capital project. As one example, the actual costs for the Calipatria Niland Upgrade project increased by 7% from the time SCWC filed its application to the filing of rebuttal testimony. SCWC also appears to have a practice of hiring vendors on a time and materials basis. Accurate budgeting and cost containment are critical management functions that require additional attention from SCWC management. We are concerned that the contingency budget may play a role in "cushioning" SCWC from the consequences of insufficient attention.

We are also aware that unanticipated capital projects may require immediate attention. The record, however, shows no historical analysis of SCWC's contingency budget expenditures on unanticipated projects. Such an analysis could be readily prepared because the general work order approval forms included in Exhibit 29 disclose when a project is funded by the contingency budget. SCWC did not do such an analysis, even after ORA recommended a disallowance. SCWC has provided us no breakdown between budget overruns and unanticipated projects that have used this fund in the past, so we will simply assume it was divided evenly between the two uses.[16]

We will allow SCWC to include a contingency budget for unanticipated projects in test years 2006 and 2007.[17] We will set SCWC's contingency budget based on unanticipated projects only, which we will assume to be 5% of the total capital budget. Our objective is to do away with the cushion for poor budgeting. Therefore, we will allow SCWC to include in its 2006 and 2007 capital budgets a contingency adder equal to 5% of the total approved capital budget. Based on the estimates in ORA's brief, the 2006 amount is $652,500.

5.5. Construction Work in Progress 2005

The Rate Case Plan requires that all GRC applications discuss regulated plant in service with "supporting analysis and documentation," and "all significant changes from last adopted and recorded shall be explained." For capital additions, the utility must derive the test year estimates by "taking the properly recorded plant balance of the latest recorded year and adding to it the average plant additions of the last five years," but may also include other alternative methodologies.

SCWC's utility plant tables show that in 2005 it plans to close $59,169,600 in construction work in progress (CWIP) to plant in service. See Exhibit 9,

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[16] SCWC provided such an analysis for the first time in its comments on the proposed decision, in violation of Rule 77.3. SCWC also presented data showing that over the last five years it has not actually spent its entire contingency budget, with an average of 16% annually remaining unspent on capital projects.

[17] SCWC included a 10% contingency adder on all forecasted 2005 projects. As discussed elsewhere in today's decision, the Commission's practice is to use last recorded plant accounts (2004) as the basis for the test years. Forecasted but not complete projects in the intervening year (2005) are not included. Accordingly, no contingency amount will be included for 2005.

McDonald, Sch. 2. That same table shows that for the five recorded years, 2000 - 2004, SCWC closed CWIP to plant in only one year, 2002, and in the amount of only $2,657,500. SCWC similarly forecasts no CWIP to close to plant in forecast years 2006 and 2007. The 2005 CWIP represents approximately 22% of SCWC's total plant in service for 2004.

In its application, SCWC did not discuss the unevenness of its capital additions or explain this anomalous CWIP forecast. At the direction of the assigned ALJ, SCWC provided more information on its 2005 CWIP forecast on June 29, 2005. SCWC provided a list of all CWIP projects that were currently underway and planned for 2005, including citations to the Commission decision approving the project. SCWC explained that the Calipatria Niland Upgrade project was a substantial component of the CWIP, and that SCWC had deferred numerous capital projects approved in its last GRC decision due to the delay in issuance of that decision. SCWC concluded that these two factors explained the unusual level of CWIP forecast to be closed to plant in 2005.

ORA stated that the Commission's practice is to allow only <u>recorded</u> CWIP to be included in rate base, with any forecasted amount excluded. ORA, therefore, allowed all CWIP that had been recorded through December 2004 to be included in rate base, but excluded all amounts forecasted to be completed in 2005. ORA reviewed the CWIP forecasts for the three districts that comprise SCWC's Region III and determined that $15,886,774 (reported as $19,469,086 with 22.5% overheads) was properly recorded CWIP that should be included in rate base. This left $15,390,000 in dispute (reported as $18,860,295 with 22.5% overheads).

In rebuttal, SCWC stated that in the first five months of 2005 it had completed $7,425,600 (reported as $9,100,000 with 22.5% overheads) of the 2005

CWIP budget. SCWC's witness contended that these actual expenditures showed that SCWC's CWIP forecast for 2005 was reasonable.

SCWC's witness McDonald admitted under cross-examination that about $4 million of the forecasted CWIP would not be completed in 2005. Adjusting for the 22.5%, shows that $3,264,000 should be subtracted from the amount in dispute, leaving $12,126,000 separating ORA's recommendation from SCWC's request.

On cross-examination, ORA's witness testified that in his 30 years at the Commission, no water utility had ever requested forecasted CWIP for the year before the test year. The Commission's practice is to take last recorded year-end data, in this case, 2004. The witness also explained that other utilities which have not completed previously approved projects, such as those that apparently comprise most of SCWC's 2005 CWIP, would identify the projects in the subsequent application and seek explicit Commission authorization to include them in rate base. Here, the witness summarized, SCWC "did not make a request" for these projects.

SCWC bears the burden of justifying each component of its rate increase request. In its application, SCWC closed an extraordinary amount of CWIP to utility plant without explanation. ORA opposed SCWC's actions and recommended that SCWC be treated consistently with past Commission practice and the forecast CWIP disallowed. On cross-examination, ORA suggested that had SCWC properly characterized and explained, with supporting analysis and documentation, its proposal in its application, then ORA's recommendation might have been different.

SCWC's presentation on this issue has not complied with the Rate Case Plan decision. One theme of that decision is to "make more productive use of the early stages of the proceeding by requiring the utility to file all necessary information with the application." Utilities are also required to identify explicitly the "primary cost increases," and "all significant capital additions shall be identified and justified." SCWC's presentation on 2005 CWIP was non-existent, and only occurred when ordered to do so.

We are disappointed with SCWC's performance, and the unnecessary controversy and litigation that ensued, but we are aware of the acute need for the facilities represented in SCWC's 2005 CWIP budget. The Rate Case Plan provides for updating recorded amounts but only until 45 days after the application is filed. Due to these extraordinary circumstances, we will extend that deadline to include SCWC's rebuttal testimony, and allow SCWC to update its recorded CWIP to that date. This will allow SCWC to include $7,425,600 of $12,126,000 that remains in dispute with ORA for 2005. The disallowed portion, $4,700,400, can be included in SCWC's 2006 capital additions, along with the $3,264,000 that SCWC admitted would not be completed in 2005.

5.6. Adder for Design of Water Supply and Distribution Plant

This issue arose for the first time in ORA's report. Apparently, the water supply and distribution plant additions tables used in SCWC's application included an additional 10% increment for design and permitting. This increment was forecasted to occur in the year prior to the year in which SCWC planned to do the project. ORA opposed including $2.6 million of these charges in Region III for the test years.

SCWC presented its justification for this new increment in its rebuttal testimony. SCWC explained that the lead time for constructing water supply and distribution projects has increased substantially, and SCWC's former plan to design, permit, and build in one calendar year is no longer reasonable. SCWC "believes that design and permitting one year ahead of construction is a reasonable time period." To calculate design and permitting costs for a particular year, SCWC summed the forecasted construction costs for all water supply and distribution improvements for the next year, "and then a factor of 10% was applied to arrive at the cost of design and permitting." The resulting amount, i.e., 10% of the construction sum, was included in the previous year's capital budgets for all water supply and distribution improvements.

As noted above, the Rate Case Plan requires water utilities' GRC applications to include testimony on regulated plant in service, with supporting analysis and documentation, and all capital additions must be identified and justified. Also as noted above, SCWC bears the burden of proof in this proceeding. SCWC's application and testimony failed to identify this novel approach to forecasting design and permitting costs, and included no justification whatsoever.

SCWC's rebuttal testimony did not remedy these deficiencies. The City of Claremont points out that no individualized assessment or justification is made for design costs that reasonably can vary from project to project, and SCWC offered no studies or surveys to justify the 10% increment on an across-the-boards basis. Claremont concludes that the 10% adder is "little more than a gleam in the Company's eye."

Design and permitting costs are valid components of a water supply or distribution improvement project. SCWC has provided no evidence that 10% of total project costs bears any relationship to expected design and permitting costs. We can envision projects where 10% is excessive, and where 10% may be too little. Until SCWC provides us with a reasoned analysis for its proposed across-the-board adder, we will continue to require design and permitting costs to be justified on a project-by-project basis.

5.7. Urban Water Management Plan

State law requires water utilities to prepare an Urban Water Management Plan every five years, with SCWC's next such plan due in December 2005. The plan must include a 20-year forecast of systems demand, evaluation of existing sources to meet these demands, and an analysis of alternatives, including reclaimed water and conservation, to meet demand. SCWC budgeted a total of $225,000 to have a consultant prepare the report. Specifically, SCWC included in 2005 capital costs $25,000 in nine of the 12 customer service areas in Region III.

ORA opposed having an outside consultant prepare the plan because SCWC staff have prepared all past reports.

In rebuttal, SCWC explained that state law changes have made the plan "a much more critical tool in evaluating a utility's future water supply situation," and Proposition 50 funding is contingent upon the plan meeting specified criteria. SCWC indicated that its internal engineering staff is fully occupied with other essential tasks and are not "well-versed" in these recent changes. SCWC therefore decided to hire an outside expert to prepare its 2005 plan.

