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Decision 06-03-015 March 2, 2006

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the Commission's Own Motion to Develop Rules and Procedures to Preserve the Public Interest Integrity of Government Financed Funding, Including Loans and Grants, to Investor-Owned Water and Sewer Utilities.	Rulemaking 04-09-002 (Filed September 2, 2004)

OPINION ADOPTING RULES TO GOVERN THE RECEIPT AND USE OF ALL FUTURE STATE GRANT FUNDS RECEIVED BY ALL CLASSES OF REGULATED WATER UTILITIES

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OPINION ADOPTING RULES TO GOVERN THE RECEIPT AND USE OF ALL FUTURE STATE GRANT FUNDS RECEIVED BY ALL CLASSES OF REGULATED WATER UTILITIES

1. Summary

This decision adopts rules that shall govern the accounting and ratemaking treatment for all future state grant funds received by all classes of regulated water utilities. With the passage of Proposition 50 - The Water Security, Clean Drinking Water, Coastal and Beach Protection Act of 2002 (Proposition 50), for the first time California's investor-owned water utilities applied for state grant funds. Receipt of these funds by Commission-regulated water utilities will allow the utilities and their customers to benefit by providing cost-free funds for needed investments in water supply, treatment, and security. Under Proposition 50, regulated water utilities can apply to the California Department of Health Services (DHS) and the California Department of Water Resources (DWR) for approximately $430 million in grants.

The draft decision proposed to adopt rules specific to the receipt of Proposition 50 funds. By Assigned Commissioner's Ruling (ACR) on January 26, 2006, the scope of the decision was expanded to adopt rules for all future state grant funds received by all classes of regulated water utilities. This change is within the scope of the rulemaking and advances the objectives of our Water Action Plan adopted December 15, 2005. The change is made in response to the numerous new bond measures recently proposed by Governor Arnold Schwarzenegger under his infrastructure plan and set forth in Assembly and Senate bills, AD 1839 (Laird) and SB 1166 (Aanestad and Machado), Flood

Protection and Clean, Safe, Reliable Water Supply Bond and Financing Acts of 2006 and 2010.[1]

Pursuant to Article XII, Section 6 of the California Constitution, the Public Utilities Code, and our own rules and regulations, the Commission prescribes all accounting and ratemaking practices for investor-owned water utilities.[2] The rules we adopt here are designed to preserve the public interest integrity of future state grant funds by ensuring that investor-owned water utilities and their shareholders will not be able to profit in any way through the receipt of public funds. Our rules meet the objective we set in this rulemaking, that "Utilities should not receive a windfall nor should shareholders benefit from grant-funded facilities even if, years later, the utility itself or the individual, grant-funded facility is subsequently leased or sold." (R.04-09-002, page 2.)

The Division of Ratepayer Advocates (DRA) requests that a new rulemaking be opened to develop a standardized set of rules for government-financed loans, as discussed in the original rulemaking, and that in the interim, the rules determined in this rulemaking be applied. We do not adopt this proposal but do direct that our Water Division incorporate the development of

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[1] All parties were given notice of this change in a January 26, 2006 ACR and afforded the opportunity to file comments on whether there is a need to further develop the record. The California Water Association (CWA) and Park Water Company (Park) filed comments supporting the change in scope of the March 21, 2005 Scoping Memo and Ruling; no party filed comments objecting to the change or requesting to further develop the record.

[2] Specific Public Utilities Code Sections applicable to this proceeding are: Section 451, which requires the Commission to set just and reasonable rates for utilities; Section 770(b) which requires that the Commission set standards consistent with those of DHS; Section 790, which provides for the disposition of net proceeds from the sale of utility property; and Section 851, which requires Commission authorization for the encumbrance or disposition of utility property.

draft rules governing government-financed loans in our next rulemaking regarding the regulation of water utilities.

2. Background - Procedural History

On September 2, 2004, the Commission issued this Order Instituting Rulemaking (OIR) and directed that it be mailed to all investor-owned water and sewer service utilities under its jurisdiction, as well as DHS, the Commission's Office of Ratepayer Advocates (ORA), and the California Water Association (CWA). Attached to the OIR were DHS's Draft "General and Specific Criteria for Proposition 50 Funding" and its "Grant Opportunities for Small Water Systems," as well as the Commission's questions for respondent utilities and proposed rules to govern the proceeds for any government grant funds received by investor-owned utilities.

The OIR required all Class A and Class B water utilities (utilities with over 2,000 service connections) and ORA to respond to the questions and proposed rules by October 4, 2004. At the request of Park Water Company (Park), the Commission's Executive Director granted an extension of time until October 18, 2004 to file opening comments. Parties filing opening comments are CWA (which represents many of the regulated water utilities in California), Park, Del Oro Water Co., Inc. (Del Oro), and Fruitridge Vista Water Company (Fruitridge).

At the request of ORA and CWA, the assigned Administrative Law Judge (ALJ), by ruling dated October 26, 2004, granted two rounds of reply comments, due on November 1, 2004, and November 12, 2004. Parties filing the first round of reply comments are ORA and Southern California Water (SoCalWater). Parties filing the second round of reply comments are CWA and Park.

Pursuant to Rule 6(a)(3) of the Commission's Rules of Practice and Procedure, the Assigned Commissioner's Scoping Memo and Ruling (March 21, 2005) determined the category of this proceeding to be "quasi-legislative" as the term is defined in Rule 5(d), narrowed the scope of the issues to focus solely on Proposition 50 grants to investor-owned water utilities, determined that hearings are not needed, and set a procedural schedule. In addition, the Assigned Commissioner ruled that all water utilities, including Classes A, B, C, and D, that had applied to the DHS for Proposition 50 grant funds were required to provide the information requested in Appendix A of the Scoping Memo by April 22, 2005. Responses were received from all Class A water utilities, while only a few Class B, C, and D water utilities that had applied for Proposition 50 funds responded; the Director of the Commission's Water Division mailed a letter to those utilities that had not responded on May 3, 2005, requesting compliance with the Scoping Memo ruling by May 16, 2005.

