 **Date of Issuance 12/21/2007**

Decision 07-12-055 December 20, 2007

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

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| In the Matter of the Application of California Water Service Company (U60W), a corporation, for an order authorizing it to increase rates charged for water service in the Bakersfield district by $11,220,000 or 22.81% in fiscal year 2007-2008, by $1,979,900 or 3.30% in fiscal year 2008-2009, and $1,979,900 or 3.17% in fiscal year 2009-2010. | Application 06-07-017 (Filed July 26, 2006) |
| And Related Matters. | Application 06-07-018<br>Application 06-07-019<br>Application 06-07-020<br>Application 06-07-021<br>Application 06-07-022<br>Application 06-07-023<br>Application 06-07-024<br>(Filed July 26, 2006) |

(See Attachment 4 for List of Appearances)

## OPINION RESOLVING GENERAL RATE CASES

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## OPINION RESOLVING GENERAL RATE CASES

### 1. Summary

Pursuant to Article XII of the California constitution, legislative statutes, and our agency's own rules and regulations, the California Public Utilities Commission (Commission) regulates the rates, operations, and terms and conditions of service of California Water Service Company (Cal Water), an investor-owned Class A water utility serving customers in 24 districts in California.[1]

In this decision, we resolve the general rate case (GRC) applications for eight of Cal Water's districts for a three-year period beginning July 1, 2007.[2] The revenue requirement we adopt will be implemented under each district's existing rate design. We are separately addressing a conservation rate design for Cal Water in our conservation proceeding, Investigation (I.) 07-01-022.

[1] Class A utilities are investor-owned water utilities with greater than 10,000 service connections. State statutes include the California Public Utilities Code and the California Water Code.

[2] Pursuant to Section 455.2, in Decision (D.) 07-06-028 we authorized an interim rate increase effective July 1, 2007. This interim rate increase is based on the rate of inflation as compared to existing rates for each district, is subject to refund, and will be adjusted upward or downward, back to July 1, 2007, based on the final rates adopted by the Commission in this decision.

For the coming GRC period, this decision adopts the following rate increases:

**System Revenue Requirement Percentage Increases For First Year**

| District | 2007-2008 |
|---|---|
| Bakersfield | 8.13% |
| Dixon | 26.38% |
| King City | 35.57% |
| Oroville | 22.67% |
| Selma[3] | 5.90% |
| South San Francisco | 12.11% |
| Westlake | 2.83% |
| Willows | 19.96% |

For the 2008/2009 escalation year Cal Water is also authorized to file a request for a step rate increase and for the 2009/2010 year is authorized to request an attrition adjustment. The methodology for these adjustments is set forth in D.04-06-018 and discussed in the Division of Ratepayer Advocates' (DRA) testimony, Exhibits 100-107.

In addition to the rate increases listed above, we also authorize Cal Water a number of additional new capital projects that can be brought into rates over

[3] Section 5.1 of the Cal Water/DRA settlement contains a 5.9% rate increase cap for the Selma district for the first year and provides that in the following year, Cal Water is allowed to file for the remaining increase that would allow it to earn its authorized rate of return in that year.

the coming GRC period through advice letter (AL) filings.[4] The additional rate increases that could be requested under the AL filings, if submitted and approved, are substantial for each district except Dixon. Table 1 to the Settlement at Attachment 1 lists these projects and the cost caps we adopt.

In arriving at today's decision, we adopt the partial settlement filed by Cal Water and DRA on February 26, 2007. In our consideration of the settlement, we direct that further refinement be done on capital asset management planning, deployment of advanced metering, and customer notice of the dollar and percentage amount of AL authorizations we have granted and the estimated year each AL would be effective.

In addition to adopting the settlement, we also resolve all disputed issues. These issues include the mechanism and funding levels for conservation programs, the allowable level of working capital, the components of a vehicle replacement policy, and a rate design issue for the Westlake district.

This decision also addresses the Extended Service Protection (ESP) service currently offered to Cal Water customers by the utility's unregulated affiliate. The Commission finds the current terms and conditions of the ESP service may violate Section 453(a) of the Public Utilities Code. We also find that the ESP service cannot be offered directly by the utility itself under the terms and conditions of the excess capacity rules adopted in D.00-07-018. We provide Cal Water guidance as to how it can properly offer the ESP service through the utility or its affiliate, and direct that it submit by application the new terms and

[4] We find it reasonable to use the AL process for these projects because at the time of the AL filing there will be certainty about the project completion date and what the final costs will be. The timing and costs of these projects is uncertain now.

conditions of service if it chooses to continue the ESP service. We also provide Cal Water with some guidance on an apparent discrepancy between its affiliate transaction rules and our excess capacity rules.

## 2. Background

On July 26, 2006, Cal Water filed GRC applications and supporting workpapers for eight of its 24 districts. The Dixon, Oroville, South San Francisco, and Willows districts are located in northern California. The Bakersfield, King City and Selma districts are located in central California, and the Westlake district is in southern California, near Los Angeles. Bakersfield is Cal Water's largest district, with 65,256 service connections.[5]

The eight applications contain rate requests for a three-year period beginning July 1, 2007 and are filed in compliance with Public Utilities Code Section 455.2 (Section 455.2) and the requirements of the Rate Case Plan (RCP) we adopted in D.04-06-018.[6] The DRA timely protested the applications.

A prehearing conference (PHC) was held on September 27, 2006, followed by Public Participation Hearings in each district in November. On November 22, 2006, the assigned Commissioner issued his scoping memo that confirmed the consolidation of the eight applications, set the scope of issues and procedural hearing schedule, and designated Administrative Law Judge (ALJ) Walwyn as the principal hearing officer.

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[5] Bakersfield and South San Francisco's last GRC increase was authorized by D.04-09-038 in 2004. Oroville and Selma's last general rate increase was authorized by D.04-04-041 in 2004. Dixon, King City, Westlake and Willows' last GRC increase was authorized by D.03-09-021 in 2003.

[6] All section references in this decision, unless specifically noted, are to the Public Utilities Code.

The scope of this proceeding does not include development of increasing block rates (IBR) for residential, commercial, industrial, agricultural and public authority customers. Prior to the PHC, Cal Water requested this proceeding be bifurcated in order to have the time necessary to develop a conservation rate design using IBR. It later filed a separate Application (A.) 06-10-026 requesting the Commission's permission to develop and implement conservation rate design for all of its districts in a separate proceeding, I.07-01-022. This request was granted in the scoping memo. Therefore, the revenue requirement adopted here will be implemented under Cal Water's existing rate design in each of the eight districts.[7]

By ruling dated November 1, 2006, the ALJ granted the motions to intervene filed by North Ranch Country Club (North Ranch) and the San Francisco Public Utilities Commission (SFPUC).[8]

Evidentiary hearings were held in San Francisco on January 16 and on March 12, 13, 22, and 29, 2007. Cal Water and DRA filed a settlement addressing most ratemaking issues on February 26, 2007. Opening briefs were filed on April 12 by Cal Water, DRA, and North Ranch and reply briefs were filed on April 19, 2007 by the same parties. The proceeding was submitted with the receipt of reply briefs.

On June 21, 2007, the Commission issued D.07-06-028, granting Cal Water interim rate relief in these eight districts beginning July 1, 2007. The interim

[7] The rate design adopted here is subject to change on a going-forward basis when a conservation rate design is adopted in I.07-01-022.

[8] North Ranch is a customer of potable and reclaimed water in the Westlake district and SFPUC is the primary water supplier to Cal Water's South San Francisco District.

rates are based on the rate of inflation as compared to existing rates for each district, with the inflation rate calculated using the most recent Consumer Price Index maintained by the U.S. Department of Labor. These interim rates are subject to true-up to the final rates adopted in this decision.

### 3. Water Quality

In our new RCP decision, D.07-05-062, we cite to the California Supreme Court's holding in *Hartwell Corp. v. Superior Court,* 27 Cal.4th 256 (2002), that the Commission has constitutional and statutory responsibilities to ensure that water utilities provide water that protects the public health and safety. In support of our responsibilities, the Commission's General Order (GO) 103 states that: "Any utility supplying water for human consumption…shall comply with the laws and regulations of the state or local Department of Health Services." (GO 103 at Section II(1)(a).) In a recent Cal Water case for the Bakersfield and South San Francisco districts, we held that GO 103 applies broadly to utility compliance with all provisions of California's Safe Drinking Water Act.[9]

In order to properly review each utility's compliance with water quality requirements, the Commission has incorporated water quality into the minimum data requirements for a GRC filing and we also provide that, when the assigned Commissioner or ALJ deem appropriate, a water quality consultant may be hired by the Commission to make specific findings and recommendations concerning the utility's water quality compliance.[10]

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[9] *See* D.04-05-060, mailed on May 28, 2004, D.04-09-039 mailed on September 28, 2004 and D.04-09-064 mailed on September 29, 2004.

[10] *See* D.07-05-062, mailed May 30, 2007, *mimeo.* at 24-5.

In its opening brief, DRA addresses the expanded role it intends to take in reviewing the water quality information in each GRC application. This role, however, will not extend to rendering an opinion on whether or not a utility complies with all water quality regulations. DRA views its role as evaluating the impact of GRC application proposals and considering the economics of proposed capital investments to assure that ratepayers receive the lowest possible rates, consistent with reliable and safe service levels.

Cal Water has submitted water quality testimony for each district based on the filing requirements of D.04-06-018, the RCP in effect at the time of filing its applications. Cal Water's testimony, summarized in Exhibit 1, states that it has not been issued a citation by the California Department of Health Services (DHS) since its last GRC in each of the eight districts and that it meets all federal and state drinking water standards.

In reviewing the reports, we find two issues of concern, both in the Bakersfield district: First, Cal Water initially estimated that it could have as many as 23 wells that might be out of compliance with the more stringent arsenic standard adopted in January 2006 by the Environmental Protection Agency. Further testing indicated only six current wells might be at risk. At hearing, Cal Water testified that these wells have all been taken off-line or blended with other water.

The second issue of concern is Cal Water's report that since the last GRC there have been seven wells in the Bakersfield district that have tested in excess of primary or secondary Maximum Contamination Levels for the following: iron, manganese, color, turbidity, sulfate, carbon tetrachloride, methyl-tertiary-

butyl ether, and 1.2-dichloroethane.[11] Cal Water testifies that these wells have either been deactivated or it has initiated the required actions such as quarterly monitoring programs.

DRA testifies that it did not have concerns with the water quality in the Bakersfield district because DHS did not reported a concern; DRA did not perform any independent review or analysis.

Based on our review, we find that the evidence does not indicate any violations of applicable water quality standards by Cal Water in these eight districts.

## 4. Partial Settlement Agreement

### 4.1. Standard of Review

On February 26, 2007, Cal Water and DRA filed a joint motion to approve a settlement agreement. The standard of review for this settlement is the criteria found in Rule 12.1(d) of the Commission's Rules of Practice and Procedure. This rule provides that, prior to approval, the Commission must find a settlement, whether contested or uncontested, "reasonable in light of the whole record, consistent with law, and in the public interest." Cal Water and DRA state that they have entered into the settlement agreement on the basis that the Commission's adoption should not be construed as a precedent or statement of policy of any kind except as it relates to the current and future proceedings addressed in the settlement.

[11] The full report is Exhibit 4.

Pursuant to Rule 12.1(b), all parties in the proceeding received notice of the settlement conference. Section 1.14 of the settlement states that the parties have not settled the Westlake district issue raised by North Ranch.

### 4.2. Terms of the Settlement

The settlement is Attachment 1 to this decision. It covers all eight districts and resolves all but five contested issues.[12] Cal Water's applications contain significant rate increases for each district. The primary causes of the requested increases are new plant investment and a higher requested rate of return; these remain the primary causes of the proposed settlement rate increases.

Of note, many of the plant projects have been removed from the settlement's revenue requirement and placed in separate advice letter filings that will come in during the upcoming GRC period. These AL authorizations contain a dollar cap for each project and cannot be filed until the project is completed.