In its brief, ORA stated that SCWC had failed to justify the cost of hiring an outside expert to prepare the 2005 plan. SCWC had not presented any tabulation of the cost of having the plan prepared by SCWC staff, or any documentation for the outside contract. Absent this information, ORA could not compare the proposed costs with past costs, and ORA concluded that SCWC had not met its burden of justifying this plant addition.

The record contains no documentation for this capital project. No copy of the contract is included, nor is there any evidence that it was competitively bid, or how the budgeted amount relates to the actual contract amounts. The cost of SCWC staff preparing previous plans is also absent from the record. Even after ORA raised this as an issue, SCWC did not use its rebuttal testimony to provide any documentation for the record. On this basis alone, SCWC has failed to meet its burden of proof.

In fact, SCWC's rebuttal testimony raises more questions than it answers. The essence of its argument seems to be that previous plans were not important, they were "filed with little, if any, further reference being made to them," but now the plans are "critical," so apparently, SCWC concludes, outside experts are needed. Perhaps SCWC may need a consultant's services for some aspects of the plan, but surely SCWC itself is most familiar with its customers' long-term needs, and SCWC's internal staff should become well-versed with state law. Moreover, SCWC has not explained its rationale for dissociating this key long-term plan from SCWC's staff and the implications the plan might have for the future. While SCWC may have a sound rationale for its decision, SCWC has not included such an explanation in the record, or any financial documentation to justify this cost.

Accordingly, SCWC has not justified including the amount budgeted for preparing the 2005 Utility Water Management Plan as a 2005 capital addition. That amount is disallowed.

On December 15, 2005, the Commission adopted its Water Action Plan, which places greater reliance on the utilities' Water Management Plans. In light of the critical importance of a thorough Water Management Plan, we will allow SCWC another opportunity to justify the expenses for outside consultants. The requirements for such a request are set out in Appendix J.

5.8. Replacement Vehicles

SCWC filed its application based on ORA's 1995 vehicle replacement policy which calls for replacement at 100,000 miles. SCWC did not rely on the prices included in that 1995 policy, which are $15,000 for a light duty truck and

$19,000 for a passenger car. SCWC proposed about $36,000 per vehicle. Twenty-four such vehicles are at issue in this proceeding.

ORA opposed using the 1995 policy and instead recommended using the State of California, Department of General Services guidelines. ORA contended that those guidelines call for replacement at 150,000 miles.

In rebuttal, SCWC first pointed out that the guidelines call for replacement of "fleet sedans and light duty trucks" at 120,000 miles, not 150,000 as ORA had erroneously contended. SCWC also recommended that prior to implementing such a change in policy, the Commission should open a proceeding to consider this issue.

The guidelines are based on the State of California's more recent experience with automobiles. ORA contends that the General Services' 2003 guidelines are superior to its own 1995 staff policy memorandum. As between the two sets of guidelines, the more recent set is more likely to accurately model circumstances during the future test years. We are not persuaded that vehicle replacement policy requires a Commission proceeding. Therefore, we will first correct ORA's recommendation to conform to the policy of sedan and light truck replacement at 120,000 miles, and adopt ORA's recommendation of the 2003 guidelines.

5.9. Well Replacements

ORA opposed the following proposed well replacements and development project:

Apple Valley Customer Service Area	
Lucerne Valley	$474,200
Papago	$403,400
Tussing	$546,500
Morongo Valley Customer Service Area	

Bella Vista	$300,000
Vale	$441,200
Wrightwood Customer Service Area	
Water Supply Development Project	$500,000

ORA explained that its analysis was based on the Commission's General Order 103, which sets the water supply requirements:

> The quantity of water delivered to the distribution system from all source facilities should be sufficient to supply adequately, dependably, and safely the total requirements of all customers under maximum consumption . . .. Combined flow from sources of supply and storage capacity should be adequate for four consecutive days of maximum use. (General Order 103, § III, ¶ 4.)

SCWC disagreed with this standard and advocated a different standard. SCWC explained that based on its operating experience wells go out of service, and this fact should be reflected in the standard. SCWC stated that to dependably meet demand, each system should have the capacity to meet maximum day demand with the largest unit out of service. SCWC noted that the California Department of Health Services (DHS) has also proposed this standard in draft revisions to the California Waterworks Standards.

SCWC has brought forward a thought-provoking recommendation to change our General Order. Such a change, however, would have long-term and far-reaching implications for this water utility and all others regulated by this Commission.[18] Most notably, such a change could lead to substantial rate increases for customers. We direct Water Division to fully investigate the DHS

[18] Unlike the General Service vehicle replacement guidelines we agree to above, the Commission adopted General Order 103 for all water utilities, and flow requirements have substantial effects on the long-term size of resources in a water system. In comparison, whether to replace a vehicle is a minor and short-term decision.

proposal, confer with other water utilities and other stakeholders, and to make further recommendations as necessary.

In the meantime, however, SCWC has not presented any specific evidence that these wells are required to meet particular needs of these systems. SCWC has not challenged ORA's tabulation of supply sources and storage and its evaluation of whether the system meets the four-day maximum use standard. SCWC has also not presented us with a well-by-well justification for exceeding the General Order 103 standard.

On our own initiative, we have analyzed the data in the record for each system in which SCWC has requested an additional well to evaluate each system's supply under various conditions. Our goal was to better understand the consequences to each system of its largest unit being out of service. The complete analysis, with record citations for all data, is found in Appendix K.

We note that the four consecutive days of maximum use standard found in G.O. 103 is a minimum standard for all systems. Specific systems may require additional flow to address particular needs of that system. General Order 103 does not preclude such enhanced flow levels but only requires an explanation, which SCWC, unfortunately, has not provided. However, we have analyzed information contained in SCWC's and ORA's testimony and concluded that the record supports certain components of SCWC's request.

As shown in our analysis, all systems show capacity deficits with the largest unit out of service. However, the extent of the deficiency varies significantly among the systems:

System	Deficit with Largest Unit out of Service	
	Gallons/Minute	Percentage
Apple Valley North	417	64.15
Apple Valley South	105	10.50

Lucerne Valley	52	21.22
Morongo del Norte	5	5.26
Morongo del Sur	219	59.19
Wrightwood	98	10.41

Apple Valley North and Morongo del Sur show system deficits of about 60% with the largest unit out of service. The other systems vary from about 5% to 21%.

While deficits in the 5 – 21% range with the largest unit out of service could still be cause for concern about the ability of SCWC to meet its customers' needs, as we noted in the Water Action Plan, we expect that conservation and water use efficiency to be, in many cases, the most cost effective means of providing water supply. Without a thorough analysis of the probability of loss of the largest supply source and the availability of water conservation, including emergency conservation measures that could be imposed in the event of unit failure, we are not convinced that these deficit levels justify the development of additional wells for these areas.

In contrast to the other systems, Apple Valley North and Morongo del Sur face about 60% supply deficits should the largest unit in each system fail. Conservation, even emergency measures, cannot reasonably be relied on to meet this need.

Our analysis indicates that Apple Valley North and Morongo del Sur have much lower reserve capacity to meet the four day maximum flow requirements of G. O. 103 that the other areas we examined. We have determined that these areas face potential significant water supply shortages if they lose their largest source of supply. This concern is compounded by significant reliance on flowing water supplies, rather than storage, in these areas to meet the important public safety fire flow requirements.

ORA argued that SCWC should construct a 500,000 gallon storage system rather than develop the proposed well. We note that 78% of this storage (388,000 gallons) would be needed simply to meet fire flow requirements and would only leave the equivalent of approximately 20 gallons per minute to apply toward meeting the minimum GO 103 rules.

Based on this analysis, we find that it is reasonable for SCWC to develop the new wells in Apple Valley North and Morongo del Sur. We authorize SCWC place into ratebase the costs of the new well in Apple Valley North, $356,700 in 2005, and Morongo del Norte, $433,300 in 2006.

5.10. Main Replacements

ORA opposed SCWC's proposed main replacements in the Barstow, Morongo Valley, San Dimas, and Wrightwood Customer Service Areas. The Wrightwood replacements are most extensive, approximately 2.3 miles of eight-inch main for about $1.3 million. ORA stated that SCWC's only justification for these replacements was "leak history" and that the documents presented by SCWC did not support this conclusion. The leak data for Finch Road, the longest main replacement at nearly one mile, show no leaks from 2000 to April 2005.

In rebuttal, SCWC provided a better rationale for the projects. In the Barstow area, SCWC explained that while the leaks were few in number they were very large leaks requiring the replacement of several feet of main and several days of work. The City of Barstow is also planning to reconstruct the street which will excavate the top two feet of street surface and thereby make the main more susceptible to breaks.

In Morongo Valley, SCWC explained that it does not have leak data by location. Field staff, however, indicate that the listed projects represent a large number of the 230 leaks fixed in the last five years.