By ACR on January 26, 2006, the scope of the decision was expanded to adopt rules for all future state grant funds received by all classes of regulated water utilities. This change is within the scope of the rulemaking and advances the objectives of our Water Action Plan adopted December 15, 2005. The change is made in response to the numerous new bond measures recently proposed by Governor Arnold Schwarzenegger under his infrastructure plan and set forth in Assembly and Senate bills, AD 1839 (Laird) and SB 1166 (Aanestad and Machado), Flood Protection and Clean, Safe, Reliable Water Supply Bond and Financing Acts of 2006 and 2010.[3]

[3] All parties were given notice of this change in a January 26, 2006 ACR and afforded the opportunity to file comments on whether there is a need to further develop the record. The California Water Association (CWA) and Park Water Company (Park) filed

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3. Eligibility for Future State Grant Funds

Proposition 50, which included additions to the Water Code – Division 26.5, was passed by California voters in the November 2002 General Election.[4] The bond measure allows the state to sell $3.46 billion in general obligation bonds for various water-related projects.[5]

With the passage of Proposition 50, investor-owned water utilities for the first time applied for state grants. Previously, water quality bond measures specifically denied investor-owned water utilities grant eligibility. Proposition 50 is silent on this issue. DHS is the primary agency in administering Proposition 50 grant funds for investor-owned utilities.[6] In its draft evaluation

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comments supporting the change in scope of the March 21, 2005 Scoping Memo and Ruling; no party filed comments objecting to the change.

[4] Subsequently, Assembly Bill 1747 (chaptered August 2003), Senate Bill (SB) 278 (chaptered September 2003), and SB 1049 (chaptered October 2003) clarified certain sections of Division 26.5 of the Water Code (regarding requirements, guidelines, and applicable projects) and sections of the Government Code, the Fish and Game Code, and the Public Resources Code.

[5] These projects include specific CALFED Bay-Delta Program projects, including urban and agricultural water use efficiency programs. In Southern California, the bond funds will contribute to projects that promote alternatives for Colorado River water use, since California must cut its use of Colorado River water. Funds will allow for the purchasing, protecting, and restoring of wetlands near urban areas. Grants are provided for water management and quality improvement programs along with funding for the development of river parkways. State security funding for local and regional water systems is added to this bond measure along with grants for desalinization and drinking water disinfection.

[6] DHS has sole responsibility to administer the allocation of Proposition 50 grant funds that private water utilities are eligible for – Water Security (Chapter 3) and Safe Drinking Water (Chapter 4); DHS and DWR have joint responsibility to administer Contaminant and Salt Removal Technologies (Chapter 6).

DWR and the State Water Resources Control Board (SWRCB) jointly administer Chapter 8 of Proposition 50 which addresses Integrated Regional Water Management.

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criteria, DHS takes the position that Proposition 50 funds should be available to all water systems, including investor-owned. This position is consistent with appellate court decisions holding that, while our state Constitution precludes the Legislature from making a gift of public funds to a private person or corporate entity (Section 6 of Article XVI of the California Constitution), as long as the funds are expended for a public purpose and the benefits accrue to the public, the allocation of public funds to private entities is not an unlawful gift.[7]

During the 2004 legislative session, legislation was proposed to prohibit DHS from awarding Proposition 50 grant funds to investor-owned water utilities.[8] The concern expressed by legislators was that private water utilities not earn a return or profit in any way from Proposition 50 grant-funded investment. The Commission has provided assurances that this would not occur. In issuing this OIR, the Commission stated its objective was to adopt rules that would ensure that "Utilities should not receive a windfall nor should shareholders benefit from grant-funded facilities even if, years later, the utility itself or the individual, grant-funded facility is subsequently leased or sold." (R.04-09-002, page 2.)

Of the current requests for Proposition 50 grant funds from investor-owned water utilities, Class A water utilities account for 83% of the total dollars requested, Class B account for 6%, Class C account for 4%, and Class D account

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Private water utilities are not eligible for these grant funds as the lead agency of the project, but are eligible in a subsidiary position.

[7] See Opinion of Attorney General No. 97-401; 80 Ops.Cal.Atty.Gen. 56, Paramount Unified School Dist. v. Teachers Assn. of Paramount (1994) 26 Cal.App.4th 1371, and County of Sonoma v. State Bd. Of Equalization (1987) 195 Cal.App.3d 982.

[8] There was also a bill in the 2003/2004 legislative session, SB 909 (Machado) that would have expressly allowed private water utilities to receive Proposition 50 funds.

for 7%. A summary of the Proposition 50 grant programs open to investor-owned water utilities, which total approximately $430 million, is attached at Appendix B. DHS is processing the first round of Proposition 50 grant fund applications and is currently scheduled to begin receiving the second round of applications in October 2005.

In the opening comments filed January 17, 2006 on Administrative Law Judge Christine M. Walwyn's December 27, 2005 draft decision (draft decision), Golden State Water Company (GSWC) recommends we expand the scope of the draft decision to apply to the receipt of all state bond funds by investor-owned water utilities (water utilities), rather than the current scope of only Proposition 50 grant funds. GSWC states the same rules should apply to all state grant funds and there is a pressing need to conform our draft decision to reflect this due to the numerous new bond measures recently announced under Governor Arnold Schwarzenegger's infrastructure plan. The Governor's proposals for water projects, facilities and programs are set forth in Assembly and Senate bills, AB 1839 (Laird) and SB 1166 (Aanestad and Machado), Flood Protection and Clean, Safe, Reliable Water Supply Bond and Financing Acts of 2006 and 2010. SB 1166 provides generally that:

> 82014. It is the intention of the people that the investment of public finds (sic) pursuant to this division should result in public benefits.
>
> 82015. It is the intention of the people that any public funds made available by this division to investor-owned utilities regulated by Public Utilities Commission will be for the benefit of the ratepayers and not the investors pursuant to oversight by the Public Utilities Commission.

In considering this legislation, GSWC states that policy makers and the public will want to be assured, in advance, that the intent of Sections 82014 and

82015 is satisfied by rules which have been adopted by the Commission. Therefore, GSWC requests the Commission to conform the current draft decision to include all future state grant funds so that "the rules are already in place ensuring that it is the ratepayers and not the shareholders who benefit through the receipt of public funds." (*Id*., at page 9.)

4. Accounting and Ratemaking Rules

The objectives for this rulemaking are to:

- adopt policies, practices, rules, and procedures that govern the application, usage, ratemaking, retirement, and sale of all future state grant-funded utility plant;
- limit rules adopted in this proceeding to state-financed grants;[9] and
- ensure that utilities do not receive a windfall or shareholders benefit from grant-funded facilities even if, years later, the utility itself or the individual, grant-funded facility is subsequently leased or sold.