The parties state they have used the AL process for projects that at this time have uncertainty regarding the time of completion and/or the cost. The AL process, as adopted in D.07-01-024, will require the projects to be completed within the cost caps established here prior to submission to the Commission, and the ALs will be subject to public review and protest and require final action by the Commission.[13]

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[12] The contested issues are addressed separately in the next section of the decision. The combined contested issues, if all decided in Cal Water's favor, would increase rates 1.67% for the Bakersfield district, 1.30% for Dixon, 1.50% for King City, 0.25% for Oroville, 1.39% for Selma, 1.01% for South San Francisco, 0.78% for Westlake and 2.25% for Willows.

[13] *See* D.07-01-024, mailed January 29, 2007, *mimeo.*, at pages 21 and 46.

#### 4.2.1. Rate Base Items

This section of the settlement, Section 3.0, contains Cal Water and DRA's agreement on numerous long-term capital plant additions. We separately discuss the settlement's provisions for each district.

Following the mandates of our Water Action Plan, we first examine the adequacy of Cal Water's planning for its plant additions, particularly its need for further action to ensure timely infrastructure replacement. We then examine another Water Action Plan objective, the deployment of advanced meters.

##### 4.2.1.1. Status of Cal Water's Capital Asset Management Planning

In our Water Action Plan, the Commission adopted six objectives, one of which is to promote water infrastructure investment. The Commission states that water utilities should augment their existing Water Management Program that is filed in each GRC, to include a long-term procurement plan, which 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."[14]

In revising the RCP for Class A water utilities, the Commission implemented this objective by adopting a requirement that each GRC application on or after July 1, 2008 contain a long-term, 6-10 year Water Supply and Facilities Master Plan to identify and address aging infrastructure needs, and that this plan be consistent with the General Accounting Office's (GAO) March 2004

[14] Water Action Plan, issued December 15, 2005, page 12.

Report, GAO 04-461: *Water Infrastructure: Comprehensive Asset Management has Potential to Help Utilities Better Identify and Plan Future Investments*.[15] We adopted the GAO's capital asset management planning requirements after the conclusion of hearings in this proceeding. Therefore, we do not make a finding of compliance here, but rather discuss what Cal Water can do as it goes forward with its planning studies in the coming three years.

Cal Water testifies that it began to take a long-term look at capital needs only in the last few years. Prior to this, it performed capital improvements on a reactive basis and it does not have a Water Supply and Facilities Master Plan (Master Plan) in place for most of its districts.[16] As an example, Cal Water testifies that approximately one-third of its 600 wells are over the industry standard for design life.[17]

In its applications, Cal Water requests funding for a Master Plan for seven of its districts, at approximately $300,000 per district.[18] In the settlement with DRA, Cal Water agrees to include funding for master plans in this GRC cycle for Bakersfield, Selma and King City and defer to the next GRC cycle master plans for Oroville, Willows, Westlake, and Dixon.[19]

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[15] *See* Appendix A, page A-28 of D.07-05-062, mailed May 30, 2007.

[16] Tr. Vol. 12 at 387.

[17] *Id.* at 418.

[18] The funding for Bakersfield is less as it is only to update and augment an existing master plan. There is no request for South San Francisco as its master plan is almost complete.

[19] Section 3.1 of the settlement and Tr. Vol 12 at 385-6. A portion of Westlake's plan, the hydraulic-model, is included in this GRC and the Bakersfield project is reduced to $207,000 to reflect some value for the previous plan.

At the request of the ALJ, Cal Water and DRA prepared a three-page document that details the work that will be done in the new master plans, including an inventory and assessment of system facilities condition and capacity, and the need for infrastructure replacement; this document is Exhibit 79. In testimony, DRA describes Cal Water's studies as integrated resource management plans and distinguishes this from the comprehensive asset management planning process proposed in the March 2004 GAO report. DRA testifies that the difference between Cal Water's current planning and the GAO's comprehensive asset management planning is that comprehensive asset management planning looks at life cycle costs for utility assets, with a focus on maintenance programs as well as replacement.

DRA testifies that it is important that the Commission direct water utilities to move in the direction of comprehensive asset management programs as well as integrated resource management planning.[20] Cal Water testifies that it has a maintenance department that is focused on moving from a reactive program to a proactive maintenance program but it is not yet fully implemented.[21] Cal Water submitted Exhibit 81 as a late-filed exhibit. In Exhibit 81, Cal Water addresses whether the planning studies currently underway meet the GAO criteria. Cal Water states that its current requests for proposals for the master plans authorized here do not meet the GAO criteria. Asset management software compatible with the 2004 GAO study is planned to be installed company-wide

[20] Tr. Vol. 13 at 499.

[21] *Id*. at 499.

by 2009 in order to meet Rate Case Plan filing requirements by the time of 2009 GRC filings.

We commend Cal Water for the planning process it has begun, while also recognizing that Cal Water needs to further refine and integrate its planning efforts in order to meet the GAO standards for comprehensive asset management planning. We find that Cal Water needs a more aggressive schedule than that proposed in Exhibit 81 in order to meet the new RCP filing requirements.

For this proceeding, we direct Cal Water to examine if the master plan process currently underway for the Bakersfield, Selma and King City districts can be augmented, either by a revised Request for Proposal or with in-house resources, to meet our new master plan requirements. Cal Water should make a compliance filing within 90 days of a final decision in this proceeding on the status and scope of possible revisions to its proposed master plans for Bakersfield, Selma, and King City.[22]

#### 4.2.1.2. Status of Advanced Metering Deployment

As part of the Commission's objective to strengthen water conservation programs, the Water Action Plan promotes metered water service and encourages the deployment of automated meter reading (AMR) equipment. We state:

> **Promote metered water service to encourage conservation.**
>
> One major conservation incentive is the elimination of flat-rate and un-metered water service. Metering water is essential to send a

[22] Cal Water testified that the Bakersfield and Selma plans are currently being worked on and the King City plan is scheduled to begin later. *See* Tr. Vol. 12 at 385.

> clear price signal and give the customer a financial incentive to conserve. In addition, installation of Automated Meter Reading (AMR) equipment can provide accurate real time water usage information, reduce labor costs associated with meter reading, and provide more detailed data of customer usage. Section 781 of the Public Utilities Code requires a showing that the metering will be cost-effective, results in a significant reduction in water use, and will not impose unreasonable costs. The CPUC will work to ensure that such a showing is made as often as possible in future water cases, and will then require metered water service. This will be accompanied by appropriate rate designs, as discussed below. (*Id.* at 7.)

In the settlement, Cal Water and DRA agree that the company may begin a major water meter installation program for the Bakersfield district. This program would authorize $8,190,000 over the coming three years, with an anticipation that these spending levels would continue for another 12 years in order to comply with Assembly Bill 2858's requirement that all flat rate customers be metered by the year 2025.

Under the settlement, Cal Water is budgeting $1,000 per home to do the metering installation, with only $25 of this amount being spent on the meter itself.[23] The metering plan does not include any AMR deployment.

We have strong concerns with this proposal. Cal Water testifies that it questions whether the $25 meters it plans to install are cost-effective and estimates AMR would add $150 to the price of an installation. It states that water costs for residential customers are much less than energy costs, water does not have peak hour costs similar to energy, and that the meter penetration in existing

[23] Tr. Vol. 12 at 423. The record is somewhat confusing. In Exhibit 100, at page 7-23, DRA states that Cal Water provided higher estimates for meter costs in earlier data requests and also included "automation" estimates.

Bakersfield neighborhoods is "spotty," thereby requiring many streets to still require a meter reader to visit. Neither Cal Water nor DRA recommend installing meters with any electronic or automated features because the parties do not think advanced metering technology would be cost effective or reliable.

Cal Water estimates that adding AMR equipment to a meter would increase installation costs for each residence by $150, and Cal Water's internal studies do not show that this would be cost effective.[24] DRA testified that its research showed an AMR meter would cost approximately $250 and have an error rate of about 20 percent; it also did not find this cost effective.[25]

On March 29, 2007, the ALJ asked the parties to explore further this issue in light of our Water Action Plan objective to promote advanced metering. In particular, the ALJ cited a recent article in the *Water Efficiency Journal* on the use of radio-read meters. This article discusses the benefits of the advanced meters, particularly the ability to improve leak detection; the article provides statistics on the rapid rate of deployment of these advanced meters, with 21% of U.S. water customers now having them, compared to 16.4% two years ago.[26]

In later testimony, Cal Water states that Pacific Gas and Electric Company (PG&E) has contacted them regarding its new advanced metering program for gas customers and discussions had begun about a combined program with water

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[24] Tr. Vol. 12 at 423-430.

[25] *Id.* at 431.

[26] Tr. Vol. 13 at 486. "Tuning in to Water Radio" by David Engle at www.waterefficiency.net.

agencies in the Bakersfield area. Cal Water has an employee who is responsible for metering and is working on this coordination.[27]

We find that a more thorough analysis of advanced water metering should take place before Cal Water proceeds to install new meters. By taking the time to further study this issue, there may also be opportunities to consider new technology or a combined program with PG&E that could prove cost-effective and capable of reliably meeting our water conservation goals. For instance, published reports from Nogales, Arizona and Santa Fe, New Mexico state that these cities have begun programs to install a FIREFLY automatic meter reading interface device that costs $94/box, can be installed on both new and existing meter connections, and is reported to be reliable, cost-effective, and helps to conserve water.[28]

Therefore, we direct Cal Water to make a compliance filing within 90 days of this decision discussing whether the $8,190,000 in funding for meter installation will be spent on new meters that are compatible with future deployment of advanced metering technology and, specifically, with the advanced metering being deployed by PG&E in the Bakersfield district.

We do not reject the settlement's provision of $8,190,000 AL authorization for meter installations in the next Bakersfield GRC cycle, rather we require further analysis and support for the manner in which meter installation takes place.

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[27] *Id*. at 487.

[28] *See* "Automated Meter Reading" at www.cityofnogales.net/amr and January 15, 2007 article "Santa Fe to check for water leaks with techno device" in Albuquerque Tribune at www.abqtrib.com/news/2007/jan/15/santa/fe/check/water/leaks-techno-device/.

We turn now to a review of ratebase for individual districts.

#### 4.2.1.3. Bakersfield District

The parties settled disagreements on 26 plant items or programs, with $134,000 in vehicle replacements remaining outside the settlement. The major changes from Cal Water's initial application are that the settlement eliminates two projects, proposed to total $3,240,000, and reduces four other projects by $335,900. Eight other projects, totaling $11,817,700, are handled through the AL process. The settlement also lowers the contingency fees included for projects, and uses these lower percentages in other districts.[29]

#### 4.2.1.4. Dixon District

The parties settled all five disputed plant issues. The major change from Cal Water's application is that its $225,000 request for a Water Supply and Facilities Master Plan has been deferred to the next GRC cycle.

#### 4.2.1.5. King City District

The parties settled all six disputed plant issues with only minor changes to Cal Water's initial requests.

#### 4.2.1.6. Oroville District

Cal Water and DRA settled all five disputed plant issues. Three of the projects involve supplying water to the Oroville treatment plant. DRA agreed to AL filings for two of the projects, with a cap of $458,200 and for the third project, reconstruction of flume F of the Powers Canal, at an estimated cost of $326,200. Cal Water agreed to do further review and report to the Commission in a

[29] The settlement adopts a 12.5% contingency fee for 2006 projects; 17.5% for 2007 projects; and 22.5% for 2008 projects.

subsequent GRC. For its requested master plan, Cal Water agreed to defer this project to the next GRC.

Finally, as with the other districts, Cal Water and DRA agreed to apply a ten-year adjusted average of recorded nonspecifics and to use this amount or Cal Water's original proposed budget, whichever is less. For Oroville, Cal Water's original budget is less.

#### 4.2.1.7. Selma Plant

The parties settled all five disputed plant issues with minor dollar adjustments to two projects. Several large projects are handled through the AL process.