In San Dimas, SCWC stated that 19 leaks have occurred in the six-inch main on Rimhurst during the last five years, and these leaks have damaged 10 driveway approaches. The six-inch main will be replaced with an eight-inch main, which will allow the currently under-sized fire hydrants to be replaced. The Calora Street main is only 360 feet long but has had three leaks in six years, which meets the standard for replacement. Baseline Road had for main leaks in 2005 alone, and the City plans to resurface the road in 2006 which will place a five-year moratorium on street work.

In the Wrightwood area, SCWC explained that the long mains to be replaced are only two inches in diameter, and the Commission's General Order 103 sets four inches as the minimum diameter for mains. The small mains do not provide sufficient flow for customers and fire flow.

In its rebuttal testimony, SCWC completed its justification for these proposed main projects. Such justification would have been better placed in SCWC's initial testimony but we find that SCWC has provided sufficient justification for these disputed main projects and we will include in the authorized capital budgets for 2005, 2006, and 2007.

5.11. Demolition of No Longer Used Wells

SCWC proposed to demolish 13 no longer used wells at 10 sites, at a cost of approximately $30,000 per well. ORA opposed including the costs of six of these demolitions because the well sites contained no other utility facilities. ORA concluded that ratepayers would not benefit from demolition at the site, which the company was likely to sell. ORA also argued that these sites have been included in rate base long after the sites stopped producing water.

In rebuttal, SCWC explained that demolition of a no longer used well is necessary to prevent contaminants from entering groundwater via the well, and to protect SCWC from liability associated with a potentially dangerous hole in the ground. SCWC also provided the Chief of the DHS Drinking Water Field Operations Branch, who testified that that demolition is recommended for all wells that have not been in use for more than a year.

Ratepayers have benefited from these wells and the costs of demolition are a necessary component of well costs. We will therefore allow these costs to be included in revenue requirement.

5.12. Permanent Electrical Generators at Via Blanca (San Dimas) and Jefferies (San Gabriel)

SCWC requested $75,000 in 2005 for a permanent electrical generator to be located at the Via Blanca pump station. SCWC stated that 400 primarily residential customers are served by this station. Under current circumstances, SCWC would require about 1.5 hours to restore power with a portable generator.

SCWC also requested $80,000 in 2005 for a permanent generator at the Jefferies plant in San Gabriel. SCWC explained that Jeffries #4 is the highest producing well in the South Arcadia system, which serves 7,000 customers. With a system-wide power failure, SCWC would be unable to maintain the DHS system pressure requirement.

ORA opposed both requests. ORA stated that SCWC owns portable generators in both customer service areas, and these generators could be used to maintain system pressure until power is restored. ORA noted that there has been no history of power outages in either location, and that customers have not complained about low water pressure. ORA, however, agreed to security improvements, electrical upgrades, and new, faster polling SCADA, which will immediately notify SCWC of a power outage..

On cross-examination, SCWC disclosed that one of the generators requires a conditional use permit, and the local planning authorities are requiring noise and drainage studies prior to issuing the permit.

SCWC has not justified these costs. In the abstract, a dedicated, permanent stand-by electrical generator would have some reliability benefit for all well and pump facilities. Justifying the cost, however, requires some standard to determine which facilities should have stand-by generators. The need for these generators now, but not when the facilities were constructed, must also be explained. The tipping point is SCWC's difficulty getting a use permit for the generator. This calls into question whether SCWC will be able to install the generator at all. Given the lack of a cost-benefit analysis, and the uncertainty, SCWC has not met its burden of justifying these costs, which are disallowed.

5.13. Relocating Pressure Regulating Valve in San Dimas

SCWC requested $43,900 in 2007 to relocate a valve, which is currently housed in a vault in the middle of a busy intersection, to an adjacent sidewalk or lawn area. SCWC stated worker safety requires moving the vault. SCWC's workers access the vault four to six times per year, for one to four hours. This requires extensive traffic protection efforts, and results in traffic disruption. The vault was installed in the mid-1980's and traffic conditions have changed substantially since then. ORA opposed the cost, contending that ratepayers have paid once to install that vault and should not be required to do so again.

Worker safety and limiting traffic interruptions justify this project. We will allow SCWC to include it in its 2007 capital additions.

5.14. Outside Service Expense and Other Operation – Orange County

SCWC requested $62,100 based on "zero-based budgeting" for outside services in the Orange County customer service area. ORA used the recorded 2004 amount of $11,600 and escalated it to 2006 dollars to recommend $12,200. In rebuttal, SCWC observed that outside services for the Orange County customer service area varied from a high of $60,700 to a low of $11,600 in the years 2000 to 2004. SCWC escalated the recorded amount for 2000 through 2003 to 2004 dollars and, along with 2004 recorded, calculated an average, and escalated it to 2006 dollars. SCWC contended that the result of $41,976 is a "more reasonable approach to projecting the test year 2006 expenditure." We agree. While ORA's use of the recorded 2004 is the most recent data, that year's expense is also the lowest for the entire five-year period. We will therefore adopt SCWC's rebuttal testimony amount of $41,976 for outside expenses for the Orange County customer service area.

SCWC has presented a similar analysis for other operation expense. For this issue, SCWC initially requested $47,200. ORA used 2004 data to arrive at $34,200. SCWC, using the five-year period, calculated $43,470, which we adopt.

5.15. Tool Clearing

Consistent with its past practices, SCWC used a tool clearing account to distribute the costs of small tools to all labor costs as a means of allocating the cost of small tools to both expense and capital. Amounts are charged to the tool clearing account and then cleared by a charge of 1.8% to all labor costs. In addition to small tools, the following items are booked to the account:

a. 1.8% of general office depreciation expense for structures and improvements and office furniture and equipment;

b. power operated equipment;

c. tool, shop, and garage equipment; and

d. all depreciation expense for communications equipment

The tool clearing amount included in Region III headquarters was $13,945, which ORA opposed as being unsupported.[19]

SCWC presented a thorough description of the tool clearing account in its rebuttal testimony. Also included was a print-out of all amounts recorded in the account for January through June 2005. Some of the entries are obviously for small tool expenses, i.e., 6ft, 25lb digger bar, $194.85, but most of the entries are for "purchase cards" and list only retail stores and amounts, such as "Stephens – C&E Lumber Company, $42.43." Purchases are listed for a wide variety of retail establishments, mostly hardware related, but also including Rite Aid, Big 5 Sporting Goods, and Target. From an accounting perspective, it is not obvious how one would ensure that only purchases of small tools were recorded in this account. SCWC also does not explain the efficiencies associated with having its highly compensated employees individually purchasing tools from retail establishments. The entries provided by SCWC for the first six months of 2005 show 377 such purchases, so on an average day two of SCWC's employees made purchases at retail stores.[20]

Setting aside these relatively minor amounts, the most significant entry in the account is "Jan to June 2005 dep" which we gather means General Office depreciation (structures, office furniture and equipment) from January to June

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[19] The record is unclear if this is ORA's sole disputed amount regarding the tool clearing account. SCWC's testimony states that this tool clearing rate is applied to all SCWC labor costs. ORA's testimony, however, only singles it out as an issue for the Region III Headquarters. ORA's brief does not list an amount in dispute and recommends that the Commission "deny SCWC's request to apply the 1.8% tool clearing percentage." SCWC's Region III total labor expense is about $5.9 million. If SCWC applied the tool clearing percentage to all Region III labor, the amount in issue is about $110,000.

[20] Approximately 58 lines per page x 6.5 pages = 377 purchases/6 months.

2005. The amount shown is $193,312.54. This is 71% of the total $271,592 debited to this account for that time period, suggesting that this account is being used primarily to allocate general office depreciation, rather than small tools. In support of including general office depreciation, SCWC states "in line with the [Uniform System of Accounts], in addition to the cost of small tools, an amount of 1.8% of the General Office depreciation expense for structures and improvements and office furniture and equipment . . . is also booked to the account." SCWC does not explain why 1.8% of general office structure and furniture depreciation should be included in a tool clearing account, nor does SCWC provide a rationale for using the percentage, 1.8%, for this purpose as well as the allocation factor.

Mathematically, however, the tool clearing account appears to working as planned. The 2005 data support SCWC's assertion that the 1.8% allocation amount is in fact clearing the account. The balance at mid-year was only -$3,957, which suggests that the percentage is a suitable allocation factor.

Overall, however, SCWC's presentation on the tools clearing account raises significant questions. The entire process seems unnecessarily complex, which could lead to obscuring data, and ultimately making ratemaking more complex than necessary. The name of the account, tools clearing, is not representative of the bulk of the amount recorded in the account, namely, general office structures and furniture. Review of past Commission decisions shows no comprehensive discussion of this account or the propriety of including general office structure and furniture depreciation.

ORA recommends that we deny SCWC's request to "apply the 1.8% tool clearing rate" because SCWC "failed to explain how the percentage was calculated and ORA has received no workpapers, records, or other papers supporting the reasonableness of this percentage." We disagree that SCWC has not supported the 1.8%, as noted above. However, SCWC has not demonstrated that the amounts recorded in this account are tools.

As we discuss elsewhere in today's decision, SCWC will be filing its general office general rate case in 2006. In that filing, SCWC must comprehensively discuss the tool clearing account. ORA is also in the process of auditing SCWC's general office. That audit should carefully review the amounts recorded in the tool clearing account. The audit data should be used as basis for ORA to recommend future ratemaking methodologies for the cost of small tools.