In the following sections, we adopt rules that meet all of these objectives. In adopting these rules, we use the ratemaking term "plant" rather than the OIR's term "facilities".

4.1 Recording Future State Grant-Funded Plant

While our discussion here references existing DHS rules for Proposition 50 grants, the rules we adopt shall apply to all future state grants to investor-owned water utilities.

DHS criteria and guidelines require matching funds for Proposition 50 grants that are not for disadvantaged communities or small water systems. A utility must apply to the Commission, either in a general rate case or by separate

[9] A separate proceeding, R.04-09-003, addresses for all Commission-regulated utilities the issue of gain on sale of utility plant from all financing sources other than Proposition 50 grants.

filing, for authority to collect from its customers for the non-grant-funded investment and for approval of the financing it proposes. The non-grant-funded portion of a construction project shall be recorded in accordance with USOA Account 100-1 – Utility Plant in Service.[10] This non-grant-funded portion, if determined to be reasonable by this Commission, shall earn a return and be eligible for a gain on its sale.

The parties that address this issue (CWA, ORA, and Park) all agree that grant-funded plant should be accounted for in the same manner as Contributions in Aid of Construction (CIAC), but as a distinct account and record; ORA and Park specify that the distinct account should not be a sub-account in CIAC. We agree with ORA and Park that CIAC differs in one significant aspect from grant-funded projects: CIAC is used to fund a utility plant project in its entirety, while state grant-funded projects can be jointly funded by grant funds and utility matching funds. The utility must separately track grant funds because of their unique characteristics and the unique rules we adopt here. This approach will also ensure that the grants are separately reported in audited financial statements and reports filed with the Commission. Further, there is a need for a clear audit trail between the utilities' fixed asset accounting system and the general ledger; utilities shall modify, as necessary, their work order tracking systems so that grant-funded projects can be reviewed and audited.

We shall adopt Park's recommendation to establish a new account, Account 266, and ORA's recommendation to title this account "Publicly

[10] USOA Account 100-1 – Utility Plant in Service (Class A), Utility Plant Instruction 3.A. "All amounts included in the accounts for tangible utility plant consisting of plant acquired as an operating unit or system shall be stated in accordance with the provisions of Utility Plant Instruction 4-B. All other tangible utility plant shall be included in the accounts at the cost incurred by the utility."

Funded Grant Plant," and limit Account 266's use to government grants. In establishing this account, we generally follow the existing format for Account 265 as it pertains to ratemaking and accounting. Contributions are not included in the determination of rate base; therefore, by using the existing accounting rules for CIAC, this Commission ensures that no return shall be earned by a water utility on state grant-funded plant.

When grant funds are initially received from the funding agency, the utility shall place these funds in a dedicated account. On the books of the utility, it shall record the grant funds as a Debit to Account 121-3 – Cash-Miscellaneous Special Deposits and a Credit to Account 266-00 – Contributions – Publicly Grant-Funded Plant. As the grant-funded plant is being constructed, the utility shall record those dollars expended as a Debit to Account 100-3 – Construction Work in Progress (CWIP) and a Credit to Account 121-3 – Cash-Miscellaneous Special Deposits. When the authorized plant (authorized by the DHS or funding agency) has been constructed, a second set of entries shall be recorded as a Debit to Account 100 – Utility Plant[11] and a Credit to Account 100-3 – CWIP for the publicly grant-funded amount.[12]

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[11] USOA for Class B, C, and D Water Utilities – Account 101-Water plant in service.

[12] An example of how to record Proposition 50 grant-funded plant is as follows: Utility receives $1,000,000 of Proposition 50 grant funds to pay for the construction of a new treatment plant. The total cost of the plant is $2,000,000 ($1,000,000 of Proposition 50 funds and $1,000,000 of utility funds). First, the $1,000,000 of Proposition 50 grant funds shall be recorded as a Debit to Account 121-3 – Cash-Miscellaneous Special Deposits and a Credit to Account 266-00 – Contributions-Publicly Grant-Funded Plant. Second, as the construction of the plant proceeds, the $1,000,000 of Proposition 50 grant funds shall be recorded as a Debit to Account 100-3 – Construction Work in Progress (CWIP) and a Credit to Account 121-3 – Cash-Miscellaneous Special Deposits. Lastly, when the construction is completed, the $1,000,000 of grant funds are then Debited to Account 100-1 – Utility Plant in Service and Credited to Account 100-3 – CWIP. The

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4.2 Operating Expenses, Administrative and General Expenses, and Taxes

Operating expenses, administrative and general expenses, and taxes associated with grant-funded plant, but not funded with grant funds, shall be allowed in the determination of rates charged by the utility, if determined to be reasonable by this Commission. These expenses are allowed ratemaking recovery because they are not funded with government funded contributions and are necessary to the maintenance of the plant that has been constructed. The reasonableness of these expenses shall be reviewed in the normal course of the general rate case process. Any indirect benefits resulting from grant-funded plant, such as reductions in operating expenses resulting from infrastructure improvements, should be projected as cost savings and imputed into the utilities' present base margin revenue requirement.[13]

Unless the utility has received authorization from DHS or the funding agency, grant funds shall not be spent on expenses. We agree with ORA and Park that grant funds that are expended for expenses authorized by DHS or another funding agency must not be included in the determination of the Results of Operations and the forecast of future expenses in a general gate case. CWA

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utility funded portion of the construction would also be recorded as a Debit to Account 100-1 – Utility Plant in Service, upon completion and credited to the specific funding mechanism (examples include Cash, Accounts Payable, Notes Payable, or Retained Earnings). This results in the total value of the asset of $2,000,000 being recorded in Account 100-1 – Utility Plant in Service. Since the $1,000,000 that represents Proposition 50 grant funds is recorded in Account 266-00, it is deducted from Utility Plant in the calculation of Rate Base.

[13] Any difference between the projected and actual savings should be trued up prospectively in each water utility's general rate case. The purpose of this rule is to prevent utilities from profiting from indirect benefits that can be predicted in the calculation of revenue requirement.

believes that inclusion or exclusion of operating expenses funded by grant funds should be determined on the specific circumstances of the case. We disagree. However, we do authorize that once the grant funds are no longer available and the utility is required to pay for these expenses out of its own funds, then these expenses shall be included in the Results of Operations and the forecast of future expenses in a general rate case.