#### 4.2.1.8. South San Francisco Plant

The parties settled all disputed plant issues except $94,100 in vehicle replacement policy. Generally, DRA agreed to Cal Water's original requests, provided the projects were subject to AL filings and capped at the proposed amounts.

#### 4.2.1.9. Westlake Plant

Cal Water and DRA settled seven of the disputed issues, with $58,000 in vehicle replacement, a disputed issue outside the settlement. For replacement of the Harris reservoir, Cal Water proposed five projects. The parties agreed two of the projects have estimated completion dates outside this GRC period and are therefore removed. The parties settled on the remaining three projects being authorized through advice letter filings, two with cost caps totaling $1,117,500, an amount $27,500 above Cal Water's initial request, and one project requiring a Commission resolution because cost estimates are not available.

Cal Water requested $300,000 for a master plan and hydraulic model. As discussed earlier, it agreed to defer its master plan to the next GRC and both parties agreed to include $100,000 for the hydraulic model.

#### 4.2.1.10. Willow Plant

Cal Water and DRA settled all eight disputed plant items, with approximately $200,000 in dollar reductions. The largest adjustment was to defer the 2008 proposed master plan and hydraulic model to the next GRC.

#### 4.2.1.11. Summary of Rate Base Section

We find the rate base section of the settlement reasonable provided Cal Water (1) reexamines the Bakersfield metering program, as discussed above, (2) performs a further review of its master planning process authorized here, and (3) notifies its customers of the potential rate impacts of the AL filings we authorize here.

We turn now to the other sections of the settlement.

### 4.2.2. Sales and Services

Cal Water and DRA differ in the number of customers in King City and Selma, the sales per customer for some classes of customers, and differences in unaccounted for water in King City and Dixon districts. The two parties have agreed to accept the recommendations of DRA, and state that in doing so they correct for a calculation error in the application and reflect more recent information. We find this reasonable.

### 4.2.3. Expense Items

Section 2.2 of the attached settlement details the parties' agreements on 14 disputed expense categories, with Bakersfield and King City having the most disputed items. The parties generally agree to use Cal Water's method for calculating expenses and provide reasonable explanations for doing so. For

personnel, DRA agrees to eight new positions in Bakersfield in the test period and one new position each in the King City, Oroville, and Selma districts; Cal Water agreed to not include three new positions in Bakersfield and one new position in King City. The parties agree to estimates that are between their original positions for transmission and distribution expenses, customer accounting, stores, and contract maintenance.

We find this section of the settlement reasonable.

#### 4.2.4. Special Facilities Fees

Cal Water initially requested an early, *ex parte* order to increase the special facilities fees charged new development connections for the Bakersfield, Dixon, King City, Selma, and Willows districts. These fees are set forth in Rule 15 of Cal Water's tariffs. The company requested $1,000 per equivalent one-inch service connection for four districts and $1,500 for Bakersfield. The amount requested is based on the per-service cost of special facilities less the district's per-service rate base.

DRA developed its recommendation based on the full cost of special facilities, arriving at a higher special fee. Both approaches were based on the Commission's policy that existing customers should not pay for customer growth.

In the settlement, the parties agree to a $1,500 special facilities fee for Dixon, King City, Selma, and Willows and a $2,000 special fee for Bakersfield; all fees are effective beginning July 1, 2007. For Bakersfield the fee would increase to $2,250 on July 1, 2008 and $2,500 on July 1, 2009.

We find this a reasonable resolution provided the effective date is the effective date of this decision.

### 4.2.5. Rate of Return

The parties had no disagreement to resolve on capital structure and cost of debt.[30] In the settlement, Cal Water and DRA reached agreement for a return on equity (ROE) of 10.20% for the coming GRC period. The settlement states that this ROE is reasonable as it is within the range of DRA's model results, and excludes Cal Water's request for a 45 basis point adjustment above its own modeling results to reflect what it characterizes as unique risk factors. Cal Water's most recently authorized ROE is 10.16%, adopted in D.06-08-011 for its Antelope Valley district.

At the hearing, the ALJ requested the parties update the forecasts of GRC period interest rates used in their ROE models and that Cal Water provide for the record its latest Securities and Exchange Commission (SEC) Annual Financial Report (Form 10-K), and the latest equity research reports by companies that report on Cal Water. This information is found in Exhibits 75 through 78.

The updated 2007-2009 average interest rate forecasts for 30-year Treasury Bonds is 5.12-5.23% and for 10-year Treasury it is 5.07-5.23%. This represents a 37-48 basis point reduction to the forecasted 30-year Treasury average used by DRA in its risk premium ROE model and a 19–35 basis point reduction in the forecasted 10-year Treasury rate used.[31] The Commission generally uses the most current financial forecasts available in establishing an ROE for the upcoming period; use of these updated figures would result in a significant downward adjustment to DRA's risk premium ROE model.

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[30] *See* Exhibit 100, Table 1-1 at page 1-2.

[31] *See* Exhibit 108 August 2006 forecasts for GRC period at 2-14 and 2-15 and Exhibit 75 December 2006 – March 2007 forecasts for the GRC period.

Reviewing the six equity reports prepared by AG Edwards, Baird, Brean Murray Carret, Edward Jones, Janney Montgomery Scott, and Stanford Group Company in February – March 2007, we find that all view Cal Water as a high quality utility and rate its shares as hold or buy. The reports view the major potential risk factors for Cal Water to be wet weather, a rise in long-term interest rates, and adverse regulatory decisions.[32]

Cal Water Service Group's 10-K report for 2006 contains a five-year performance graph that shows the company outperforming the S&P 500 and AG Edwards Water Utility Index for the changes in cumulative shareholder return on common stock. In compliance with SEC regulations, the comparison assumes $100 was invested on December 31, 2001, in California Water Service Group's common stock and in each of the foregoing indices and assumes reinvestment of dividends.[33]

Based on the record evidence, we are concerned that the parties did not update the interest rate forecasts prior to reaching a settlement. The updated forecasts would lower DRA's risk premium model ROE by 0.19% to 0.48%. This is a substantial change and we should take this into consideration in weighing the settlement as a whole. The weight of our concern is lessened by the parties' argument that the settlement's ROE (10.20%) falls within DRA's model results. The ROE would still fall within DRA's model results if the updated interest rate forecasts were applied.[34]

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[32] *See* Exhibits 77 and 78.

[33] *See* Exhibit 76 at 27.

[34] In Exhibit 100, DRA's Discounted Cash Flow model yielded an ROE of 8.30% and its Risk Premium model yielded a range of 10.53% to 11.15%.

We find the ROE of 10.20% at the top of a reasonable range, and not a cause for rejecting the settlement as a whole.

### 4.3. Action on the Proposed Settlement

Based on our review of the settlement, we have concerns with three areas: the scope of the master plans authorized to be completed in this GRC period, the meter installation program in Bakersfield, and the notice to customers of the AL filings authorized for this GRC period.

We have given specific direction on the master planning and metering programs. For the customer notification issue, we direct Cal Water to provide direct notice to its customers of the rate offset filings, as provided under GO 96-B general rule 4.2 rather than the lesser notice allowed under Water Industry Rule 3.1. We make this change due to the magnitude of the AL potential rate increases contained in the settlement.

With the refinements discussed above, we find the settlement to be reasonable in light of the whole record, consistent with the law, and in the public interest.

## 5. Issues Not Included in the Settlement Agreement

### 5.1. Reclaimed Water Rates for Westlake District

North Ranch is a Cal Water customer in the Westlake district taking service under Cal Water's reclaimed and potable water tariffs. It testifies that Cal Water's existing rate for reclaimed water is not just and reasonable because (1) it is not cost-based, and (2) our conservation objectives encourage water

utilities to convert golf course irrigation usage from potable water to reclaimed water.[35]

North Ranch recognizes that rates may include factors other than cost, but it does not find that Cal Water has met its burden of proof in this proceeding to justify reclaimed water service revenues increasing by 8.5% to 9.4% when other district revenues are projected to increase by 2.8% to 3.6%. North Ranch requests the Commission (1) freeze the existing monthly service charge at $260 for a six-inch meter; (2) roll back the existing consumption charge from $1.5989 to $1.41 per 100 cubic feet, thereby eliminating one-half of the differential between what Cal Water pays and what it charges for reclaimed water; and (3) direct Cal Water to submit a comprehensive cost allocation study in its next rate proceeding so that the Commission and interested parties can readily identify the cost of furnishing reclaimed water service.[36]

Cal Water's position is that the rate design methodology for reclaimed water adopted by settlement in the last GRC proceeding should be maintained, and that this methodology is the same as first adopted in D.93-06-090.[37] This methodology is described by Cal Water as follows: the quantity rate for reclaimed water is set to include the wholesale cost differential and all other costs are set at 80% of potable cost levels.[38]

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[35] North Ranch testifies the issues it raises are applicable to all reclaimed water customers in the Westlake District.

[36] Exhibit 113 at page 10.

[37] *See* Tr. Vol. 12 at 461, Exhibit 61, and Reply Brief at 14.

[38] Tr. Vol. 12 at 461-2.

Cal Water asserts that the existing rate methodology should be maintained because North Ranch has not set forth a sufficient basis to justify altering the rate methodology in this proceeding.[39]

DRA does not directly address this issue in testimony or brief.[40]

#### 5.1.1. Discussion

The reclaimed water sold to North Ranch is purchased from the Calleguas Municipal Water District (Calleguas) at wholesale rates; a portion of Cal Water's potable water is also purchased from Calleguas. Cal Water incurs no treatment or pumping costs for the reclaimed water. It incurs virtually no operating costs; and its facility investment is approximately $14,480, less depreciation.[41]

In D.93-06-090, we first set a reclaimed water rate. In this decision, we find that having North Ranch's golf course use reclaimed water rather than potable water is beneficial to all customers as it makes available additional potable water for the system. We find that every effort should be made to induce the use of reclaimed water and that lower rates for reclaimed water would promote this objective.[42] Further, we find that it would not be reasonable to set North Ranch's rate based solely on cost of service ratemaking because this will not capture any of the revenues North Ranch has been contributing to the overall costs of the system when it uses potable water for its golf course, nor will it capture the benefits of fire protection that North Ranch will continue to receive.

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[39] Opening Brief at 27.

[40] In response to an ALJ question, its attorney states on the record that DRA intends to stick with the current rate design structure. Tr. Vol. 12 at 466.

[41] D.03-09-021 at 81.

[42] D.93-09-021, 1993 Cal. PUC LEXIS 347, pages 4 and 5.

For these reasons, we chose in D.93-06-090 to treat reclaimed water as an additional water source rather than a separate and distinct service for ratemaking purposes. We recognize that certain municipal water districts provide a 25% rate differential between potable water and reclaimed water service, but if Cal Water's reclaimed water rates were set at a level 25% below its potable water rates, the rates would be non-compensatory and would require potable water customers to subsidize the service. Therefore, we conclude the rates for reclaimed water should be the same as the rate for potable water except for a differential in quantity rates based on the wholesale rate difference to purchase reclaimed and potable water. This results in an overall rate differential of 13%.[43]

In adopting this rate design in D.93-06-090, we emphasized that reclaimed water service is relatively new and our ratemaking treatment should not be considered as a precedent for future ratemaking for reclaimed water.[44]

In D.03-09-021, the last GRC proceeding for Westlake, the Commission found that the record established Cal Water's existing rate for reclaimed water provided for a 33% markup over wholesale costs. North Ranch's expert testified that this markup was excessive.

The Commission in D.03-09-021 adopted a non-precedential Joint Recommendation on Reclaimed Water Rates reached by Cal Water, DRA, North Ranch and the consumer group Aglet. In the Joint Recommendation, the parties agreed to reduce the reclaimed water rate (both the service charge and

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[43] *Id.* at 4 and 5.