For this Region III general rate case, we disallow SCWC's request to include the tool clearing amount in labor expense for the reasons set out above. Therefore, we disallow the $13,945 addition to labor expense in Region III.

5.16. Labor Expenses

The comparison exhibit of disputed issues shows that ORA and SCWC differ on $566,117 in forecasted operations, maintenance, and administrative and general labor expense.

In its brief, ORA states that the most salient issue causing the difference was ORA relying on actual salaries paid in 2004 and SCWC's practice of adding in salary for temporarily vacant positions. ORA contended that SCWC's practice amounted to employing "phantom" personnel by assuming a vacancy rate of zero.

SCWC did not address this issue in its brief. SCWC also did not identify any other issues that led to the differences between ORA's and SCWC's labor expense estimates. We will therefore apply our resolution of the vacancy rate issue to the entire disputed labor amount.

The Commission recently stated that, when used for forecasting labor costs, historic payroll amounts should <u>not</u> be altered to remove temporary vacancies:

> [W]hen payroll costs are brought forward, no adjustment should be made for temporary vacancies absent a showing of extraordinary circumstances. Most utilities will at some point have position vacancies caused by, *e.g.*, separations, retirements, or intentionally holding a position open for cost savings. To the extent there were vacancies in the recorded year, we should assume there will also be comparable vacancy savings in the test and escalation years.

San Gabriel Water Company, D.05-07-044, *mimeo.*, at page 10.

SCWC has presented no reason to deviate from this standard, and we will adhere to it. We will adopt ORA's estimates for labor expenses for all customer service areas, the district offices, and Region III headquarters.

5.17. Other Maintenance Expenses

SCWC requested the following increase in its expenses for other maintenance:

Adopted 2004	Recorded 2004	Requested 2006	Percent Increase
$2,331,200	$2,283,700	$3,100,800	36%

SCWC explained that it arrived at this forecast by using recorded maintenance costs from 2000 through 2004, and separating out the work order maintenance from the total. The remaining amount for each historical year was then escalated into 2004 dollars, averaged, and used to forecast similar, i.e., non-work order, maintenance for the test year. Work order maintenance for the test year was based on planned work orders for those years.

In its report, ORA objected to using "planned work orders" as relying on the "subjective judgment of the district manager, rather than any clear methodology." Based on data provided by SCWC, and representations as to which data were anomalous, ORA prepared other maintenance expense forecasts for each customer service area in Region III. ORA's total was $525,000 less than SCWC's.

In rebuttal, SCWC contended that its approach to forecasting other maintenance expense was "zero-based budgeting," which is "widely accepted" even though it "may or may not reflect past experience."

According to Merriam-Webster's dictionary,[21] "zero-based" means "having each item justified on the basis of cost or need." As described above, SCWC disaggregated its other maintenance costs into "work order" and "non-work order" maintenance and used historic averages to forecast the non-work order maintenance. SCWC did not use zero-based budgeting to forecast non-work order maintenance.

SCWC's claim of "zero-based" budgeting also falls short for the work order maintenance. Zero-based budgeting requires justification for each item, as compared to all other competing needs. As ORA points out in its brief, SCWC's testimony includes no such documentation. SCWC appears to have prepared a wish list rather than a comprehensive analysis of potential expenditures that begins with the assumption of zero. Such an analysis is particularly necessary to justify SCWC's substantial proposed increase in other maintenance expenses.

ORA used the best available historical data to prepare customer service area specific forecasts. SCWC has not shown that its forecasts are conceptually sound or sufficiently documented. We, therefore, adopt ORA's estimate of $2,576,000 for other maintenance expense.

5.18. Working Cash

Consistent with Standard Practice U-16-W, SCWC included depreciation and uncollectibles in the working cash calculation. ORA opposed this, relying on D.04-09-061. As with all other Class A water utilities, we will allow SCWC to conform to the standard practice until it is changed.

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[21] Collegiate Dictionary, 10th Ed., 1993, at page 1,376.

5.19. Contract to Serve the Calipatria Prison

On September 21, 1990, SCWC and the California Department of Corrections (Department) entered into an agreement for water services to the Department's prison near Calipatria. The agreement provided that SCWC would construct, at the Department's expense, a pipeline to SCWC's Calipatria water treatment plant. The agreement specified that the Department would pay to SCWC a water service rate comprised of a fixed and variable charge. The monthly fixed charge was capped at $1,480.50[22] and the variable charge was set initially at $0.2032[23] per 100 cubic feet of water delivered. The variable charge is subject to change but may not exceed "a fair, reasonable, customary, and non-discriminatory charge" for the Department's "equitable share" of SCWC's costs for water supply, operation, maintenance, and repair of facilities to provide water to the prison. Capital costs incurred prior or pursuant to the agreement are excluded from the variable charge.

SCWC filed this special contract with the Commission on June 5, 1991, pursuant to General Order 96-A, Section X.B. (Service to Governmental Agencies.) Since that time, it has been included in SCWC's tariffs.

The Department purchases about 40% of the output of SCWC's Calipatria water treatment plant, and is by far SCWC's largest customer in Region III.

As discussed elsewhere in today's decision, SCWC has recently constructed a significant upgrade to this plant. SCWC and the Department

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[22] As specified in the agreement, this amount is one-twelfth of one percent of the total "actual direct" cost of the pipeline paid by the Department. SCWC's tariff filing shows that the actual fixed charge worked out to be $1,377, which suggests that SCWC's actual costs were below its budget for the prison pipeline.

[23] The Department asserts in its brief that the variable rate has been increased twice but does not state the current rate.

discussed but were unable to resolve modifications to the Department's charges to recover the costs of the plant upgrade.

In its application, SCWC included service to the prison at the unmodified prices pursuant to the contract. ORA in its report opposed retaining the special contract rate for the prison and recommended that the prison pay the otherwise applicable tariff rate, which results in $428,463 in additional annual revenue for SCWC.

Shortly after ORA submitted its report, the Department intervened in this proceeding. In its closing brief, the Department explained that it had been excluded from any discussions with SCWC regarding the type of plant or extent of upgrades to be made, and that SCWC simply expected the Department to pay a share based on its usage. The Department stated that the cost estimates it has received from SCWC have "escalated at every turn" and no "meaningful cost data" has been forthcoming. The Department was similarly dissatisfied with SCWC's cost presentations in this proceeding, expressing surprise at the "obfuscation and lack of clarity in the submittal for the financial costs of the proposed new Calipatria plant." The Department estimated that it could construct a water treatment plant to meet the prison's needs for about $3 million. Extrapolating from that estimate, the Department suggested that a reasonable cost for SCWC's Calipatria plant would be about $7.5 million. The Department supported, however, ORA's recommendation that about $10 million should be included in rate base. The Department made no specific recommendation regarding any changes to the rate it pays.

In the overall stipulation, SCWC agreed with ORA that absent an alternative agreement, the prison should pay the otherwise applicable tariff rate.[24] In its reply brief, SCWC specifically requested for the first time that the Commission permanently suspend the prison's discounted tariff. SCWC, however, provided no legal analysis supporting its authority to make such a request in this docket.

We are in no position to consider SCWC's tardy request to suspend the Department's tariff in today's decision. SCWC should use the same process and notice requirements that it had used to seek approval, namely the advice letter process, to seek suspension of this special contract.

ORA and the City of Claremont also requested that shareholders be responsible for any revenue requirement "shortfall" caused by implementing changes to the prison rate. We agree. SCWC has done a poor job of dealing with this issue. The Department is SCWC's largest customer and is openly threatening to leave the system. SCWC should have resolved this issue well before it filed the application. A customer that comprises 40% of the usage must be handled carefully, and the balance between striking a special deal and losing a major customer is a delicate one. Such questions should not be recognized for the first time in rebuttal testimony. The record in this proceeding leaves the impression that SCWC is defaulting the issue to the Commission without a thorough analysis of the risks and a comprehensive plan to address any impacts. The Department currently pays almost $1 million each year. Losing a customer of this size could substantially reduce operating revenues. We do not intend to insulate SCWC from any operating revenue consequences of its delay in resolving this delicate balance.

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[24] SCWC did not agree to the ratemaking treatment for the change in revenue from the prison.

SCWC's Region III test year and escalation years analysis shall show the prison taking service at its projected usage levels at the otherwise applicable Region III tariff rate, unless and until the Commission approves a different rate for the prison.[25] In this way, SCWC will bear any shortfalls caused by delay in implementing a new rate for the prison.

5.20. Cost of Capital

SCWC requested a rate of return of 9.66% for test year 2006 and 9.67% for 2007. This reflected a capital structure that was 50% debt and 50% equity. SCWC's requested return on equity was 11.65% in all years. In testimony, SCWC's expert witness explained that 11.65% was necessary to meet the goals of attracting investment capital to SCWC and allowing the company to maintain its A+ credit rating.