4.3 Depreciation

ORA and Park recommend that depreciation should be calculated using the existing methodology detailed in the Commission's Standard Practice U-4, while CWA recommends that straight-line depreciation should be used, as proposed in the OIR. We find no reason to deviate from our existing practice and, therefore, agree with ORA and Park that the existing rules should be followed. This means that depreciation on Proposition 50 grant-funded plant is recorded as a Debit to Account 266-01 and a Credit to Account 250 - Reserve for Depreciation of Utility Plant. The depreciation amount accrued each year shall be calculated in the same way as non-contributed plant (Standard Practices U-04-SM and U-04-W).

We agree with CWA that grant funds used to acquire land should not be amortized and included in the depreciation category; we also agree with ORA's recommendation that this apply to all non-depreciable property, which includes water rights.

While depreciation expenses from grant-funded plant should be excluded from ratemaking as a deduction, ORA and Park are correct in recommending that the utilities should deduct the depreciation expenses for income tax purposes and flow through to their customers any benefits derived from the tax deduction in the most direct fashion possible. We adopt this recommended rule.

5. Construction of State Grant-Funded Plant

Projects funded by state grants may involve extensive planning and require several years to complete. We expect funding agencies will adopt timing rules specific to the grants they administer.[14] However, in the event construction or study completion time limits are not established by the funding agency, then the following provisions are reasonable and shall apply: (1) construction of the project must start within one year after execution of the funding agreement; (2) the project shall conclude within three years after execution of the funding agreement; (3) utilities must seek Commission approval for extensions of time limits at least two months prior to the expiration of those limits or risk loss of undelivered funding; and (4) extension requests may be submitted by advice letter to the Commission's Water Division Director, who shall prepare a resolution for the Commission's consideration.

All parties generally agree that construction of plant using grant funds should be put out for bid, with some flexibility allowed on the minimum number of bids, the criteria for awarding bids, and the possibility of sole source contracts under special circumstances. Parties also recommend that affiliate companies be allowed to bid if the process is in compliance with the Commission's affiliate rules. While our affiliate transaction rules are sufficient for other transactions, the situation here is unique. Affiliate companies by definition share the same shareholders with the utility and, therefore, under the objectives we have set in this OIR, cannot earn a profit from state grant funds. We do not expect a utility affiliate to bid on a contract if it is precluded from earning a profit; therefore, we shall exclude affiliate transactions on projects involving state grant funds.

[14] DHS has adopted specific rules for Proposition 50 grants.

In summary, we adopt a rule requiring utilities to utilize a competitive bidding process when awarding contracts for the construction of state grant-funded projects, with the following criteria:

- A minimum of three competitive bids shall be required unless justification is provided showing why the minimum could not be met;
- If the utility does not choose the lowest bid, it must provide a detailed justification explaining why it chose not to accept the lowest bid;
- Utilities should be allowed to enter sole source contracts under special circumstances. Utilities need to seek by advice letter filing a Commission resolution granting a waiver for sole source contracts;
- Affiliate companies are not allowed to participate.

Next, we address the OIR's proposed rule that utilities may not use grant funds for work done prior to the execution of the funding agreement. CWA urges the Commission not to adopt the proposed rule because it may conflict with rules adopted by the funding agencies. ORA urges the Commission to retain the rule in order to avoid a potential windfall to the utility based on the lag time between a general rate case effective date and when the Proposition 50 funds are finally approved. Based on these comments, we find it reasonable to adopt a rule that utilities may not use grant funds for work done prior to the execution of the funding agreement unless the funding agency has authorized this use and the Commission has reviewed and approved the ratemaking treatment.

6. Gain on Sale of State Grant-Funded Plant

6.1 Overview

In order to ensure that private water utilities do not receive a gain on the sale of state grant-funded plant, parties generally proposed rules whereby the utility would return sales proceeds to the funding agency. These funds would then be available for future public projects.

We take a different approach. We design our rules here to ensure that the plant sold retains its public interest integrity, i.e., no private company or its shareholders profit in any way and the public retains the benefit of a cost-free financed plant. We can accomplish this if the selling and purchasing water companies are both under the Commission's regulation. We can also ensure this if the purchasing entity is a public water agency. Only in the instance where the purchaser is an entity other than a private or municipal water provider do we find need for the selling utility to return all sales proceeds to the funding agency, or to an equivalent public agency if the original funding agency no longer exists or is unable to accept remittance.

In order to ensure the Commission has prior review and approval over all grant funded plant, we shall require water utilities to notify the Director of the Water Division and the Director of the Division of Ratepayer Advocates 30 days prior to the disposition and encumbrance of all grant-funded plant.[15]

These rules apply to property such as land, plant, or water rights. In determining the proceeds in each of the following types of sales, the cost of disposal shall be deducted from the amount received in arriving at the final

[15] This is in addition to the existing Section 851 requirements for plant that is used and useful.

amount received. The OIR raises the issue of intellectual property, the example being grant funds used for the purpose of conducting a study. In cases such as this, the Commission should individually review the matter in the utility's general rate case, or by separate application if requested.

6.2 Sale to a Regulated Water Utility

We find our objectives are best met by adopting the following rule to apply to the transfer of an asset, district, or total utility to another Commission-regulated water utility. If the asset to be transferred has been paid for with grant funds in whole or in part, the transferring utility may not receive compensation for that portion of the asset that has been funded with grant funds, and the purchasing utility shall record a non-ratebase asset in Account 266; the non-grant-funded portion of the asset, if any, should transfer at fair market value, pursuant to Section 2720.

An earlier Commission decision gives guidance on how to preserve the public interest integrity of grant-funded plant that is sold to another regulated water utility. In D.98-11-019 (Lucerne Water Company acquired by Dominguez Water Corporation), the "fair market value" is based on the value of land and "company funded plant assets"[16] – non-utility funded plant such as Contributions[17] and advances are not included in the valuation. This decision also defines the value of "non-rate-based assets"[18] such as those funded with Contributions and Safe Drinking Water Bond Act (SDWBA) loans at their existing book value on the books of the selling utility. Since these items are not

[16] D.98-11-019, p. 9.