[44] *Id.* at 4.

volumetric components) proposed by Cal Water in its application by 20%, but only so far as the resulting rate would not be lower than the previously applicable rate. If the rate resulting from applying the discount was lower than the previously applicable rate, then the previously applicable rate would remain in effect. We found this a reasonable compromise between the parties.[45]

Based on our discussion above, we find there is no precedential policy established for reclaimed water ratemaking in the Westlake district. This is clearly stated in both D.93-06-090 and D.03-09-021. North Ranch is correct that it is Cal Water's burden of proof to support a ratemaking treatment here. We find Cal Water's showing is weak.

We find that while the ratemaking methodology first adopted in D.93-06-090 did not carry directly through to D.03-09-021, there are some general policies that the Commission has followed over the past 14 years. First, we have consistently established reclaimed water rates in the context of the entire system's costs, based on the finding that fire protection service is provided to reclaimed water users and that there are some facility investments and some cost responsibility for administrative and general expenses. Our ratemaking also recognizes the differential that exists in the wholesale purchase costs of reclaimed and potable water.

In D.93-06-090, we set the rates the same for reclaimed and potable water except for the differential in wholesale commodity rates. Ten years later, in D.03-09-021, we found it reasonable to lower the service charge and volumetric

[45] D.03-09-021 at 82.

rate proposed by Cal Water by 20%, but only so far as the resulting rate would not be lower than the previously applicable rate.

#### 5.1.2. Conclusion

Based on the discussion above, we find it reasonable to maintain North Ranch's and other reclaimed water customers' existing water rates, both service charge and volumetric rate. This adopts North Ranch's request in regard to its fixed customer charge, and for the commodity rate it provides a benefit to reclaimed water customers because potable water customers will receive an immediate volumetric rate increase under the proposed settlement in 2007 and 2008. Reclaimed water customers should be refunded the interim rate surcharge and they are not subject to the rate true-up. Reclaimed water customers will continue to be subject to AL filings in the coming GRC period, both to reflect changes in wholesale purchased costs for reclaimed water and for any facilities additions authorized that are deemed used and useful in the provision of fire protection service. It will also be subject to the 2009-2010 attrition adjustment.

We direct Cal Water to provide a detailed proposal for reclaimed water rates in the next GRC filing. We do not require that this proposal be based on a comprehensive cost allocation study.

### 5.2. Vehicle Replacement Policy

DRA recommends the Commission adopt the vehicle replacement criteria of the Department of General Services (DGS) for Cal Water because DGS' policy reflects a more contemporary perspective than the policy DRA and Cal Water developed in a 1996 settlement. Further, the Commission adopted DRA's recommendation to use the DGS criteria for Southern California Water Company

(SCWC) in D.06-01-025, and this criteria should be consistently used for all water utilities.[46]

In its Bakersfield report, DRA mistakenly testifies that the DGS policy is to allow a vehicle to be replaced when the age of vehicle is eight years old or the miles driven have reached 150,000.[47] In its briefs, DRA corrects the DGS mileage standard to 120,000 and recognizes that DGS guidelines also allow that vehicles can be replaced earlier with an appropriate supporting report. DRA does not find the additional reporting required to replace a vehicle early would be burdensome for a water utility, stating that instead it is good management to generate such inspection reports to justify when vehicles should be replaced.[48]

Cal Water argues that it has used its current policy since the 1996 settlement agreement with DRA adopted in D.96-06-034, and therefore should be allowed to continue to use the policy. Its existing policy calls for replacement of vehicles that are (1) six years old and have 100,000 miles; or (2) are eight years old (regardless of mileage); or (3) have 125,000 miles (regardless of age). Further, it states DGS' policy would make budgeting for the three-year rate case plan more expensive and difficult due to the prescribed cost-effectiveness review that would be required to replace vehicles with less than eight years or 120,000 miles.[49]

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[46] *See* D.06-01-025 discussion, *mimeo*., at pages 44-45, and Conclusion of Law 24, *mimeo*., at page 82.

[47] Exhibit 100, page 7-19.

[48] Opening Brief at 5 and Reply Brief at 3.

[49] Opening Brief at 20-21.

Cal Water does not support its position with any fleet management study or data on its own history of vehicle repair and maintenance expenses. Cal Water references in its cross-examination a new study being prepared by the Department of Transportation but does not provide any detail.[50]

The dispute here is only on the first of Cal Water's three criteria: six years or 100,000 miles. We find the DGS policy is reasonable as it is based on more current vehicle information than was used in the 1996 settlement and the policy is currently applied to a wide range of state vehicles. In addition, we have already adopted this policy for another Class A water utility, Southern California Water Company. Therefore, we adopt the DGS criteria for Cal Water's vehicle replacement policy.[51]

### 5.3. Conservation Expenses

Cal Water requests the Commission include in each district's rate base an amount equal to 1.5% of revenues, totaling $1.06 million for the eight districts, to be used for water conservation expenses. Cal Water seeks to dramatically increase its water conservation spending in order to strengthen its water conservation programs to a level comparable to those of energy utilities. Cal Water chose the amount of 1.5% based on a conservation agreement it signed with two other water utilities and several environmental groups; DRA was not a party to this agreement.

Recognizing that it has underspent authorized conservation funds in the past, Cal Water proposes to use balancing accounts for each district to track its

[50] Tr. at 261.

[51] As discussed, DGS's vehicle replacement policy is properly stated in DRA's briefs.

expenditures and to then divert money not spent to other programs or return the money to ratepayers in the next GRC.[52]

As an alternative proposal, Cal Water introduces DRA's recommendation in another proceeding, Cal-Am's Los Angeles district, that a memorandum account be used to track conservation expenditures.[53]

DRA objects to Cal Water's original proposal because it would be detrimental to ratepayers to allow Cal Water such a substantial increase in ratepayer provided funds without Cal Water providing any real evidence to the Commission of its ability to utilize these funds efficiently or in full. DRA testifies that historically Cal Water has significantly underspent its authorized conservation funds.[54] DRA is supportive of conservation but does not support the Commission relying on an arbitrary factor of 1.5% of revenues as the appropriate level of expenditures. DRA also questions Cal Water's proposal to divert authorized but unspent conservation funds to unspecified "other programs." DRA's proposal is to use existing levels of authorization as the basis for Cal Water's conservation funding in the coming GRC period.

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[52] Cal Water also committed to spending its conservation funds, outside of educational projects, on programs that have been found to be cost-effective using the Best Management Practices (BMP) set by the California Urban Water Conservation Council and to providing regular reports to the Commission staff, so that expenditures are continually monitored.

[53] This is entered as Exhibit 67 in this proceeding.

[54] For the largest district, Bakersfield, see Exhibit 100 and Tr. Vol. 11, pages 329-341. Specifically, DRA cites to testimony that for 2004 in Bakersfield, the Commission authorized $103,000 and Cal Water spent only $5,480, just 5% of the funds provided by customers. In this proceeding, Cal Water is requesting $714,122 for Bakersfield and DRA testifies that as of July 2006 the company had spent only $17,945 for the first half of

*Footnote continued on next page*

We commend Cal Water for its willingness to make a greater commitment to conservation programs than it has in the past. However, we share DRA's concern that there is little evidence that 1.5% of revenues is an attainable level for expenditures in the coming three years, and even if attainable, that the conservation programs will be effective when implemented so quickly and without detailed measurement and evaluation procedures.

We do not share Cal Water's view that DRA does not support the Commission's conservation goals. Rather, Exhibit 67 shows that DRA has exercised leadership in water conservation programs and supports our Water Action Plan objective to strengthen effective conservation efforts by the water utilities.

We find the DRA memorandum account proposal for conservation expenses in A.06-01-005, Exhibit 67, introduced by Cal Water in this proceeding is a preferable alternative to either party's proposal. Specifically, the mechanism in Exhibit 67 would authorize a memorandum account to track conservation program costs, up to certain annual dollar amounts, and allow recovery from ratepayers after the costs have been confirmed to be prudent. The exhibit also recommends the utility submit an annual conservation report detailing efforts and results.

A memorandum rather than a balancing account ensures Cal Water only receives funds for its actual expenditures and removes the need for Cal Water to divert funds to "other programs" or to reimburse ratepayers in the next GRC. It also allows the Commission to carefully review actual expenditures prior to

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the year. Cal Water later updated its Bakersfield figures to show total 2006 expenditures of $135,000. *See* DRA Opening Brief at page 6.

ratepayer recovery. Exhibit 67 also discusses Cal-Am's plans to implement its conservation program in coordination with the area's three wholesale water agencies and to use grant assistance provided by these agencies to help fund its increased conservation efforts. Cal Water could follow the same policy and also plan for gradual expansion of various water conservation program aspects to match anticipated customer interest, participation levels, and efforts to identify customers with the highest water savings potential.

We find Exhibit 67's requirement for an annual conservation report detailing the utility's efforts and results is critical to achieving our conservation objective. Cal Water and DRA could consult with the California Urban Water Conservation Council (CUWCC) in developing this. The CUWCC coordinates statewide urban water conservation, has adopted 14 BMPs, which we reference in our Water Action Plan, and can provide guidance in designing comprehensive measurement and evaluation procedures.

In conclusion, we find our Water Action Plan conservation objective is best met by adoption of a memorandum account to track expenditures that are made, and measured, based on detailed annual reports. We encourage Cal Water and DRA to work collaboratively to develop specific plans for each district. Their efforts should include coordinating with the existing conservation programs of all wholesale water agencies in each district and identifying any available grant funding. Cal Water should file a conservation budget and measurement and evaluation proposal for each district within 90 days of this decision and then make ongoing reports and budget proposals on at least an annual basis.

We should establish funding caps for Cal Water's conservation expenses and these caps should be consistent with the record here and our conservation objectives. We find DRA's proposal to authorize only existing levels of

conservation expense would provide insufficient funding to meet our Water Action Plan conservation objective. Cal Water proposes we authorize 1.5% of revenues but does not adequately support that this is an appropriate level of expenditure. In its opening brief, Cal Water does cite to D.06-08-011, *mimeo.* at 43, to establish that in its 2005 GRC proceeding for eight other districts, it reached agreement with DRA on a water conservation budget that was equivalent to approximately .54% of revenues; Cal Water asserts that this was a substantial increase from prior years.[55] We also note that in Exhibit 67, DRA recommends a conservation expense level cap for California-American Water Company's (Cal-Am) Los Angeles district that computes to approximately 1% of revenues for Cal-Am's district.

The Commission is currently considering conservation policies, to include appropriate funding levels, for other Cal Water districts and for other Class A water utilities in its water conservation proceeding, I.07-01-022. Therefore, the level of conservation funding we authorize here is limited to the specific districts and GRC period of this proceeding and should not be construed as a precedent or statement of policy. Given this limitation, and recognizing we are adopting a memorandum account mechanism and reporting requirements, we should set a 1.0% of revenue cap for the 2007/2008 test year, and raise this to a 1.5% revenue cap for the following two years.

### 5.4. Working Capital

The contested issue here is the number of lead/lag days that should be reflected for state and federal income taxes. Cal Water proposes to include in

[55] Opening Brief at 24.

rates a 45-day lead/lag figure for state and federal income taxes based on a new lead/lag study it completed in 2006. It states its study was performed consistent with the Commission's Standard Practice U-16 guidelines and the overall study was found by DRA to be "comprehensive" and "well-documented"; therefore, the specific tax calculations contained in the study should be adopted. Cal Water objects to DRA's proposal that Cal Water continue to use a 93-day lead/lag time for taxes as the 93 days was originally adopted in D.03-09-021 as part of a settlement, and Commission policy holds that a settlement should not be used as precedent in future proceedings.