SCWC's witness derived the recommended return on equity based on the results of four costing methodologies:

a. Ibbotson capital Asset Pricing Model (CAPM)

b. Risk Premium "Aa" through "Baa" Bond Yield Spread Analysis

c. Discounted Cash Flow

d. Fama – French Three Factor Model

SCWC adjusted the results from these market value methodologies upward to obtain asset book value rate of return. In its rebuttal testimony, SCWC's witness reduced the recommended return on equity to 11.30%, citing decreases in long-term interest rates and equity costs.

ORA did not dispute SCWC's proposed capital structure or cost of debt, but ORA disagreed with SCWC's approach and result for return on equity. ORA used the first three listed equity cost methodologies, averaged the results, and

[25] When the Commission approves a different rate, it shall address any on-going revenue deficiency.

recommended a return on equity of 9.35%. ORA opposed use of the Fama-French methodology because it is a variation on CAPM, and has not been generally accepted by the Commission. ORA also contended that SCWC's proposal to adjust the results of the models upwards to convert from a market to book valued rate of return is unnecessary because the market value has historically provided stable and reasonable estimates of equity costs.

SCWC bears the burden of proving that its current authorized return on equity of 9.90% should be increased to 11.30%. SCWC's own testimony showed that the twin objectives of the return on equity are to ensure that SCWC can attract capital and maintain its credit rating. SCWC's testimony also showed that, with the current return on equity of 9.90%, SCWC's stock price has increased over 20% in 2005 and that its credit rating is A+. These facts undermine SCWC's argument that its current return on equity must be increased to attract capital and maintain its credit rating.

ORA's studies show a range of equity returns between 7.63% and 9.89%. SCWC's primary criticism of ORA's recommendation of 9.35% is that it is based only on the Commission's past accepted methodologies, and does not reflect "ongoing innovations, creative adaptations and a general forward-moving learning curve," all of which, SCWC contends, support its recommended 11.30%. SCWC also compares ORA's current recommendation to the Commission's most recent authorized returns on equity for three other water utilities – all of which are about 10.1%.

We are not persuaded that SCWC's "innovations" are necessary to achieve a just and reasonable return on equity. Actual market data conclusively show that SCWC is currently able to attract capital and maintain its credit rating. Today's decision approves a rate increase of 5.81% which is above expected inflation. Overall, SCWC's test year operations will not be significantly different from its current operations. SCWC has presented us with no reason to expect that current market circumstances will change. Accordingly, we conclude that SCWC has failed to justify an increase in its return on equity.

ORA has presented us with a standard analysis showing a range of options between 7.63% and 9.89%, with the average of 9.35% as ORA's recommendation. As SCWC points out, however, this amount is substantially below the Commission's most recently approved amounts for other utilities. While ORA correctly observes that these recently approved equity returns were the result of settlement negotiations, ORA has not provided any rationale supporting a significantly lower return for SCWC. Therefore, based on the presentations of the parties, we find that neither SCWC nor ORA has justified changing SCWC's current 9.90% return on equity.

The Commission has wide latitude in ratesetting, and has previously considered the quality of management actions as one factor in setting return on equity. See California Water Services (Salinas District), D.04-07-033, and decisions cited therein. As noted throughout today's decision, we have found several management shortcomings. SCWC shows limited interest in efficiency improvements and aggressive cost cutting as alternatives to double digit rate increases. SCWC's request for two more senior vice presidents, with scant justification, well illustrates management's inattention to cost cutting. Throughout today's decision, we point out numerous issues where SCWC failed to justify its requested increase. SCWC's presentation of the Calipatria Niland Upgrade project costs and the failure to apply for State Revolving Fund loans,[26] the Department of Corrections contract, and the various updates to the

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[26] ORA testified that SCWC filed a pre-loan application in 1997 for funds to construct the Calipatria Niland Upgrade project but SCWC was "not ready" when the final application was due in 2001.

application, are all examples of issues where substantial management improvement is needed. The previously-cited California Water Services decision imposes a negative return on equity adjustment of 50 basis points for a pattern of regulatory violations, and discusses previous Commission decisions imposing 10 and 20 basis point negative adjustments for failure to pursue Commission policy directives.

We find that SCWC's management lapses are not as severe as California Water Services, and more in line with failing to pursue Commission directives. We, therefore, will reduce SCWC's authorized ROE by 10 basis points to draw management's attention to the need to zealously pursue cost cutting and efficiency improvements, and to better plan, construct, and document significant plant upgrades. We, therefore, conclude that SCWC's return on equity should be 9.80%.

Test Year 2006
Escalation Years 2007 and 2008

	Capital Structure	Cost	Weighted Cost
Debt	50.00%	7.66%	3.83
Common Equity	50.00%	9.80%	4.90
Total	100.00%		8.73

5.21. General Office Stipulation

In addition to the Bear Valley Electric system, SCWC owns and operates water systems in 16 operating districts throughout California. At SCWC's headquarters in San Dimas, California, the following services are provided for all operating districts: accounting, centralized customer service, risk management, employee development, finance, human resources, information service, water quality, and regulatory affairs. Collectively known as "general office," the costs for these services are apportioned to the various operating districts. The Commission conducts a rate case for general office every three years as set out in the Rate Case Plan. Pursuant to that schedule, SCWC files its general office along with its Region III GRC.

SCWC included its general office filing with its February 2005 Region III filing. In that filing, SCWC sought a 51% increase in total general office expenses from 2004 recorded to 2006 test year. One of the components of the requested increase was a 13% increase in employees, from 114 to 129. Two of these employees were Senior Vice Presidents.

Also in its application, SCWC asked that the schedule for filing its General Office be changed from filing with Region III to filing with its Region II, which is made in the year following Region III. SCWC stated that Region III is comprised of eight districts, while Region II has only one. SCWC contended that moving general office to the Region II schedule would help balance the workload among the years in the three-year rate case cycle.

Through negotiations, SCWC and ORA were able to agree on a general office allocation for this general rate case. The general office stipulation is Attachment 1 to this decision. ORA did not agree with SCWC that the general office filing should be permanently moved to Region II schedule.

The SCWC/ORA stipulation provides for 9.4% increase in total general office expenses from 2004 recorded to test year 2006. Region III's allocated share increases from $8,231,584 recorded in 2004 to $9,362,776 in test year 2006, a 13.7% increase:

	'06 SCWC Requested	Test Year '06 Stipulation	Region III '06 Allocation
Expenses	36,562,200	29,534,972	9,362,776
Rate Base	22,776,500	13,260,346	4,203,615

	'04 Adopted	'04 Recorded	'04 Adopted Allocation Region III	'04 Recorded Region III Allocation

Expenses	28,463,200[27]	26,988,800[28]	8,693,800[29]	8,231,584[30]
Rate Base	22,358,200[31]	22,147,000[32]		

Pursuant to Rule 51.1(e), the Commission stipulations must be reasonable in light of the record, consistent with the law, and in the public interest. The parties contend that the general office stipulation meets these standards, and we agree.

The record in this proceeding shows that SCWC sought a significant (over 50%) increase in its general office expenses for test year 2006. SCWC's evidence justifying this increase is scant. For example, SCWC provides less than one page of testimony (double spaced) to justify both of the proposed senior vice presidents. SCWC already has a CEO, two senior vice presidents, and seven vice presidents. Moreover, the proposed organization chart shows a top-heavy management structure, with two senior vice presidents having only one direct report each. Two senior vice presidents report to a third senior vice president, resulting in a four-level executive management chain. Accordingly, for the reasons discussed, the record does not include sufficient justification for SCWC's proposed increase in general office.

In contrast, the stipulated increase of $1.1 million dollars reflects an increase of 13.75% increase in expense allocation over a two-year period, or about a 7% increase for each year. Even after allowing for inflation, the

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27 D.04-03-039, Appendix A.

28 SCWC General Office Report, Table 3-A.

29 SCWC Supplemental Information, page 2.

30 Calculated by applying 30.5% to recorded total expenses.

31 D.04-03-039, Appendix D.

32 SCWC General Office Report, Table 3-G.

stipulated amount represents a modest actual increase in general office expenses. We, therefore, conclude that it is reasonable in light of the record.

As for the rate base component, the stipulated amount of $13,260,346 represents a substantial reduction from SCWC's proposed General Office rate base. We will, therefore, find that it is reasonable in light of the record.

The stipulation provides for reasonable amounts for general office expense and rate base and is thus consistent with the law. The public interest is served by resolving this issue without litigation for this general rate case, and conducting a thorough review of SCWC's General Office operations along with the 2006 Region II general rate case filing.

The parties did not resolve the issue of whether the General Office filing should be permanently rescheduled to accompany the Region II general rate case. We will defer resolution of this question until the completion of the Region II case. At that time, all interested parties will have had an opportunity to process the case with both Region II and General Office. This experience should inform the final resolution of this issue. Therefore, we will defer the General Office filing until 2006, and leave any further rescheduling to be resolved in that proceeding.

5.22. Overall Stipulation

On September 16, 2005, SCWC and ORA filed and served a second stipulation, which is Attachment 2 to today's decision. Overall, the stipulated resolution resulted in a $768,900 increase in Region III operating revenues, and left about $10.7 million worth of issues in dispute.