[17] As we have discussed earlier, government provided funds, such as Proposition 50 grant funds are categorized as Contributions by this Commission and the USOA.

[18] D.98-11-019, p. 12.

included in the valuation of a water utility's "fair market value," the selling utility receives no compensation at the disposal of contributed plant. The purchasing utility does not earn a return on either the existing book value or any premium to account for market value at the time of acquisition, since the contributed plant is recorded at its existing cost (not inflated for market value at the time of sale) in Contributions, which is deducted in the calculation of rate base.

Performing the fair market valuation of a single asset, a district, or a total utility without giving monetary consideration for the portion funded by contributions (including grant-funded plant) is appropriate since the selling utility did not expend its own funds for the contributed portion of the plant and therefore should not be reimbursed for or profit from its sale.

The portion of the asset disposed of that has been funded with non-grant funds shall be accounted for in accordance with the USOA Account 100-1 – Utility Plant in Service,[19] and included in the determination of the "fair market value," using the amount paid to the selling company for the non-grant-funded plant as the value of the plant recorded by the purchasing company. A gain shall be earned by the selling company on non-grant-funded plant and a return may be earned by the purchasing company on non-grant-funded plant.[20]

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[19] See Account 392, Utility Plant Sold, Instruction 12 and 12F.

[20] As an example, we consider an asset owned by Utility F that was funded 50% with Proposition 50 grant funds and 50% with utility funds. It is sold to Utility G for $6,000. The original total book value of the asset was $2,000,000, with $1,000,000 funded with Proposition 50 grant funds and $1,000,000 funded with utility funds. The depreciated value of the asset is $10,000 ($5,000 attributable to the Proposition 50 grant funds and $5,000 attributable to non-Proposition 50 funds). Utility F shall recognize a gain of $1,000 on the non-Proposition 50 funded plant. Utility G would record the total asset value of $11,000 in Account 100-1 – Utility Plant in Service ($6,000 for

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We next consider the sale of plant that is wholly financed from grants. Based on the valuation discussed above, the plant would not be included in the valuation of the company. On the books of the selling company, Account 266 shall be reduced by the depreciated book value of the asset, and no compensation shall be recorded since no payment shall be received for the grant-funded plant that has been disposed of. On the books of the purchasing company, both Account 100-1 and Account 266-01 shall be increased by that same depreciated book value so that no return is earned on the grant-funded asset by the purchasing company.

In its comments, Park raises a concern that the disposition of utility plant for no cost would be in violation of Sections 2718-2720, because those code sections require that assets acquired by a utility that are included in rate base be valued at fair market value. Since assets funded with grant funds are not part of rate base, the requirements of this code section do not apply.

When grant-funded plant is sold as part of the sale of a district or a total utility, the valuation of the district or total utility shall not include the value of grant-funded plant In that way, the value of these non-rate base items are not included in the determination of the payment to the selling company or the value of the rate base acquired by the purchasing utility. And, consistent with D.98-11-019, the grant-funded plant would be recorded on the books of the

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non-Proposition 50 funded asset at the price it paid and $5,000 for Proposition 50 grant-funded plant at its current depreciated book value), and a Credit to Account 266-01 of $5,000 (the depreciated book value). In this way, Utility G earns a return on the non-Proposition 50 grant-funded plant of $6,000 only ($11,000 - $5,000).

purchasing utility at its depreciated book value, not its fair market value. In the case of the sale of the utility itself, the same rules apply as for a district.[21]

7. Sale to Public Water Provider

When grant-funded plant is sold to a municipal water provider, or other public entity providing water service to the public, the public interest integrity of the grant is preserved. A municipal provider would deploy the grant plant to provide water service to the public and there is not a concern with profit being realized by a private entity or its shareholders. While the Commission has no jurisdiction over how the public entity records the purchase or charges rates, the rules governing the transaction from the seller's position would still apply.

In some cases, it may be difficult or impossible to perform a valuation of the "fair market value" of a district or total utility without the grant-funded plant. If there is no way to perform the valuation any other way, the grant-funded plant must be deducted from the "fair market value" of the total utility that has been determined by the valuation. Since the value of the grant-funded plant in the valuation has most likely been inflated, the selling utility should inflate the depreciated book value of the grant-funded plant using the Handy Whitman index. This inflated value of grant-funded plant should be

[21] For example, Utility A decides to sell one of its three districts (call it District X) to Utility B. District X includes Proposition 50 grant-funded plant with a depreciated value of $50,000. Valuation of the district shall not include the Proposition 50 grant-funded plant. Therefore, not only does Utility A not receive payment for the depreciated book value of the Proposition 50 grant-funded plant, it receives no gain on its disposition, either. Utility B must record the Proposition 50 grant-funded plant at the depreciated book value of the seller ($50,000) in Account 100-1 and Account 266. Since the selling utility did not receive payment for the Proposition 50 plant, it receives no gain or reimbursement for the book value of the Proposition 50 plant. Since Utility B records the Proposition 50 plant it has acquired in Account 266 at its depreciated book value, no return is earned by it.

deducted from the "fair market value" of the utility. This "Adjusted Fair Market Value" would then be used to determine the reasonable purchase price of the utility.

8. Sale to an Entity Other Than Regulated Water Utilities or Public Water Provider

This is the category where the Commission cannot ensure that the grant-funded plant sold retains its public interest integrity. The purchasing entities may include private companies as well as cities or counties exercising eminent domain powers for purposes of land development. Consistent with our objectives in this OIR, we find that the appropriate treatment in these cases is for the buyer to pay fair market value and for the selling utility to remit all proceeds received from the sale to the original funding agency, or another designated state agency.

9. Notification to the Commission

Utilities must receive Commission approval for SDWBA and Drinking Water State Revolving Fund loans because these loans are repaid by the utility through a surcharge to ratepayers. For any portion of plant that is paid for by non-grant funds, this same procedure shall be followed. The utility should seek Commission approval through the application process, either in its general rate case or separately.

For plant wholly funded by a grant, as well as for the partially grant-funded portion of a plant, we should require notification to the Director of the Water Division when the utility signs a letter of commitment with the funding agency administering the grant and again upon completing the funding agreement execution with the funding agency.

In addition, each utility that receives grant funds shall so state in its Annual Report to the Commission, with the detail of the type and location of the plant constructed.