DRA testifies that since the methods for paying state corporation franchise and federal income taxes have not changed since Cal Water's last Bakersfield GRC proceeding, the same methods should continue to apply. It testifies that despite Cal Water's best efforts to explain its new position, it has not provided a comprehensible justification for using a lead/lag figure that is approximately half that previously found to be appropriate. DRA states the methodology used to establish the 93 days is a weighted average calculation that recognizes that tax payments are not made on a uniform quarterly basis but that instead Cal Water's taxes are paid predominately toward the end of the year.[56] Further, it states its method is consistent with the purpose of establishing a working cash figure in rate base, which is for ratepayers to compensate investors for any funds that they permanently commit to the business for the purpose of paying operating expenses in advance of receipt of offsetting revenues from customers and in

[56] Tr. Vol. 11, at pages 317-20.

order to maintain minimum bank balances.[57] In its opening brief, DRA also uses data submitted in this proceeding as Exhibits 109, 110, and 111 to perform a current analysis resulting in 137.2 days for federal income tax and 110.9 for state corporation franchise tax; Cal Water objects in its reply brief to DRA submitting further analysis at the briefing stage.

In considering this issue, we weigh whether Cal Water has met its burden of proof to show the reasonableness of a 45-day lead/lag for state and federal income taxes. Cal Water supports its proposal with a 2006 comprehensive study but does not clearly refute DRA's concerns that the tax analysis contained in the study's Table 17, entered as Exhibit 109, may be based on faulty premises or possible double-counting. While DRA's 93-day recommendation was originally adopted as part of a settlement in D.03-09-021, it has been used since in five subsequent Cal Water GRC proceedings, as reflected in D.05-07-022, D.04-09-038, D.04-04-041, D.04-03-040, and D.03-10-005. To suddenly reduce the existing lead/lag level for taxes by over half requires a detailed explanation; it is not sufficient to simply state that the overall study conforms to Standard Practice U-16.

In addition, the Commission uses the Standard Practice U-16 methodology for other utility industries and has previously found it appropriate to compare the tax day calculations for nonwater utilities in establishing a reasonable level for a water utility. In a San Gabriel Valley Water Company (SGVWC) case, D.83-10-002, the Commission adopted a staff proposed 86.2-day lag time for California Corporation Franchise Tax (CCFT), stating:

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[57] DRA bases its definition on CPUC Standard Practice SP U-16-W, Determination of Working Cash Allowance, issued May 16, 2002, paragraph D.5.

> Staff's estimate is in line with previous Commission decisions. In SGVWC's application for a rate increase for its Fontana Division, we adopted a working cash allowance that used 82.2 lag-days for payment of CCFT. In a recent General Telephone Company of California rate case, staff estimated the CCFT lag-days at 96.3 and General estimated the lag days to be 75.8. In the current Pacific Gas and Electric Company's general rate case application, staff has estimated the lag-days for payment of CCFT to be 82.6 days and the utility has agreed with staff's calculations. Comparable CCFT lag-day estimates have been used for other utilities.[58]

We note that both energy and water utilities have their highest customer usage in the summer months, and so both would be collecting revenues and paying taxes toward the mid to latter part of the year, consistent with DRA's testimony. A more recent PG&E case, D.94-02-042, found that using Standard Practice U-16 methodology resulted in average lag-days of 121.70 for federal income tax and 83.41 for CCFT; these figures are again closer to DRA's 93 lag-day recommendation than Cal Water's 45 lag-day proposal.[59]

The record on the issue is somewhat confusing and this issue would benefit from further analysis in future Cal Water GRC proceedings. Based on the evidence before us, we find that Cal Water did not meet its burden of proof to show that 45 lag-days is reasonable. We find that DRA's recommendation of 93 days is supported by Cal Water's existing authorized levels and the cases

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[58] *See* 1983 Cal. PUC LEXIS 1007; 12 CPUC2d 718, *mimeo*. at page 9.

[59] *See* 1994 Cal. PUC LEXIS 82; 53 CPUC2d 215, *mimeo*. at pages 12 and 39. Note that the Commission, for ratemaking purposes, inserted the values of zero for current and deferred income taxes due to large tax advantages PG&E would realize in the test period.

discussed here. Further, DRA's contention that the working capital calculation should reflect that actual tax payments are not uniform each quarter is supported by a previous Commission decision that held the utility's working cash needs for federal income tax and CCFT should be based "on the most beneficial (to ratepayers) payment date for FIT and CCFT."[60]

Based on the above discussion, we adopt a 93 average lag-day calculation for federal income taxes and CCFT.

### 5.5. Extended Service Protection (ESP) Service

We review here the ESP service being marketed to Cal Water customers. Cal Water's unregulated affiliate CWS Utility Services (CWSUS) offers the ESP service, a $4.95/month protection plan that guarantees the company will quickly repair or replace a customer's water line if it breaks between Cal Water's meter, generally located at the street curb, and the customer's house. CWSUS uses utility personnel, equipment, and marketing to provide the ESP service and reimburses Cal Water the incremental expenses incurred by the utility in making its employees and equipment available and also credits ratepayers an amount equal to 10% of the ESP service's gross revenues.

CWSUS advertises to Cal Water customers that if their water line breaks due to an earthquake, tree root, or cold spell, they will need to hire a contractor to excavate the broken pipe and then get a plumber to come out and fix or repair the line, at a cost of $1,000 or more, or they can sign up for ESP service and with one call to the water professionals they know and trust, their service line will be

[60] *See Southern California Edison,* D.84-12-068, 1984 Cal. PUC LEXIS 1050; 16 CPUC2d 721, *mimeo.* at page 53.

repaired or replaced at no charge, usually within 24 hours. A copy of the ESP service marketing brochure CWSUS sends to Cal Water customers is attached.[61]

Cal Water did not submit the ESP service to the Commission for review prior to entering an Inter-Company Services Agreement with CWSUS and it asserts a claim of confidentiality for all cost data and market projections.[62] The ESP service was first introduced by CWSUS in 2005 in the South San Francisco district and extended to Dixon, King City, Oroville, Selma, Westlake, and Willows districts in 2006. CWSUS now offers the service in all of Cal Water's California districts.[63]

The ESP service raises important questions as to the criteria and process under which monopoly water utilities and their affiliate companies may engage in providing competitive services, how the Commission measures the relevant market and degree of competition, and the regulatory oversight the Commission provides to prevent cross-subsidization and anti-competitive practices. In addressing these issues, we consider applicable statutes, the Commission's rules for water utilities, similar programs offered by other utilities or their affiliates, prior Commission decisions, and case law.

In our review of the ESP service, we will determine whether CWSUS is properly offering the service as an affiliate by purporting to act under our excess capacity rules. If we find that the ESP service may not be offered by an

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[61] *See* Attachment 2, Material from Cal Water October 2, 2006 filing "Response to Request for Information."

[62] In its GRC applications, Cal Water references the ESP program, which led to the ALJ requesting further information be filed and briefed. The Inter-Company Service Agreement is entered into evidence as Exhibit 82.

[63] DRA Opening Brief at 18.

unregulated affiliate under our excess capacity rules, we will then consider Cal Water's request that we allow the ESP service to be offered directly by Cal Water under our excess capacity rules. We will also examine the option for CWSUS to offer the service under Cal Water's affiliate transaction rules by terms of its 1997 holding company decision, D.97-12-011. Lastly, we will evaluate whether Cal Water has complied with Public Utilities Code section 453, which prohibits a utility from providing a preference to its affiliate.

It is to be expected that an entrepreneurial entity such as CWSUS, Cal Water's unregulated affiliate, would search for opportunities to serve market niches such as this one. Our review of the ESP service is designed not to prevent the service from being offered, but to assure that the manner in which it is offered is consistent with the law, and that it does not rely on resources taken inappropriately from Cal Water's captive customers.

#### 5.5.1. Excess Capacity Rules

In 1997, the Commission issued R.97-10-049, a rulemaking "to provide rules and appropriate guidelines for regulated water utilities and staff governing the proper accounting and ratemaking for privatization and the use of underutilized and excess capacity." In D.00-07-018, the Commission adopted excess capacity rules for water utilities. The purpose of the excess capacity rules is to provide for the use of water utilities' underutilized and excess capacity in a manner that is beneficial to ratepayers and shareholders, without violating any law, regulation, or Commission policy regarding anti-competitive practices.

The excess capacity rules include a methodology for water utilities to allocate revenue from non-tariffed projects between ratepayers and

shareholders.[64] (D.00-07-018, p. 20, Ordering Paragraph 2; 2000 Cal. PUC LEXIS 571, *27.) This methodology created a distinction between "active" and "passive" non-tariffed offerings by the utility. D.00-07-018 adopted Appendix A ("Appendix A"),[65] designating many potential non-tariffed offerings as either active or passive, and stating that any non-tariffed offerings by the utility not present on the list would be designated as active if the shareholders incurred incremental investments costs of $125,000 or more. For active projects, the water

[64] The excess capacity rules for water utilities are modeled on energy utility rules. *See* D.97-12-088, 77 CPUC2d 422, 1997 Cal. PUC LEXIS 1139.

[65] We note that Appendix A was referenced, but not attached, to D.00-07-018. Appendix A was later published by Executive Director decision in D.01-01-026. D.03-04-028 made some modifications to D.00-07-018 to purportedly correct an unintended exemption for certain projects from the advice letter filing requirement of the decision and to clarify the Commission's methodology. Finding of Fact 3 in D.03-04-028 states that "D.00-07-018 contains no discussion or justification for an exemption of listed active non-tariffed offerings from the advice letter-filing requirements" as listed in Appendix A. (D.03-04-028, pp. 4, 8, Finding of Fact 3.) D.03-04-028 also required all non-tariffed offerings from water utilities to be subject to prior Commission review and approval. (D.03-04-028, pp. 4, 8, Finding of Fact 2.) In D.04-12-023, the Commission reversed many of the modifications that D.03-04-028 made to D.00-07-018, including the requirement that all non-tariffed offerings be subject to prior Commission review and approval. In D.04-12-023 the Commission reinstated the requirement set forth in D.00-07-018 that water utilities only have to seek advice letter approval for active, non-tariffed investments under the excess capacity rules. (D.04-12-023, p. 3.) The Commission determined that "[a]ll passive investments, and active investments as described in Attachment A of D.00-07-018, were specifically excluded from the advice letter filing requirement." (*Id.*) While D.04-12-023 made a finding stating that "[t]he record in this proceeding requires water utilities to seek advice letter approval for only active investments not listed in Attachment A of D.00-07-018," Finding of Fact 3 in D.03-04-028 was not removed. (D.04-12-023, p. 6, Finding of Fact 4.) In sum, D.00-07-018 remains mostly unchanged, with a few minor clarifications made in D.03-04-028 and D.04-12-023.

utility shareholders would receive 90% of the revenue, and for passive projects, 70%. Ratepayers would receive the remaining 10% and 30%, respectively.[66]

The excess capacity rules generally require water utilities to seek advice letter approval for active, non-tariffed investments. All passive investments and active investments as are described in Appendix A of D.00-07-018 were specifically excluded from the advice letter filing requirement. The advice letter must contain detailed information regarding the proposed service.[67] In order to ensure that ratepayers are not subsidizing new competitive ventures, the excess capacity rules also require the water utility make a showing in its advice letter filing that:

a. The involved portion of utility assets or capacity has been acquired for the purpose of and is necessary and useful in providing tariffed utility services,
b. The involved portion of such asset or capacity may be used in offering the non-tariffed product or service without affecting the cost, quality, or reliability of the tariffed products,
c. The non-tariffed product or service will be marketed with minimal or no ratepayer capital, minimal or no new forms of liability or business risk, and no undue diversion of utility management attention,

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[66] *See* D.04-12-023, pp. 1-3.

[67] Some of the information a utility must provide in the advice letter includes: an accounting mechanism to allocate costs of assets in rate base and expenses in rate between tariffed an non-tariffed services; a detailed description of proposed accounting for transaction costs and revenues; a complete identification of all regulated assets that will be used in the proposed transaction; and a complete list of all employees that will participate in fulfilling the terms of the transaction, with an estimate of the amount of time each will spend. (D.00-07-018, Ordering Paragraph 3, pp. 20-21; 2000 Cal. PUC LEXIS 571, *28-29.)

d. The non-tariffed product or service does not violate any law, regulation, or Commission policy regarding anti-competitive practices.