The stipulated issues included numerous relatively minor plant additions in all of the customer service areas. Six major plant additions are addressed by allowing SCWC to file advice letters, for a not to exceed amount, when the facilities are operational. The stipulation also includes a list of SCWC's proposed plant additions that ORA did not dispute, number of customers, average sales per customer, and SCWC's supply mix.

Operations and maintenance and administrative and general costs are also resolved. Finally, the SCWC stipulates that it does not oppose ORA's recommendation that the Calipatria State Prison should be subject to the Region III tariff rate, rather than a contractual rate.

To approve this stipulation, we must find that it is reasonable in light of the record, consistent with the law, and in the public interest. This stipulation resolves many issues in this proceeding, and results in a small fraction of SCWC's proposed increase in operating revenues. It is, therefore, reasonable in light of the record.

Pursuant to § 451, all SCWC charges must be just and reasonable. This stipulation is consistent with the law because it provides for ratemaking assumptions that are supported by the record. The stipulation is in the public interest because full evidentiary litigation of these issues would have required substantial resources of all the parties. The stipulation also allows the parties to focus their limited resources are the issues of greater impact and thus importance.

We, therefore, find that the overall stipulation meets the standards of Rule 51.5(e) and we adopt it.

5.23. Rate and Efficiency Comparison Metrics

The City of Claremont proposed that the Commission include in the hearing process a comparative rate survey and analysis of other water purveyors in the region. Such a comparison would begin with systematic operational comparisons with other purveyors, e.g., leakage rates, and efficiency assessments for personnel and resources. Such metrics would be helpful in evaluating management's success in economically meeting customers' needs.

We are intrigued by this proposal. Comparing efficiency among water purveyors could enable us to capture some of the benefits of a competitive market without the disruptions of deregulation. We direct our Water Division to consider ways that comparative metrics could be developed and used to assist us in our regulatory role.

On December 15, 2005, we adopted our Water Action Plan which includes increasing water utility efficiency, particularly with regard to energy consumption, as one of our important near-term goals. Consistent with that goal, we invite all Class A water utilities to develop and propose efficiency incentive rate mechanisms. We are primarily interested in energy efficiency, but we also encourage mechanisms that create incentives for operational efficiencies such as management productivity, and overall cost reductions, while maintaining reliability and customer service. Among the broad range of mechanisms we suggest utilities consider are ROE enhancements for meeting specific standards or mechanisms that share cost savings between ratepayers and shareholders. We encourage innovative proposals that require a minimum of administrative oversight. Such proposals may be brought forward in a general rate case or other appropriate filing.

6. Categorization and Need for Hearings

In Resolution ALJ 176-3147, dated February 10, 2005, the Commission preliminarily categorized this proceeding as ratesetting, and preliminarily determined that hearings were necessary. The categorization is affirmed, and hearings were duly held.

7. Comments on Proposed Decision

The proposed decision of the assigned Administrative Law Judge (ALJ) was mailed to the parties in accordance with Pub. Util Code § 311(d) and

Rule 77.1 of the Commission's Rules of Practice and Procedure. Comments were filed on December 5, 2005, and reply comments were filed on December 12, 2005.

Substantive comments were submitted by ORA and SCWC. The City of Claremont submitted a comment which did not raise any specific issues. Neither ORA's nor SCWC's comments complied with Rule 77.3 and included a list of proposed changes and proposed findings of fact and conclusions of law. The absence of specific recommended changes impeded the evaluation of comments, as well as any actual changes to the proposed decision.

ORA contended that the proposed decision should be clarified to prevent double-counting of capital projects included in both the 2005 construction work in progress amount as well as the 2005 capital budget. ORA identified no specific projects or amounts that were included in both budgets. Consequently, we are not able to enact any correction to the proposed decision. ORA also requested clarification that SCWC was allowed to include in rate base only actual 2006 construction work in progress, and not a forecasted amount. This proposed clarification is inconsistent our ratemaking methodology, which is based on a forecasted test year, in this case, 2006. All amounts for 2006 are forecasts by definition.

ORA also criticized SCWC for offering new evidence in rebuttal testimony. ORA stated that this "last minute supplemental material" undermines the Commission's requirements for fair notice and due process. We agree. The Rate Case Plan, discussed above, requires the utility to provide complete information early in the process. As noted throughout today's decision, SCWC has failed to comply with this requirement.

SCWC provided several comments on the proposed decision. Each issue is summarized below in italic print and our resolution of the issue follows:

1. *Public Participation Hearings*

The two minor proposed edits have been incorporated.

2. Capital disallowances where SCWC requests opportunity to reapply

SCWC requested clarification that where its requested capital expenditures[33] have been disallowed for failure to present sufficient documentation, it may seek to justify such amounts in a future application. SCWC may request recovery for these expenditures in a future application, subject to reasonableness review; only prudently incurred capital costs will be allowed into rate base, and if SCWC's showing is no stronger than in this application, the result will again be no recovery.

3. Calipatria Pump Station

SCWC stated that Exhibit 14 contained a "reference" to the items for which no documentation was provided. Review of the cited page, however, shows no bid information, cost estimates, or general work order. The disallowed amounts do not appear on the page. The referenced page provides no basis for altering the proposed decision.

4. In-Line Pump Station

SCWC contended that the disallowed amount, $77,167, was included in the post-application amount that had been disallowed elsewhere in the proposed decision, resulting in a double-counted disallowance. The amount, however, is discussed in ORA report and attributed to the SCWC's application. (See Exhibit 41 at 5-23 to 5-25.) Thus, the record does not support SCWC's assertion that the amount was added after the application such that double-counting would occur.

5. Capital Overheads

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[33] The specific disallowances for which SCWC sought such clarification are: Calipatria plant water transmission main, Calipatria plant engineering costs, well replacements, and electrical generators.

In its application, SCWC used a 22.5% adder to recover capital overheads. Because SCWC's capital budget fluctuates, the proposed decision instead adopted a methodology using a set amount (based on 2004 actuals) and allowed the percentage adder to fluctuate to recover the set amount. SCWC commented that this methodology assumed that all projects were opened and closed in a single year, and that the proposed decision failed to adjust the 2005 budget for disallowed capital projects. SCWC did not, however, demonstrate fundamental flows in the basic approach of holding the amount of overhead to be allocated relatively constant through the years. We developed this methodology as an interim measure pending full review of the overhead costs and allocation process in SCWC's next general office GRC, and SCWC has not shown that it is inappropriate for this limited purpose.

SCWC points out that the 2005 amount should be corrected to remove work performed in prior years as these plant accounts have been closed. Our objective is to adopt this interim methodology on a going-forward basis only. Consequently, we have incorporated SCWC's requested correction.

6. Contingency Adder

We have revised this discussion to clarify that we are setting the contingency budget based only on unanticipated projects, with the objective of strongly discouraging reliance on this fund for budget overruns.

7. Urban Water Management Plan

SCWC did not identify any errors in the proposed decision but rather reargued its previously-stated position. Consistent with Rule 77.3, such comments are given no weight.

Since issuing the proposed decision, the Commission adopted the Water Action Plan, which attaches greater importance to the Water Management Plan. In light of this development, the text of the decision has been altered to allow

SCWC another opportunity to justify its outside expenses for its Water Management Plan.

8. Labor Expenses

SCWC stated that the $566,117 disallowance was an error because only $68,000 was due to the Morongo Superintendent position. The proposed decision, however, attributes the difference to ORA's and SCWC's vacancy rate forecasts. SCWC assumed a zero vacancy rate and ORA assumed that the 2004 vacancy rate was a reasonable estimate for the future vacancy rate.

SCWC stated that the proposed decision relies on a San Gabriel Valley decision where the Commission initially disallowed vacant positions but then allowed an annual advice letter "for positions filled that year." Rather than the across-the-board update SCWC suggests, Ordering Paragraph 3 of D.05-07-044 excludes specific planned new hires from San Gabriel's revenue requirement pending actual hiring. When these authorized new positions are filled, San Gabriel is then allowed to add the costs to revenue requirement via advice letter. These advice letters do not undermine the basic premise that a zero vacancy rate is an unreasonable assumption.

9. Other Maintenance Expenses

SCWC contended that the proposed decision was "wrong" to adopt ORA's expense estimate because it was based on recorded maintenance expense, in a year where the Commission had reduced the adopted amount in an earlier decision. Because the proposed decision did not discuss the reduced adopted amount when relying on the recorded amount, SCWC concludes that ORA's estimate should not be adopted. Although unstated, presumably SCWC would have the Commission adopt SCWC's forecast. SCWC's forecast was subjective and amounted to a "wish list" rather than a comprehensive analysis, and ORA used actual, recorded maintenance expense, not the reduced adopted amount.

SCWC failed to justify its forecasting methodology, and ORA's methodology was reasonable.

10. Calipatria Prison Contract

SCWC identified no factual or legal errors in the proposed decision, but described the result as "unfair." SCWC is responsible for ensuring that it provides reasonable service to the prison. ORA contended that exempting the prison from any costs of the new water treatment plant was unreasonable, and the proposed decision adopted ORA's position. Should SCWC negotiate, and the Commission approve, an alternative tariff rate for the prison, any revenue requirement deficiency must be documented and addressed.