10. Comments to the Draft Decision

The draft decision of ALJ Walwyn was mailed to the parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.7 of the Commission's Rules of Practice and Procedure. Comments were filed on January 17, 2006, and reply comments were filed on January 23, 2006. Several substantive changes are made in response to these comments, particularly in Sections 4.1, 4.2, and 6.1.

The draft decision proposed to adopt rules specific to the receipt of Proposition 50 funds. By Assigned Commissioner's Ruling (ACR) on January 26, 2006, the scope of the decision was expanded to adopt rules for all future state grant funds received by all classes of regulated water utilities. This change is within the scope of the rulemaking and advances the objectives of our Water Action Plan adopted December 15, 2005. The change is made in response to the numerous new bond measures recently proposed by Governor Arnold Schwarzenegger under his infrastructure plan and set forth in Assembly and Senate bills, AD 1839 (Laird) and SB 1166 (Aanestad and Machado), Flood Protection and Clean, Safe, Reliable Water Supply Bond and Financing Acts of 2006 and 2010.[22]

[22] All parties were given notice of this change in a January 26, 2006 ACR and afforded the opportunity to file comments on whether there is a need to further develop the record. The California Water Association (CWA) and Park Water Company (Park) filed comments supporting the change in scope of the March 21, 2005 Scoping Memo and Ruling; no party filed comments objecting to the change.

11. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and Christine M. Walwyn is the assigned ALJ in this proceeding.

Findings of Fact

1. Receipt of state grant funds by Commission-regulated water utilities will allow the utilities and their customers to benefit by providing cost-free funds for needed investments in water supply, treatment, and security.

2. The rules we adopt here are designed to preserve the public interest integrity of state grant funds by ensuring that investor-owned water utilities and their shareholders will not be able to profit in any way through the receipt of public funds, and that the public retains the benefit of public funding.

3. DHS criteria and guidelines require matching funds for Proposition 50 grants that are not for disadvantaged communities or small water systems.

4. Utilities must apply to the Commission, either in a general rate case or by separate filing, for authority to collect from their customers for the non-grant-funded investment and for approval of the financing it proposes for this investment.

5. Our existing account for CIAC differs from state grant-funded projects because CIAC is used to fund a utility plant project in its entirety, while state grant projects can be jointly funded by grant funds and utility-provided funds. It is important to separately track state grant funds.

6. There is a need for a clear audit trail between the utilities' fixed asset accounting system and the general ledger. Utilities should modify, as necessary, their work order tracking systems so that grant-funded projects can be reviewed and audited.

7. We should establish a new account, Account 266, titled "Publicly Funded Grant Plant" and limit its use to government grants. Account 266 should follow the existing format for Account 265 as it pertains to not being eligible for rate base recovery, records and depreciation.

8. When state grant funds are initially received from the funding agency, the water utility shall place these funds in a dedicated account.

9. Operating expenses, administrative and general expenses, and taxes associated with grant-funded plant, but not funded with grant funds, shall be allowed in the determination of rates, if determined to be reasonable by the Commission.

10. Any indirect benefits resulting from grant-funded plant such as reductions in operating expenses resulting from infrastructure improvements, must be projected as cost savings and imputed into the utilities' present base margin revenue requirement.

11. Unless the utility has received authorization from DHS or the funding agency, grant funds should not be spent on expenses. Grant funds that are expended for expenses authorized by DHS or another funding agency, must not be included in the determination of the Results of Operations and the forecast of future expenses in a general rate case. Once grant funds are no longer available and the utility is required to pay for these expenses out of its own funds, then these expenses shall be included in the Results of Operations and the forecast of future expenses in a general rate case.

12. Depreciation on grant-funded plant must be calculated using the existing methodology detailed in the Commission's Standard Practice U-4. Grant funds used to acquire land or other non-depreciable property such as water rights, may not be amortized or included in this category.

13. The utilities must deduct depreciation expenses for income tax purposes and flow through to their customers any benefits derived from the tax deduction in the most direct fashion possible.

14. In the event construction or study completion time limits are not established by the funding agency, then the following provisions are reasonable and should apply:

- Construction of the project must start within one year after execution of the funding agreement;
- The project shall conclude within three years after execution of the funding agreement;
- Utilities must seek Commission approval for extensions of time limits at least two months prior to the expiration of those limits or risk loss of undelivered funding; and
- Extension requests may be submitted by advice letter to the Commission's Water Division Director for processing as a Commission resolution.

15. Because they share the same shareholders, neither utilities nor their parent and affiliate companies should be allowed to earn a profit on grant-funded projects. Therefore, parent and affiliate companies should not participate in construction of grant-funded plant.

16. Water utilities should use a competitive bidding process specified by the funding agency when awarding contracts for the construction of grant-funded projects.

17. In the event construction or study completion time limits are not established by the funding agency, then the following provisions are reasonable and should apply:

- A minimum of three competitive bids shall be required unless justification is provided showing why the minimum could not be met;

- If the utility does not choose the lowest bid, it should provide a detailed justification explaining why it chose not to accept the lowest bid;
- Utilities should be allowed to enter sole source contracts under special circumstances. Utilities must seek a Commission waiver for sole source contracts.
- Affiliate companies are not allowed to participate.

18. Water utilities may not use grant funds for work done prior to the execution of the grant funding agreement unless the funding agency has authorized this use. At the time of the utility's next general rate case, the Commission will review and determine the appropriate ratemaking treatment for the work performed prior to grant funding that was not authorized by the funding agency.

19. In order to ensure that the Commission has prior review and approval over all grant-funded plant transactions, water utilities shall notify the Director of the Water Division and the Director of the Division of Ratepayer Advocates 30 days prior to the disposition and encumbrance of grant-funded plant.

20. The rules we adopt here should apply to all tangible property funded with state grants. In determining the proceeds in each of the following types of sales, the cost of disposal shall be deducted from the amount received in arriving at the final amount received. In cases of intangible property, such as the intellectual property of a study, the Commission should individually review the matter in the utility's general rate case or, if requested, by separate application.

21. The following rule should apply to the transfer of an asset district, or total utility to another Commission-regulated water utility. If the asset to be transferred has been paid for with grant funds in whole or part, the transferring utility may not receive compensation for the portion of the asset that has been funded with grant funds, and the purchasing utility shall record a non-ratebase

asset in Account 266. The non-grant portion of the asset, if any, should transfer at fair market value pursuant to Section 2720.