(D.00-07-018, p. 19, Conclusion of Law 8; 2000 Cal. PUC LEXIS 571, *26-27; *see also* Ordering Paragraph 4, pp. 20-21, 2000 Cal. PUC LEXIS 571, *29.)

The key issue we review here is whether CWSUS may offer its ESP service, a monthly protection plan for "customer-owned pipe service," under the excess capacity rules. If CWSUS may not offer the ESP service under the excess capacity rules, then we will examine whether Cal Water itself may offer this service pursuant to the excess capacity rules.

#### 5.5.1.1. Positions of the Parties

Cal Water asserts it is authorized under the Commission's excess capacity rules to provide its current ESP service through its unregulated affiliate, CWSUS. Specifically, Cal Water states that the ESP service meets the definition of a "Customer Ancillary Service" under Appendix A to D.00-07-018.[68] Cal Water testifies that as a utility, it is prohibited from directly offering a competitive service by its affiliate transaction rules. Therefore, if the Commission had not intended the excess capacity mechanism to apply to services offered by unregulated water affiliates, Cal Water and most other Class A water utilities would not be eligible to offer competitive services under the excess capacity rules.

[68] The category "Customer Ancillary Services" that Cal Water cites to is described as "Customer Facility Related Services, Including Maintenance Contracts." This category is designated as an "active" service and has a gross revenue sharing mechanism of 10% to ratepayers and 90% to shareholders, after incremental costs are reimbursed to the ratepayers.

Further, by offering a competitive service through an affiliate rather than the utility itself, Cal Water argues that there are fewer potential cross-subsidy issues. Cal Water also states that the Commission has a policy preference to offer non-tariffed services through an affiliate rather than the utility itself, citing to *In re Southern California Water Company*, D.04-03-039, mailed on March 3, 2004, *mimeo*. at page 28.[69] Should the Commission find that Cal Water is prohibited from offering affiliate services under the excess capacity rules, Cal Water states that to the extent that the Commission will allow the ESP program to be offered through the regulated water utility itself, and authorizes Cal Water to do so, the company is willing and prepared to transfer the program to the regulated utility.[70] Finally, Cal Water asserts that as a utility it can provide exclusive services to its affiliate provided the services are non-tariffed and readily available to customers from competitors.

On the issue of what requirements govern the ESP service, DRA contends that Cal Water's affiliate transaction rules, not the excess capacity rules, govern the provision of competitive services by non-regulated affiliates.

#### 5.5.1.2. May an Affiliate Offer a Service Under the Excess Capacity Rules?

We first address whether an affiliate may offer a service pursuant to the excess capacity rules. Cal Water currently offers the ESP service through its affiliate, CWSUS. The excess capacity rules adopted in D.00-07-018 were never meant to be used by an affiliate. In the decision opening up the Commission's rulemaking on excess capacity rules for water utilities, D.97-10-049, the

[69] *See also* Tr. Vol. 13 at 562-3.

[70] Opening Brief at 13.

Commission clearly stated that any rules promulgated in the proceeding were for water utilities, not their affiliates.[71] In D.00-07-018, we repeatedly stated that "water utilities" will provide the non-tariffed services under the excess capacity rules.[72] Moreover, in Cal Water's 2003 GRC proceeding, we again cited to the excess capacity rules applying to water utilities and discussed the different treatment that should be followed.[73] In a 2004 SCWC decision, we rejected SCWC's argument that the excess capacity rules could be applied to affiliate transactions.[74]

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[71] Specifically, in D.97-10-049, the Commission stated: "We believe that this OIR is the correct forum to provide rules and appropriate guidelines for **regulated water utilities** and staff governing the proper accounting and ratemaking for privatization and the use of underutilized excess capacity." (D.97-10-049, 1997 Cal. PUC LEXIS 1062, *4 (emphasis added).)

[72] For example, in D.00-07-018, we made the following statements: (1) "We will require **subject utilities** to file an Advice Letter before providing new non-tariffed products and services (D.00-07-018, p. 15 (emphasis added)); (2) "Therefore, the water utility proposing the new service or product should show that there is or will be investment above $125,000 . . ." (D.00-07-018, p. 14 (emphasis added)); and (3) "The public interest requires that the water utilities have a means of obtaining Commission review and approval prior to entering into a new active non-tariffed endeavor." (D.00-07-018, Conclusion of Law 5, p. 19 (emphasis added).)

[73] *See* D.03-09-021, mailed September 5, 2003, *mimeo.* at 24-25.

[74] *See* D.04-03-039, mailed March 18, 2004, *mimeo.* at 28-29. In response to SCWC's decision to allow its affiliate, ASUS, to offer services under the excess capacity rules rather than SCWC's affiliate transaction rules, the Commission stated: "SCWC has misinterpreted the intent of that decision [D.00-07-018]. The revenue sharing mechanism is intended to apply to a water utility (1) providing non-tariffed services, (2) sharing the gross revenues with ratepayers, and (3) absorbing all incremental costs. It does not apply to non-regulated affiliates of the water utility." (D.04-03-039, p. 29.) We reiterate our holding in D.04-03-039 that only a utility may offer a service pursuant to the excess capacity rules.

In addition, our excess capacity rules for water utilities are modeled on energy utility rules, specifically the revenue sharing mechanism for "other operating revenues" adopted in the Southern California Edison Company(Edison)/DRA settlement in D.99-09-070. Edison's revenue sharing mechanism, as well as the generic rules for energy utility non-tariffed services, Rule VII, Utility Products and Services, apply only to utility non-tariffed services.[75]

Clearly, Cal Water's claim that it may offer the ESP service through its affiliate under the excess capacity rules lacks merit.

Cal Water asserts that its affiliate transaction rules prohibit it from directly offering an unregulated service. We have reviewed the relevant sections of Cal Water's affiliate transaction rules, and find that Cal Water is correct. Cal Water's affiliate transaction rules state that unregulated operations and employees whose primary responsibilities are to conduct unregulated operations should be transferred from the utility to the affiliate.[76] Thus, under its affiliate transaction rules, Cal Water may not offer an unregulated service; only its affiliate may offer an unregulated service. We recognize that this limits the type of services Cal Water may offer. However, this proceeding is not the appropriate forum to

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[75] Rule VII was adopted in D.97-12-088, as modified by D.98-09-035.

[76] Cal Water cites to D.97-12-011, Appendix A, XII. This section of the settlement agreement adopted by Cal Water's holding company decision states, in relevant part: "A. Unregulated operations, including all pertinent contracts, that are performed by the Utility shall be transferred to the appropriate affiliate as soon as the requisite consents are obtained . . . C. The utility shall endeavor to transfer to its affiliates employees whose primary responsibility is to conduct unregulated operations. The timing of such transfer will take into consideration the Utility's employment obligations to such employees, its obligations under its Union contracts and the cost of providing comparable terms of employment." (D.97-12-011, 1997 Cal. PUC LEXIS 1212, *14-15.)

address the merits of Cal Water's holding company decision. If Cal Water wishes to offer unregulated services under our excess capacity rules, then we suggest that it file a petition to modify this provision of its holding company decision, D.97-12-011.

#### 5.5.1.3. Is the ESP Service Utilizing Cal Water's Excess Capacity?

In its filings, Cal Water stated that should the Commission find that CWSUS is prohibited from offering the ESP service under the excess capacity rules, then to the extent that the Commission will allow the ESP program to be offered through the regulated water utility itself, and authorizes Cal Water to do so, the company is willing and prepared to transfer the program to the regulated utility. In considering the applicability of the excess capacity rules to an ESP service offered by Cal Water, we first address whether offering the ESP service allows Cal Water to better utilize excess capacity in a manner that increases overall efficiency.

To provide the ESP service, Cal Water needs skilled workers to repair and replace water lines, an inventory of water pipe, and heavy equipment for trenching. Cal Water uses utility personnel and assets on an "as-needed" basis, paying a short-term incremental rate. In some of its smaller districts, Cal Water has only one or two employees able to perform this work, and they are employees vital to the provision of utility service. The equipment and inventory needed for ESP service is also basic to water utility service and in this proceeding, as in most GRC proceedings, Cal Water is asking for additional equipment, vehicles, water pipe, and technical personnel – the same assets it uses to provide ESP service. Cal Water makes no showing that its utility personnel, equipment, and inventory are underutilized, and perhaps, therefore, redundant.

Thus, Cal Water has not demonstrated that the ESP service is using excess capacity.

Furthermore, the type of assets used in the ESP offering is not similar to the offerings of energy utilities under their excess capacity rules, upon which the water utility excess capacity rules are based. The energy utilities have used their excess capacity rules for temporarily available capacity in buildings and compatible secondary uses such as leasing land under transmission lines to nurseries and leasing "dark fiber" capacity.[77] Similar to what the Commission has allowed for energy utilities, this Commission has authorized water utilities to lease temporarily available capacity in buildings under its excess capacity rules. An example of this is Apple Valley Ranchos Water Company's inclusion of non-tariff lease revenue, using D.00-07-018 methodology in its 2003 GRC proceeding.[78]

In sum, we find that the ESP service does not meet the definition of excess capacity we have used for energy utilities because the ESP service uses personnel and operating inventory, which have been justified as essential to the provision of utility services, not fixed assets. An ESP service is not the type of service the Commission envisioned being offered under the excess capacity rules.

Although we have determined that the ESP service is not using Cal Water's underutilized excess capacity, we will review whether the ESP service

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[77] *See* D.97-12-088 *mimeo*. at 75, 77 CPUC2d 422, 1997 Cal. PUC LEXIS 1139, and Tr. Vol. 13 at 574.

[78] *See* D.03-08-069, mailed August 25, 2003, *mimeo*. at page 10 and Finding of Fact 13 at page 48.

complies with other aspects of our excess capacity rules in order to provide some guidance to Cal Water for future service offerings under these rules.

#### 5.5.1.4. Is the ESP Service Exempt from Advice Letter Filing Requirements Pursuant to Appendix A?

We next turn to Cal Water's claim that the ESP service is an active service that is therefore exempt from the advice letter requirements of the excess capacity rules under Appendix A. Cal Water states that it thought the category "Customer Ancillary Services" which is described as "Customer Facility Related Services, Including Maintenance Contracts," authorized an ESP-type service.

We recognize that the record evidence in the excess capacity proceeding, R.97-10-049, is insufficient to support Cal Water's conclusion that the category "Customer Ancillary Services" in Appendix A, which is described as "Customer Facility Related Services, Including Maintenance Contracts," authorized an ESP-type service. As previously mentioned, Appendix A is not discussed in D.00-07-018 and it was inadvertently omitted when D.00-07-018 was issued.[79] In the absence of guidance in D.00-07-018, we review the "Customer Ancillary Services" exemption here in light of our reading of the excess capacity decision.

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[79] D.00-07-018 does not provide any discussion on the exceptions listed in Appendix A. Rather, the decision merely states: "CWA provided a designation of various potential non-tariffed activities, divided into passive and active investments (Exhibit A, CWA Comments on the Administrative Law Judge's Ruling dated September 14, 1999). We will adopt this designation (*See* Appendix A.)" (D.00-07-018, 2000 Cal PUC LEXIS 571, *19.) We find that while Cal Water may have thought a non-tariffed service like ESP was included in Appendix A, the record is insufficient to establish this. We also note that D.00-07-018, including Appendix A, concerns new offerings by a water utility. There is no discussion or authorization for an existing affiliate service, categorized as competitive, to be brought under these rules.

We disagree with Cal Water's assertion that the ESP service is a "maintenance contract." The common definition of maintenance is the upkeep, repair, and preservation of existing facilities.[80] The excavation and replacement of a water service line goes well beyond this definition. (*See* Attachment 2, an advertisement of the ESP service, which includes water service line replacement.) When Cal Water's service personnel replace water lines in the utility's system, Cal Water capitalizes any new pipe that is installed. In Exhibit 3, Chapter 5, Cal Water defines maintenance expenses as "the cost of repairing and maintaining the water system in good operating condition."[81]

We view the ESP service more analogous to an insurance-type product, similar to buying insurance for damage to one's home.[82] While local plumbers and contractors commonly perform one time repair or replacement services, they may not be in the same competitive market as the ESP service if they do not also offer an insurance program. For example, if a home is damaged by fire, the homeowner will call his insurance company for repairs. He will not consider calling a contractor and paying the full cost of all necessary repairs as a competitive option. In fact, he has paid a regular insurance premium to avoid that option.