11. Return on Equity

SCWC seeks an award of 10.1% return on equity, consistent with recent Commission decisions for other Class A water utilities. No law or policy requires the Commission to set identical returns on equity for all Class A water utilities. SCWC also objected to the 15 basis point negative adjustment for management shortcomings, and argued that it was unsupported in the record. Today's decision includes numerous specific references supporting the adjustment. We have nevertheless reduced the adjustment to 10 basis points to correspond to the lower end of the range in the cited decisions.

In reply comments, the City of Claremont opposed SCWC's and the proposed decision's reliance on information supplied for the first time in rebuttal testimony and contended that such reliance violated basic notions of due process and the rate case plan. The City of Claremont also objected to allowing SCWC any further opportunities to pursue disallowed items in future rate cases, particularly for any region other than Region III.

ORA replied that SCWC's comments essentially re-argued positions from its testimony and briefs, rather than pointing out errors of fact or law in the proposed decision. ORA also objected to re-litigating issues in future rate cases.

SCWC's reply comments confirmed that no capital projects allowed in 2005 additions were duplicated in the construction work in progress allowance. SCWC also raised a new issue, its low income rate program memorandum account. Raising a new issue in reply comments violates Rule 77.5, and we are in no position to evaluate it at this point in the proceeding.

8. Assignment of Proceeding

Dian M. Grueneich is the Assigned Commissioner and Maribeth A. Bushey is the assigned ALJ.

Findings of Fact

1. SCWC failed to comply timely with the Rate Case Plan decision's requirements to submit a complete application with supporting documentation and analysis.

2. The parties submitted a stipulation which resolved the general office allocation for purposes of Region III and this rate case. The stipulation did not resolve the issue of rescheduling SCWC's general office general rate case.

3. On September 16, 2005, ORA and SCWC jointly filed an stipulation resolving numerous issues in this proceeding and providing for a $770,000 increase in 2006 test year revenue requirement, with issues accounting for $10.7 million in revenue requirement remaining in dispute.

4. With its current return on equity of 9.9%, SCWC is able to attract capital and maintain its credit rating.

5. ORA's studies show a range of equity returns between 7.63% and 9.89% would be reasonable, and are based only on the Commission's accepted methodologies. This range is well below the most recent return on equity amounts the Commission had adopted for other Class A water utilities.

6. SCWC's projected cost of the Calipatria Niland Upgrade project increased by 7.3% between the time it filed its application and its rebuttal testimony.

7. The Rate Case Plan decision precludes updates to general rate case applications, with two exceptions.

8. SCWC provided no documentation to support its request for $500,000 (with overheads) for grading, paving, and SCADA.

9. SCWC provided two inconsistent bid evaluating sheets to support its request for electrical, instrumentation, and chemical feeding equipment, but explained the inconsistencies on cross-examination.

10. SCWC provided no documentation to support its request for $198,839 for electrical gear and finished water pumps at the Calipatria pump station.

11. SCWC provided documentation to support its request for $117,918 of change orders on the two 1.1 MG reservoirs at Calipatria, bringing the total for this item to $1,103,236.

12. SCWC provided no support for $77,167 of the $555,102 it sought for an in-line pump station to serve the prison. The remaining amount, $477,935 comprised of a vendor bid for $426,100 and $51,835 in SCWC direct services, was supported by a SCWC General Work Order.

13. SCWC awarded the contract for the Calipatria Niland transmission main to Roland Construction, the second lowest bidder in the second round, but included no general work order implementing this contract, and Roland Construction's second bid was 17% higher than its first.

14. ORA's recommendation to use Roland Construction's initial bid and excluding any SCWC direct costs is too punitive.

15. SCWC provided no record references to documentation to justify its request of $1,405,000 for engineering and consulting costs.

16. On the Commission's own initiative, review of the record showed evidence supporting $1,177,600 out of the requested $1,405,000 for engineers and consultants.

17. SCWC sequentially used two contractors, both on a time and materials basis, to build the office/lab/electric building for a total of $491,429. SCWC provided general work orders supporting both contracts but ORA opposed allowing the second due to inadequate explanation for the two-contractor process.

18. SCWC's unsigned and invalid general work order for Backwash Sludge Basins for $269,194 does not justify its request for $200,000 for backwash decant basins.

19. SCWC has not justified its request for the following components of its Calipatria Niland Upgrade project:

Paving, grading, and SCADA	$ 408,000
Pump Station, Calipatria	$ 198,839
Inline Pump Station	$ 77,167
Water Transmission Main	$ 100,960
Engineering and Consulting	$ 227,400
Backwash Decant Basins	$ 200,000
TOTAL	**$1,212,366**

20. The Calipatria Niland Upgrade project total allowed costs are $11,859,954.

21. Using an overhead pool and a fixed allocation factor methodology to distribute indirect capital overheads is inappropriate where annual capital budgets or annual total indirect costs materially vary.

22. SCWC's 2005, 2006, and 2007 capital budgets are anomalously high, and an allocation factor should be calculated for those years, pending a comprehensive analysis of this issue in the next general office rate case.

23. The following overhead allocation factors are supported by the record and should be adopted:

	2005	2006	2007
Gross Additions	31,670	14,550.9	17,142.9
Indirect Cost Estimate	2,870.0	2,950.0	3,050.0
Allocation Factor	9.1%	20.3%	17.8%

24. SCWC has not justified using its contingency budget for project cost overruns but has justified using the fund for unanticipated projects. A 5% adder is reasonable for unanticipated projects.

25. SCWC's application forecast closing an extraordinary amount construction work in progress to a plant accounts in 2005. This issue was not identified or explained as required by the Rate Case Plan.

26. Due to extraordinary circumstances, SCWC's recorded 2005 construction work in progress should be updated to the amount shown as recorded in its rebuttal testimony, $7,425,600. The disallowed portion should be included in 2006.

27. On the Commission's own initiative, analysis of record evidence supports the requested wells in the Apple Valley North system ($356,700) and Morongo del Sur system ($433,300).

28. SCWC did not justify its request for $225,000 for outside consultants to prepare the 2005 Urban Water Management Plan.

29. The Department of General Services 2003 vehicle replacement guidelines are more recent than ORA's 1995 vehicle replacement policy, and ORA supports the Department's guidelines.

30. SCWC's rebuttal testimony adequately supported its request for main replacements in Barstow, Morongo Valley, San Dimas, and Wrightwood Customer Service Areas.

31. SCWC justified including the cost of six well demolitions in revenue requirement.

32. SCWC has not demonstrated that permanent stand-by electric generators are needed at Via Blanca or Jefferies.

33. Worker safety and traffic convenience justify relocating the pressure regulating valve in San Dimas.

34. SCWC's rebuttal testimony calculated outside services and other operation expense for the Orange County customer service area based on recorded amounts for 2000 to 2004, which is a reasonable approach.

35. SCWC has not shown that the tool clearing account is allocating the cost of small tools.

36. SCWC did not use zero-based budgeting to forecast non-work order or work order maintenance.

37. ORA's forecast of other maintenance expense is based on best available historical information and is reasonable.

Conclusions of Law

1. SCWC filed this Region III general rate case pursuant to the new three year GRC cycle requirements for Class A water utilities set forth in § 455.2 and implemented by the Commission under its new Rate Case Plan in D.04-06-018, which provided for an 11-month expedited schedule for January 2005 filings.

2. The Commission should consider requiring all Class A water companies to prepare and publish comparative rate and efficiency metrics.

3. SCWC bears the burden of proving that its proposed rate increases are "justified," with testimony, including supporting analysis and documentation, describing the components of its proposed increase. All significant changes from the last adopted and record amounts must be explained, and all forecasted amounts must include an explanation of the forecasting method.

4. SCWC has not met its burden of proving that its return on equity must be increased.

5. ORA has not justified changing SCWC's current 9.9% ROE.

6. The Commission has previously made negative adjustments to a public utility's return on equity in response to management actions.

7. SCWC's return on equity should be adjusted downward by 10 basis points for management's inattention to efficiency improvements and cost cutting, poor planning and budgeting of and failure to seek outside funding for the Calipatria Niland Upgrade project, and mishandling of the Department of Corrections contract.

8. The following capital structure and return should be adopted for SCWC:

Test Year 2006
Escalation Years 2007 and 2008

	Capital Structure	Cost	Weighted Cost
Debt	50.00%	7.66%	3.83
Common Equity	50.00%	9.80%	4.90
Total	100.00%		8.73

9. Updates to general rate case applications are only allowed within 45 days of filing for additional recorded data, or in extraordinary circumstances. SCWC's request to update its total for the Calipatria Niland Upgrade project meets neither standard for updating, and should be denied.

10. SCWC has failed to justify its request for $500,000 for grading, paving, and SCADA equipment at the Calipatria Niland Upgrade project.

11. SCWC's cost estimates for electrical, instrumentation, and chemical feeding equipment are justified in the record.

12. SCWC did not meet its burden of justifying $198,839 for electrical gear and finished water pumps at the Calipatria pump station.

13. SCWC justified including $1,103,236 in rate base for two 1.1 MG reservoirs at Calipatria.

14. SCWC should be authorized to include in the costs for the Calipatria Water Treatment Plant an in-line pump station in the amount of $477,935, reflecting a disallowance of $77,167 to SCWC's request.