22. When grant-funded plant is sold to a public water provider that will deploy the asset to provide water service to the public, the public interest integrity of the grant is preserved, and the rules governing the transaction from the selling utility's position would be the same as if the sale were to a Commission-regulated utility.

23. When grant-funded assets are sold to an entity other than a utility or public water provider, such as private unregulated companies, or cities or counties exercising eminent domain powers for purposes other than acquiring a municipal water system, the public interest integrity of the grant is not preserved. In these instances, the appropriate treatment is for the buyer to pay fair market value and for the selling utility to remit all proceeds received from the sale to the original funding agency, or another designated state agency.

24. For plant wholly funded by a grant, as well as for the partially funded portion of a plant, the utility must notify the Director of the Water Division when the utility signs a letter of commitment with the state agency administering the fund and again upon completing the funding agreement execution with the funding agency. For any portion of plant that is paid for by non-grant funds, the utility must obtain Commission approval in its general rate case or through separate application.

25. Each utility that receives state grant funds should so state in its Annual Report to the Commission, with detail of the type, dollar value, and location of the plant constructed.

26. We should direct the Water Division to incorporate the development of draft rules governing government-funded loans in its next rulemaking regarding the regulation of privately-held water utilities.

Conclusions of Law

1. Pursuant to Article XII, Section 6 of the California Constitution, the Public Utilities Code statutes, and our own adopted rules and regulations, the Commission prescribes all accounting and ratemaking practices for investor-owned utilities.

2. We should adopt rules that govern the accounting and ratemaking treatment for state grant-funded plant that ensure that utilities and their shareholders will not be able to profit in any way through the receipt of public funds.

3. The rules described in the foregoing Opinion and Findings of Fact, and set forth in Appendix A, should be adopted.

4. This proceeding should be closed.

O R D E R

IT IS ORDERED:

1. The rules attached in Appendix A are adopted.
2. Rulemaking 04-09-002 is closed.

This order is effective today.

Dated March 2, 2006, at San Francisco, California.

MICHAEL R. PEEVEY
President
GEOFFREY F. BROWN
DIAN M. GRUENEICH

JOHN A. BOHN
RACHELLE B. CHONG
Commissioners

APPENDIX A

RULES FOR THE ACCOUNTING OF STATE GRANT FUNDS

These rules shall apply to all transactions involving state grant funds.

1. No return shall be earned by Commission-regulated water utilities (Utilities) on grant-funded plant.
2. No gain shall be recovered by utilities on the disposition of Proposition 50 grant-funded plant.
3. When government-provided Grant Funds are received from the funding agency, the utility must place these funds in a separate account that is restricted to government grant funds only. On the books of the company, it shall record the funds as a Debit to Account 121-3 – Cash-Miscellaneous Special Deposits and a Credit to Account 266 – Publicly Funded Grant Plant. As the grant funded plant is being constructed, the utility shall record those dollars expended as a Debit to Account 100-3 – Construction Work in Progress (CWIP) and a Credit to Account 121-3 – Cash-Miscellaneous Special Deposits. When the authorized plant (authorized by the California Department of Health Services (DHS), the Department of Water Resources (DWR) or another funding agency) has been constructed, a second set of entries shall be recorded as a Debit to Account 100-1 – Utility Plant in Service and a Credit to Account 121-3 – Cash-Miscellaneous Special Deposits. Account 266 shall follow the following rules:

    3.1 This account shall include only publicly funded grants.

    3.2 The records supporting the entries to this account must be so kept that the utility can furnish information as to the purpose of each grant, and shall be segregated between depreciable and non-depreciable property.

    3.3 Depreciation accrued on the depreciable portion of properties included in this account shall be charged to this account rather than to Account 503, Depreciation, the charges to this account to continue until such time as the balance in this account applicable to such properties has been completely amortized. (See Utility Plant Instruction 3.F.[1]) The

[1] Utility Plant Instruction 3.F. "Utility plant contributed to the utility or constructed by it from contributions to it of cash or its equivalent shall be charged to the utility plant accounts at cost of construction. There shall be credited to the depreciation and

Footnote continued on next page

balance in the account applicable to non-depreciable property shall remain unchanged until such time as the property is sold or otherwise retired. At time of retirement of non-depreciable property, which was acquired by grant funds, the costs thereof shall be credited to the appropriate plant account and charged to this account in order to eliminate any credit balance in the grant account applicable thereto.

3.4 It is intended under the provisions contained in the preceding paragraph that the credit balance in the account will be written off over a period equal to the actual service life of the property involved. The net salvage realized on the retirement of grant-funded property shall be recorded as a credit to Account 250, Reserve for Depreciation of Utility Plant.

4. Operating Expenses, Administrative and General Expenses, and Taxes associated with grant-funded plant, but not funded with grant funds, shall be allowed, if determined to be reasonable by this Commission. The reasonableness of these costs shall be determined in the general rate case that addresses the results of operations for the district these expenses occur in.

5. Any indirect benefits resulting from grant-funded plant such as reductions in operating expenses resulting from infrastructure improvements, must be projected as cost savings and imputed into the utilities' revenue requirement.

6. Unless the utility has received authorization from DHS or the funding agency, grant funds should not be spent on expenses. Grant funds that are expended for expenses authorized by DHS or another funding agency, must not be included in the determination of the Results of Operations and the forecast of future expenses in a general rate case.

7. Depreciation on grant-funded plant must be calculated using the existing methodology detailed in the Commission's Standard Practice U-4. Grant funds used to acquire land should not be amortized or included in this category as well as other non-depreciable property such as water rights.

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amortization reserve accounts the estimated amount of depreciation and amortization applicable to the property at the time of this contribution to the utility. The difference between the amounts included in the utility plant account and the reserve accounts shall be credited to Account 265, Contributions in Aid of Construction."

8. The utilities must deduct depreciation expenses for income tax purposes and flow through to their customers any benefits derived from the tax deduction in the most direct fashion possible.

9. In the event construction or study completion time limits are not established by the funding agency, then the following provisions are reasonable and should apply:

   - Construction of the project must start within one year after execution of the funding agreement;
   - The project shall conclude within three years after execution of the funding agreement;
   - Utilities must seek Commission approval for extensions of time limits at least two months prior to the expiration of those limits or risk loss of undelivered funding; and
   - Extension requests may be submitted by advice letter to the Commission's Water Division Director for processing as a Commission resolution.