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[80] *Webster's New World Dictionary, Third College Edition,* pages 815-16.

[81] *See* Exhibit 3, page 33.

[82] By using an insurance analogy, we do not imply that the ESP service is an insurance product under the regulatory oversight of the Insurance Commission. Section 22 of the Insurance Code states: "Insurance is a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event." (*West's Annotated California Codes,* Volume 42, published 2006, p. 14.)

#### 5.5.1.5. May Cal Water Offer the ESP Service Under the Advice Letter Filing Requirements of the Excess Capacity Rules?

Because Cal Water believed CWSUS was exempt from filing an advice letter under Appendix A, it did not file an advice letter that complies with our excess capacity rules. Nevertheless, we will examine whether Cal Water may directly offer the ESP service as an active service under our excess capacity rules.

The excess capacity rules require a utility showing that ratepayers are not subsidizing new competitive ventures or being charged excessive prices for a non-tariffed service.[83] In order to make this showing, Cal Water cited to inside wiring service offered by local telephone companies as a utility-provided service that is similar to the ESP service. Inside wire was historically installed, owned, and maintained by the local telephone utility for its customers and was part of a customer's basic telephone rate. It was only in 1982 with the break-up of the AT&T system that telephone customers were given the option of using a different company to install/maintain the inside wire or to self-provision. Federal and state regulatory agencies found it in the public interest for local telephone companies to continue to maintain the wire for customers who did not want to seek a competitive alternative. Therefore, inside wire service, called "WirePro" by Pacific Bell, became a separate "below the line" service provided by local phone companies using fully allocated cost accounting and subject to audit and review by regulators. For local service telephone utilities, the

[83] *See* D.00-07-018, Conclusion of Law 8, p. 19, 2000 Cal. PUC LEXIS 571, *26-27; *see also* D.00-07-018, Ordering Paragraph 4, pp. 20-21, 2000 Cal. PUC LEXIS 571, *29.

Commission founded a "New Regulatory Framework" in D.89-10-031, which established three levels of regulatory oversight of utility provided services, based on whether the service was a basic monopoly service (Category I), a discretionary and partially competitive service (Category II), or a fully competitive service (Category III). Pacific Bell's WirePro was initially classified as a Category II service, and thus given only limited competitive pricing discretion.[84]

Ten years later, in D.99-06-053,[85] the Commission granted Pacific Bell's request for a Category III service designation. In making this reclassification, we found that Pacific Bell had demonstrated that it had "insignificant market power" and we authorized increased pricing flexibility. (D.99-06-053, Conclusion of Law 15, Ordering Paragraphs 6, 7, 1999 Cal. PUC LEXIS 309, *111, *113.) Within two years of D.99-06-053, the monthly price for WirePro had risen from $.60 to $2.99. On June 11, 2001, DRA filed a Petition for Modification of D.99-06-053 requesting the Commission recategorize the WirePro service back to Category II due to the excessive price increases, which DRA asserted demonstrated Pacific Bell's continuing dominant market power in the inside wire services market. In D.02-12-062, we denied DRA's requested relief but did adopt a "provisional cap" on the price of WirePro. (D.02-12-062, pp. 17-18, Ordering Paragraph 2; 2002 Cal. PUC LEXIS 925, *25.) This cap was later

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[84] *In Re Alternative Regulatory Frameworks for Local Exchange Carriers*, D.89-10-031, 33 CPUC 2d 43.

[85] D.99-06-053, 1999 Cal. PUC LEXIS 309, was modified by D.99-09-036, 1999 Cal. PUC LEXIS 603. D.99-09-036 modified D.99-06-053 to include findings related to the relevant residential inside wire repair market, to modify certain holdings, to modify Ordering Paragraph 8, and to correct other minor errors. (1999 Cal. PUC LEXIS 603, *26.)

removed when the Commission lessened its regulatory oversight of local telephone utilities. The price for WirePro today is $5.00 per month.

Inside wire was historically installed, owned, and maintained by the local telephone utility for its customers and was part of their basic telephone rate. This is distinct from the ESP service where the water customer's water line from the utility meter to the residence has never been installed, owned, or repaired by Cal Water. For these reasons, we find that the inside wire service, as discussed in the Pacific Bell Wirepro cases,[86] is different from Cal Water's ESP service. We also determine that Cal Water's reliance on the inside wiring services decisions does not meet the excess capacity rules requirement that it make a showing that ratepayers are not subsidizing new competitive ventures or being charged excessive prices for a non-tariffed service.

There is a similarity between inside wire service and ESP service in that the Commission needs to ensure that anticompetitive behavior does not occur with regard to both services. However, unlike local telephone service, the Commission has not reviewed the supporting costs and pricing data for the ESP service to determine if the price being charged utility customers is just and reasonable. Nor has the Commission analyzed the level of competition for the ESP service in the districts served by Cal Water to determine the level of market power Cal Water holds for the ESP service. Moreover, while the Commission has provided a lengthy regulatory path for the local service telephone utilities to move to a competitive framework, we have not provided a regulatory

[86] *See* D.89-10-031; D.99-06-053; D.99-09-036; D.02-12-062.

framework that sets forth different types of regulatory oversight for water utilities to enter potential and fully developed competitive markets.

For the aforementioned reasons, Cal Water has failed to demonstrate that the ESP service complies with the law, regulation, or Commission policy regarding anti-competitive practices. Short-term incremental cost raises concerns of cross-subsidization unless the assets are truly excess capacity or have secondary compatible uses. DRA also provided evidence that shared services are not being compensated by the non-regulated operation. In the case of the ESP service, Cal Water's proposal to use excess capacity rules would not allow the Commission to protect ratepayers against cross-subsidization or market power abuses. We also find that the ESP service failed to meet the excess capacity requirements adopted by the Commission in D.00-07-018 because Cal Water did not make the required showing that the service does not violate any law, regulation, or Commission policy regarding anti-competitive practices.[87]

#### 5.5.1.6. When May a Utility Offer an Unregulated Service Under Our Excess Capacity Rules?

In summary, we find that the ESP service does not qualify as a utility non-tariffed service under the excess capacity rules adopted in D.00-07-018, as modified by D.03-04-028 and D.04-12-023. If Cal Water is able to demonstrate that the assets it uses to provide its ESP service are excess capacity, and that it

[87] Specifically: (1) we have no record to determine whether the manner in which the ESP service is being offered interferes with the development of a competitive market for the service; (2) we do not have a record to determine whether ratepayers are subsidizing a shareholder competitive venture; and (3) we do not have a record to determine whether ratepayers are paying a price for the service that is not just and reasonable.

does not violate any law, regulation, or Commission policy regarding anti-competitive practices, then we will re-examine whether Cal Water may offer the ESP service under the excess capacity rules. However, based on the record evidence available in this proceeding, we are doubtful that an ESP-type service could ever satisfy the requirements of our excess capacity rules.

We recognize that there may be some confusion among water utilities concerning what type of services can be offered under the excess capacity rules. While we do not revisit the 1997 rulemaking which culminated in D.00-07-018 adopting the excess capacity rules, we believe that some guidance on this issue would be useful to water utilities and their affiliates.

As previously discussed, the excess capacity rules were modeled from the energy affiliate transaction rules as set forth in D.97-12-088 and the revenue sharing mechanism for "other operating revenues" adopted in the Edison/DRA settlement in D.99-09-070. In adopting excess capacity rules for water utilities in D.00-07-018, the Commission made modifications to the energy utilities affiliate transaction rules and the Edison/DRA settlement so that they would be better suited to water utilities.

The primary objective of the excess capacity rules is to allow water utilities to use temporarily underutilized assets in rate base in a manner that gives additional revenue for the benefit of ratepayers and shareholders, providing it can do so without violating any law, regulation, or Commission policy regarding anti-competitive practices. The ESP service uses personnel and operating inventory, not fixed assets, and these personnel and inventory are dedicated to providing basic utility service. Here, we have determined that utility personnel and equipment are generally not likely to be the type of assets that we envision being "excess capacity." We intended for excess capacity to include things such

as billing services, space in buildings owned or leased by utilities, and extra capacity in dark fiber capacity.

### 5.5.2. Cal Water's Affiliate Transaction Rules

Because we find, for different reasons, that neither CWSUS nor Cal Water may offer the ESP service under our excess capacity rules, we will examine whether this service maybe offered through an affiliate pursuant to Cal Water's affiliate transaction rules.

In 1996, Cal Water filed an application asking the Commission for authorization to form a holding company structure. In D.97-12-011, the Commission approved Cal Water's holding company structure subject to several conditions.[88] These conditions are commonly referred to as Cal Water's affiliate transaction rules. The major provisions of the settlement agreement adopting the affiliate transaction rules for Cal Water are as follows:

1. Cal Water will provide the Commission access to its directors, officers, and employees for Commission inquiry into utility operations. Cal Water will also provide the Commission access to its books and records. In addition, Cal Water will file an annual report summarizing all transactions between the regulated and unregulated portions of the holding company.
2. Cal Water will maintain a capital structure, including dividend policy, that is consistent with Commission decisions. The regulated utility shall issue only its own debt and shall not guarantee any debt of the unregulated companies.
3. Common costs shall be allocated in a manner consistent with Commission decisions.

[88] D.97-12-011 adopted a settlement agreement between the Commission's Water Division and Cal Water. The California Water Utility Council also supported the settlement.

4. Assets and goods transferred from the utility to any affiliate shall be priced at cost or fair market value, whichever is higher. Assets and goods transferred to the utility from an affiliate shall be at the lower of cost or market.

(D.97-12-011, 77 CPUC2d 53, 1997 Cal. PUC LEXIS 1212, *2-3.)

For purposes of our review of the ESP service, the key affiliate transaction rule is the fourth rule. According to Cal Water's affiliate transaction rules, CWSUS must pay Cal Water the cost or fair market value (whichever is higher) of any assets or goods used by CWSUS or transferred from Cal Water to CWSUS.

Another important provision of Cal Water's affiliate transaction rules is regarding the transfer of assets and goods from the utility. Pursuant to D.97-12-011, "[a]ll transfers of assets and goods from the Utility to any affiliate shall be in compliance with the applicable provisions of the Public Utilities Code and Commission policies." (D.97-12-011, 1997 Cal. PUC LEXIS 1212, *15, Section XIII of the Settlement Agreement.)

#### 5.5.2.1. Positions of the Parties

Cal Water contends that its affiliate, CWSUS, is currently offering the ESP service in conformance with its affiliate transaction rules. DRA asserts, on the other hand, that the evidence here shows that Cal Water's ratepayers are not being fully compensated for ESP services under the affiliate transaction rules. DRA recommends the Commission direct Cal Water to file an application for the ESP service that fully complies with its affiliate transaction rules, and that the Commission use its own auditors to perform an audit of all non-tariffed activities by Cal Water and any expenses found to have been improperly borne by ratepayers should be refunded. Further, DRA recommends that the Commission adopt broader rules governing the standard of conduct between water utilities

and their affiliates and cites to the energy utilities' affiliate transaction rules as a helpful model.

#### 5.5.2.2. Discussion

CWSUS may offer the ESP service so long as its offering meets the requirements set forth in Cal Water's affiliate transaction rules. Specifically, in order to offer the ESP service, CWSUS must pay Cal Water cost or fair market value, whichever is higher, of the goods and services it uses from Cal Water. Based on the record before us, it is clear that the ESP service currently does not comply with Cal Water's affiliate transaction rules. CWSUS uses utility personnel, equipment and marketing to provide the ESP service, but only reimburses Cal Water the incremental expenses incurred by Cal Water in making its employees and equipment available and also credits ratepayers an amount equal to 10% of the ESP service's gross revenues. In order to comply with its affiliate transaction rules, CWSUS must reimburse Cal Water the cost or fair market value (whichever is higher), not the incremental cost, for its use of Cal Water's goods and services in providing the ESP service. Fair market value is the price that would be paid under an arms-length transaction.