15. The lowest bid for the Calipatria Niland transmission main, plus SCWC's direct costs, is a reasonable estimate for the cost of this transmission main, and should be adopted.

16. SCWC's request for the cost of engineering and consulting services for the Calipatria Niland Upgrade project, less the unsupported $227,400 contract, should be adopted.

17. SCWC's two general work orders for its office/lab/electrical building support allowance of $491,429 for this item.

18. SCWC's request for $200,000 for backwash decant basins is unjustified and should be denied.

19. SCWC should be allowed a 5% adder to its annual capital budgets for unanticipated projects.

20. Pursuant to the Rate Case Plan, extraordinary circumstances support allowing SCWC to update its recorded 2005 construction work in progress to the amount shown as recorded in its rebuttal testimony, $7,425,600.

21. SCWC should be authorized to include in rate base new wells in the Apple Valley North and Morongo del Sur Systems.

22. SCWC provided no justification for its 10% adder for design of water supply and distribution plant, and the request should be denied.

23. SCWC's request for $225,000 for outside consultants to prepare the Urban Water Management Plan should be denied, but SCWC should be allowed to justify these costs as provided in Appendix J.

24. SCWC should be allowed to recover the costs of replacing vehicles consistent with the Department of General Services vehicle replacement guidelines.

25. SCWC has not shown that the water supply standard found in General Order 103 should be modified; however, ORA should investigate the

Department of Health Services alternative proposal and make such recommendations as are necessary.

26. SCWC request for main replacements in Barstow, Morongo Valley, San Dimas, and Wrightwood Customer Service Areas should be granted.

27. The cost of six well demolitions should be included in revenue requirement.

28. SCWC has not justified the need for permanent stand-by electric generators are needed at Via Blanca or Jefferies.

29. SCWC's revenue requirement should include the costs of relocating the pressure regulating valve in San Dimas.

30. We should adopt $41,976 for outside services for the Orange County customer service area, and $43,470 for other operation expense.

31. The 1.8% small tool clearing account allocation on Region III headquarters labor should be disallowed, pending a thorough review of this account in the next general office rate case.

32. Consistent with Commission precedent, when used for forecasting labor costs, historic payroll amounts should not be altered to remove temporary vacancies.

33. ORA's forecast of other maintenance expense should be adopted.

34. Consistent with Standard Practice U-16-W, SCWC should include depreciation and uncollectibles in the working cash calculation.

35. SCWC should use the advice letter process if it wishes to suspend its special contract with the Department of Corrections and Rehabilitation.

36. SCWC's 2006, 2007, and 2008 revenue requirement should reflect service to the prison at the Region III tariff rate.

37. The General Office and Overall Stipulations are reasonable in light of the record, consistent with the law, and in the public interest. Both Stipulations should be approved.

O R D E R

IT IS ORDERED that:

1. Southern California Water Company (SCWC) is authorized to file in accordance with General Order 96-A, or successor general order, and to make effective on not less than five days' notice, the revised tariff schedules for 2006 included as Appendix E to this order. The revised tariff schedules shall apply to service rendered on and after their effective date.

2. Advice letters for escalation year rate increases for 2007 and 2008 shall be filed in accordance with General Order 96-A, or successor general order, no later than 45 days prior to the first day of the escalation year. The filing shall include appropriate work papers. The increase shall be reduced if SCWC's rate of return on rate base, adjusted to reflect rates then in effect, normal ratemaking adjustments, and the adopted change to the pro forma test, for the 12 months ending September 30 of the preceding year, exceeds the amount authorized in this decision. The advice letters shall be reviewed by the Water Division for conformity with this decision, the Rate Case Plan decision (D.04-06-018), and shall go into effect upon Water Division's determination of compliance, not earlier than the first day of the escalation year, 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 may allow the tariffs to go into effect but require that all amounts so collected be subject to refund. Water Division may reject or

suspend the advice letter if it finds that the proposed increase does not comply with this decision or other Commission requirements.

3. The General Office Stipulation, attached hereto as Appendix B, is approved and adopted. The parties shall comply with the terms of the Stipulation.

4. SCWC shall file its next general office general rate case with its Region II filing in January 2006. SCWC shall comply with Ordering Paragraph 6 of Decision 04-03-039, regarding a thorough cost study and analysis of SCWC's corporate affiliates. SCWC shall also prepare a comprehensive study of the costs it assigns to the capital overhead pool. The study shall include, but not be limited to, justification of the level of expenses in relation to SCWC's historic overhead rate (12% in 1991) as well as to comparable water purveyors, including regulated and publicly owned water utilities. SCWC shall also prepare a comprehensive study of its tool clearing account, focusing on costs assigned for recovery through the account. For both the overhead and tool clearing accounts, SCWC shall assess whether alternative ratemaking methodologies would be better suited for addressing these costs. Further scheduling of SCWC's general office filings shall also be resolved in that proceeding.

5. The Overall Stipulation, attached hereto as Appendix C, is approved and adopted. The parties shall comply with the terms of the Stipulation.

6. SCWC is authorized to seek recovery of outside costs necessary to prepare its Urban Water Management Plan as set forth in Appendix J.

7. The Water Division shall consider developing rate and efficiency metrics to compare Class A water utilities to other water purveyors in California.

8. Application 05-02-004 is closed.

This order is effective today.

Dated January 12, 2006, at San Francisco, California.

MICHAEL R. PEEVEY
President
GEOFFREY F. BROWN
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
Commissioners

I reserve the right to file a concurrence.

/s/ JOHN A. BOHN
Commissioner

APPENDIX A – LIST OF APPEARANCES

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(END OF APPENDIX A)

Concurring and dissenting in part of Commissioner Bohn of Southern California Water Company.

I concur in the results of this decision but disagree with some of the reasoning imposing a downward adjustment to the cost of capital because of management shortcomings. Though finding that 9.8% is within the bounds of reasonableness, changing Southern California Water Company's rate of return when the decision finds that neither Southern California Water Company nor the Commission's Office of Ratepayer Advocates had justified a change from the current level of 9.9%. Such penalty adjustment confuses a very real need to insist on an effective management, with the Public need to assure access to adequate capita;

By lowering the rate of return we allow Southern California Water Company to earn we have, in effect, imposed a penalty for poor management quality. I am not against taking punitive action if we believe that a utilities behavior warrants sanctions. I am particularly concerned that sufficient notice was not given to Southern California Water Company that a penalty for poor management was under consideration and that the Southern California Water Company was not able to respond to specific claims of poor quality management.

In my experience, poor management has its own penalty. This is aptly demonstrated in the decision where many of Southern California Water Company's requests are denied because the company was unable to provide sufficient documentation and justification for the requested items. Companies must sustain their burden or justify expenditures before we will allow them to be recovered in rates.

There are several key areas of this decision that, in light of the Commission's recently adopted Water Action Plan, merit additional comment. One of the four key principles in our Water Action Plan was "Highly Reliable Water Supplies."[1] To further this key principle, this decision contains a detailed analysis of reliability that takes a more sophisticated look at water reliability by looking at what the supply situation would be should a utility lose its largest source of water in a particular area. The analysis contained in this decision begins to address the issue of how much capacity above and beyond that needed to meet the minimum reliability standards outline in our General Order 103 is appropriate. Applying this analysis, we find that additional investment in new water sources in two areas is warranted. This additional infrastructure investment will better ensure the reliability of water supply to consumers.

The Water Action Plan envisions a new and expanded role for a Water Management Program that is filed with each rate case. The Commission is seeking to use this Water Management Program as a basis for pre-approval of major water supply projects and to evaluate current infrastructure investments.

> Included within the Water Management Program should be a long-term procurement plan, including appropriate water conservation and efficiency estimates, to enable more efficient planning for future investment needs. As part of the long term procurement section, alternative financing techniques (e.g., loans, subsidies, project financing) could be evaluated. The long term procurement plan should include planning for major investments required to upgrade or replace existing water utility infrastructure, accelerate cost-effective conservation investments, fund installation of water meters capable of measuring water use by individual users, and where appropriate the installation of Advanced Metering technologies. Plans should take into consideration the impact that water

[1] California Public Utilities Commission, *Water Action Plan*: Adopted: December 15, 2005, page 3.

> development has on land use, and facilitate coordination between water IOUs and local governments. *CPUC Water Action Plan* (page 12)[2]

With our new emphasis that the Water Management Program will play in our regulatory process and in our evaluation of the reasonableness of additional capital investment in infrastructure, we anticipate a corresponding increase in the amount of effort that each utility expends in developing this plan. This decision allows Southern California Water Company to seek recovery of these costs up to $112,500 per year for the hiring of outside expertise necessary to prepare a Water Management Program that is robust enough for its new, more central role, in our regulatory process.

In sum I support the results of this decision. However, I cannot support the rationale for reducing the return on equity by 10 basis points to 9.8% because of poor management. Given that the cost of capital is set at a level to attract the funds it takes a utility to service its customers and run its business, a separate penalty would be more appropriate in these types of cases.

/s/ John A. Bohn
Commissioner

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[2] Ibid; page 12.