10. Because they share the same shareholders, neither utilities nor their affiliate companies and their shareholders should be allowed to engineer or install the facilities for grant-funded projects.

11. Water utilities should use a competitive bidding process specified by the funding agency when awarding contracts for the construction of grant-funded projects.

12. In the event construction or study completion time limits are not established by the funding agency, then the following provisions are reasonable and should apply:

   - A minimum of three competitive bids shall be required unless justification is provided showing why the minimum could not be met;
   - If the utility does not choose the lowest bid, it must provide a detailed justification explaining why it chose not to accept the lowest bid;
   - Utilities should be allowed to enter sole source contracts under special circumstances. Utilities must seek by advice letter filing a Commission resolution granting a waiver for sole source contracts;
   - Affiliate companies are not allowed to participate.

13. Water utilities may not use grant funds for work done prior to the execution of the grant funding agreement unless the funding agency has authorized this use. At the time of the utility's next general rate case, the Commission will review and determine the appropriate ratemaking treatment for the work performed prior to grant funding that was not authorized by the funding agency.

14. These rules apply to all tangible property funded with state grants. In determining the proceeds in each of the following types of sales, the cost of disposal shall be deducted from the amount received in arriving at the final amount received. In cases of intangible property, such as the intellectual property of a study, the Commission should individually review the matter in the utility's general rate case or, if requested, by separate application.

15. In order to ensure that the Commission has prior review and approval over all grant-funded plant transactions, water utilities shall notify the Director of the Water Division and the Director of the Division of Ratepayer Advocates 30 days prior to the disposition and encumbrance of grant-funded plant.

16. The following rule should apply to the transfer of an asset, district, or total utility to another Commission-regulated water utility. If the asset to be transferred has been paid for with grant funds in whole or part, the transferring utility may not receive compensation for the portion of the asset that has been funded with grant funds, and the purchasing utility shall record a non-ratebase asset in Account 266. The non-grant portion of the asset, if any, should transfer at fair market value.[2]

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[2] For example, Utility A decides to sell one of its three districts (call it District X) to Utility B. District X includes Proposition 50 grant-funded plant with a depreciated value of $50,000. Valuation of the district shall not include the Proposition 50 grant-funded plant. Therefore, not only does Utility A not receive payment for the depreciated book value of the Proposition 50 grant-funded plant, it receives no gain on its disposition, either. Utility B must record the Proposition 50 grant-funded plant at the depreciated book value of the seller ($50,000) in Account 100-1 and Account 266. Since the selling utility did not receive payment for the Proposition 50 plant, it receives no gain or reimbursement for the book value of the Proposition 50 plant. Since Utility B records the Proposition 50 plant it has acquired in Account 266 at its depreciated book value, no return is earned by it.

17. When grant-funded plant is sold to a publicly-owned water provider that will deploy the asset to provide water service to the public, the public interest integrity of the grant is preserved, and the rules governing the transaction from the selling utility's position would be the same as if the sale were to a utility.

18. When grant-funded assets are sold to an entity other than a utility or public water provider, such as private unregulated companies or cities or counties exercising eminent domain powers for purposes other than acquiring a municipal water system, the public interest integrity of the grant is not preserved. In these instances, the appropriate treatment is for the buyer to pay fair market value and for the selling utility to remit all proceeds received from the sale of the grant-funded asset to the original funding agency, or another designated state agency.

19. For plant wholly funded by a grant, as well as for the partially funded portion of a plant, the utility must notify the Director of the Water Division when the utility signs a letter of commitment with the state agency administering the fund and again upon completing the funding agreement execution with the responsible agency. For any portion of plant that is paid for by non-grant grant funds, the utility must obtain Commission approval in its general rate case or through separate application.

20. All utilities that receive state grant funds must provide the following information regarding its grant-funded plant in its Annual Report to the Commission: (1) Amount of grant funds received, (2) Amount of grant funds spent in the year covered by the Annual Report, and (3) Description of plant constructed with grant funds.

21. When the "fair market value" valuation of a district or total utility is difficult or impossible to perform without the grant-funded plant, the grant-funded plant must be deducted from the "fair market value" of the total utility that has been determined by the valuation. Since the value of the grant-funded plant in the valuation has most likely been inflated, the selling utility should inflate the depreciated book value of the grant-funded plant using the Handy Whitman index. This inflated value of grant-funded plant should be deducted from the "fair market value" of the utility. This "Adjusted Fair market Value" would then be used to determine the reasonable purchase price of the utility.

(END OF APPENDIX A)

APPENDIX B

Summary of Prop 50 Grant Programs Open to Regulated Utilities
Funds Available for Each Chapter

Chapter 3 – Water Security, Approximately (Approx.) $50,000,000 Total (Ttl)
Grants range from $50,000 - $10,000,000

Chapter 4a1 – Small Community Water System Facilities, Approx. $14,000,000 Ttl
Grants range from $5,000 - $2,000,000

Chapter 4a2 – Contaminant Treatment & Removal, Approx. $14,000,000 Ttl
Grants range from $50,000 - $2,000,000

Chapter 4a3 – Community Water System Monitoring Facilities, Approx. $14,000,000 Ttl
Grants range from $5,000 - $2,000,000

Chapter 4a4 – Drinking Water Source Protection, Approx. $14,000,000 Ttl
Grants range from $50,000 - $2,000,000

Chapter 4a5 – Disinfection Byproduct Treatment Facilities, Approx. $14,000,000 Ttl
Grants range from $50,000 - $2,000,000

Chapter 4b – Southern California Projects to Reduce Demand on Colorado River, Approx. $260,000,000 Ttl
Grants range from $50,000 - $20,000,000

Chapter 6b – Contaminant Removal, Approx. $25,000,000 Ttl
Grants range from $50,000 - $5,000,000

Chapter 6c – UV & Ozone Disinfection, Approx. $25,000,000 Ttl
Grants range from $50,000 - $5,000,000

SOURCE: Prop 50 Pre-Application Instructions, Attachment A, Summary Table of Prop 50 Grant Programs, Department of Health Services

(END OF APPENDIX B)