Moreover, the ESP service must also comply with Section 453(a) in order for CWSUS to be able to offer this service under Cal Water's affiliate transaction rules, as discussed in the following section.

We do not at this time adopt DRA's recommendation that the Commission use the energy affiliate rules as a model to adopt standards of conduct and rules to protect consumer interests and foster competition in the non-utility markets. This is a matter the Commission may choose to pursue in a rulemaking. For the ESP service before us here, we find that existing statutes, rules and case law are sufficient. Should further issues arise demonstrating a need for additional rules,

DRA should pursue the procedural process that is appropriate to the circumstances.

### 5.5.3. Public Utilities Code Section 453(a)

Both the excess capacity rules and Cal Water's affiliate transaction rules require Cal Water to comply with applicable law or Commission policies.[89] One of the applicable provisions of the Public Utilities Code that Cal Water must comply with in regard to both the excess capacity rules and any affiliate transaction is Public Utilities Code section 453(a) ("Section 453(a)"). Section 453(a) provides:

> No public utility shall, as to rates, charges, service, facilities, or in any other respect, make or grant any preference or advantage to any corporation or person or subject any corporation or person to any prejudice or disadvantage.

(Pub. Util. Code, § 453(a).) Thus, Section 453(a) prohibits a utility from providing a preference to its affiliate. For energy utilities, transactions between the utility and its affiliates is limited to tariffed products and services, the sale or purchase of goods, property, products or services made generally available by the utility or affiliate to all market participants through an open, competitive bidding process, or as provided for in rules on joint purchases and corporate support.[90] The question we face here is whether Cal Water's offering of its

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[89] *See* D.00-07-018, Ordering Paragraph 4, 2000 Cal. PUC LEXIS 571, *29; D.97-12-011, 1997 Cal. PUC LEXIS 1212, *15, Section XIII of the Settlement Agreement. We note that because we have already determined the ESP service may not be offered pursuant to the excess capacity rules, we will only make this inquiry with respect to Cal Water's affiliate transaction rules.

[90] *See* Affiliate Transaction Rules, Section III. Nondiscrimination, attached to D.98-08-035.

services exclusively to CWSUS for the ESP service is in compliance with Section 453(a).

#### 5.5.3.1. Positions of the Parties

Cal Water asserts that as a utility, it may offer exclusive services to its affiliate as long as the services are non-tariffed and readily available by competitors to customers from other sources. Cal Water states that the support services and products it provides to CWSUS are all available from different sources, and its competitors can readily obtain from other sources billing services, maintenance and repair personnel, etc. Because Cal Water is not providing monopoly services, it contends that there is no evidence of disadvantage to any competitor of CWSUS. Cal Water asserts that the preference prohibited by Section 453(a) is limited to a preference in a tariffed service.

DRA, on the other hand, contends that Cal Water has violated Section 453(a) by granting an undue preference to its affiliate.

#### 5.5.3.2. Discussion

In reviewing whether the ESP service complies with Section 453(a), we will first examine relevant case law. In California Portland Cement Company v. Union Pacific Railroad Company (1955) 54 CPUC 539, the Commission held that for a preference or prejudice under Section 453(a) to be unlawful, "the preference or prejudice must be unjust or undue. To be undue, the preference or prejudice must be shown to be a source of advantage to the parties or traffic allegedly favored and a detriment to the other parties or traffic." (Id. at 542.) Thus, pursuant to California Portland Cement, a utility offering may not violate Section 453(a) if it is not a source of advantage to the party offering the service or if it does not favor the party offering the service, to the detriment of other parties.

In a later case, Gay Law Students Association et al. v. Pacific Telephone and Telegraph Company (1979) 24 Cal.3d 458, the California Supreme Court applied a similar standard broadly to all aspects of utility operations, including discrimination in employment. The Court stated:

> Having, by force of law, specifically guaranteed the public utility's monopoly status, the Legislature was not oblivious to the need to guard against the misuse of monopoly power. Drawing upon the well-established common law doctrine that a monopoly is not free to exercise its power arbitrarily, the Legislature enacted a specific and comprehensive statutory provision to prohibit discrimination by any public utility.

(*Id.* at 10.)

In a recent case where a telecommunications utility was providing a preference to its unregulated affiliate, the Commission found a violation of Section 453(a). (*See* D.05-05-049, *Raw Bandwidth Communications, Inc. v. SBC California Inc.*, Order Modifying D.05-01-034 and D.04-05-006, Denying Rehearing of Decision, as Modified ("*Raw Bandwidth*").) In *Raw Bandwidth*, the Commission held that SBC's favorable treatment of 611 calls regarding DSL service that came from its own affiliate's customers did not comply with Section 453(a). (D.05-05-049, p. 5.)

The ESP service we are considering here may be similar to the problem in Raw Bandwidth because both situations involve the utility giving a possibly unfair competitive preference to its affiliate when a customer calls for repair service of an unregulated product that connects to the utility's facilities. Specifically, the ESP service is advertised as "it only takes one call to the water professionals you know and trust to have your water service line repaired or replaced." In *Raw Bandwidth*, customers who subscribed to a SBC-affiliate internet service provider (ISP) only made one call to obtain repairs, whereas

subscribers to non-affiliated ISPs had to make multiple calls. (D.05-05-049, p. 6; 2005 Cal. PUC LEXIS 202, *10.) In *Raw Bandwidth* we found:

> Pub. Util. Code Section 453 prohibits SBC California's practice of requiring on 611 calls for digital subscriber line repair service, the subscribers of unaffiliated ISPs to hang up and call their service department while subscribers of its affiliates are not required to take that extra step.

(D.05-05-049, p. 22, Conclusion of Law 2; 2005 Cal. PUC LEXIS 202, *39.) Thus, under *Raw Bandwidth*, the ESP service appears to not be in compliance with Section 453(a).

We recognize that the question of the the ESP service's failure to comply with Section 453(a) is not limited to the one-call repair issue, nor is this issue necessarily the most egregious of the preferences. We discuss one-call repair because in *Raw Bandwidth*, the Commission found that one-call repair preference *by itself* was sufficient for a finding that the utility violated Section 453(a).

One preference that rises to the level of a barrier to entry for competitors is the physical connection to the Cal Water system. Cal Water states the homeowner must first call Cal Water to turn off the water to the property before it can call a contractor or plumber. Cal Water's requirement that it be called to shut off the water to the property is shown in the ad it sends customers.[91] The ability to directly contact utility water customers is another preference that competitors cannot provide, as is the "simple" sign-up for service application attached to the brochure for the homeowner to fill out, and the ability to pay for

[91] *See* Attachment 2. This ad may be incorrect. Cal Water should address whether plumbers and other water professionals not employed by Cal Water or its affiliates will be given direct access to the valve in any future filings regarding ESP service.

ESP on the customer's monthly water bill. Cal Water has testified that these services are provided only to CWSUS. These preferences, however, may rise to the level of being "unjust" or "undue."

We next turn to whether Cal Water is improperly using its monopolistic power to offer the ESP service. Cal Water and DRA agree that the ESP service is a competitive service, although they disagree on the nature of the market. Cal Water testified that the market includes local plumbers providing one-time repair service as well as other companies that may offer maintenance contracts with terms and conditions similar to the ESP service or companies that offer a service protection plan for water service lines as well as other home needs such as in-house plumbing or electrical repairs. Cal Water cites to a program similar to the ESP service offered by Suburban Water Company to its customers.[92] DRA views the ESP service as a voluntary water service line maintenance program offered for a monthly fee.[93]

As previously discussed, we reject Cal Water's assertion that the ESP service is a "maintenance contract." Rather, we view the ESP service more as an insurance product, similar to buying insurance for damage to your home. We question whether there is a viable competitive market for the ESP service in the districts served by Cal Water. No evidence is presented to support Cal Water's

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[92] In D.06-08-017, the Commission adopted a non-precedential settlement that includes a utility service designated as "customers houseline maintenance services" being provided under the provisions of D.00-07-018. This program is not mentioned in the decision itself and no further information is provided in the settlement. *See* D.06-08-017, mailed August 25, 2006, *mimeo*. at Section 3.6 of Appendix A, page 6.

[93] Opening Brief at 7.

claim. For here, it is sufficient to find that the ESP service is at least a potentially competitive service.

Cal Water provides utility repair personnel, equipment, and pipe, as well as billing and marketing services, and its utility service representatives to answer ESP calls and schedule repairs. In testimony and briefs, Cal Water asserted that it can provide these utility resources on an exclusive basis to its affiliate without violation the provisions of Section 453(a). Cal Water and DRA agree that for a preference or advantage to be prohibited by Section 453(a), it must rise to a level of being "unjust or undue." We concur.[94] For the public utilities we regulate today, water utilities retain the most monopolistic power and thus the Commission should be most vigilant in ensuring that customers are protected from the utility affording any person or corporation unjust or undue preference.

In offering the ESP service, Cal Water uses utility personnel, equipment, and inventory on an as-needed basis and reimburses utility ratepayers for direct costs at a short-term incremental rate, plus 10% of gross revenues. A competitive company offering an insurance program or a one-time repair service may not have access to these extensive resources on an on-call basis at Cal Water's incremental cost structure.[95] In addition, a competitor would not have the

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[94] Both *California Portland Cement Company v. Union Pacific Railroad Company* (1955) 54 CPUC 539 and *Gay Law Students Association et al. v. Pacific Telephone and Telegraph Company* (1979) 24 Cal.3d 458 determined that for a preference or advantage to be prohibited by Section 453(a), it must rise to a level of being "unjust or undue."

[95] Under Cal Water's affiliate transaction rules, CWSUS would be required to reimburse Cal Water at the greater of cost or fair market value. Fair market value is defined in Public Utilities Code Section 2720, and is in general terms the price that is established under an arms-length transaction.

advantage of the utility's name, reputation, size, and monopoly customer base to market the service.

We find that, in this case, Cal Water is using its monopoly power to contact its utility customers in an effort to sell them a non-tariffed service that is not essential to its utility function. If we allow this, it may open the door to Cal Water also using its utility personnel and assets to offer sewer repair protection and in-home plumbing protection services similar to those now offered through American Water's utility affiliates, and any other business ventures it finds could be profitable. Our conclusion here is consistent with our holding in *Raw Bandwidth* where we found that SBC gave an unfair competitive preference to its affiliate regarding customer calls for repair service of an unregulated product that connects to the utility's facilities.[96]

As the ESP service is currently being offered, we find that Cal Water may not be in compliance with Section 453(a) because it is granting undue and unjust preferences to CWSUS for the ESP service. Cal Water has given CWSUS exclusive access to its utility customers for the ESP service. Cal Water also has considerable resources and the goodwill of its reputation, all paid for by the utility customers. Further, DRA's evidence points to possible undue and unjust preference in the price Cal Water sells its utility services, on an exclusive basis, to CWSUS. Cal Water's affiliate transaction rules state that "all transfers of assets and goods from the Utility to any affiliate shall be in compliance with the applicable provisions of the Public Utilities Code and Commission policies." A

[96] D.05-05-049, p. 22, Conclusion of Law 2, 4; 2005 Cal. PUC LEXIS 202,*39-40.

violation of Section 453(a) would also be a violation of Cal Water's affiliate transaction rules.

We think that CWSUS could, under Cal Water's affiliate transaction rules, offer an ESP-type service that clearly complies with Section 453(a). However, Cal Water will have to ensure that any preference given to an affiliate is not "unjust" or "undue." One way to demonstrate that a preference to an affiliate is not unjust or undue would be for CWSUS to hire independent contractors, instead of using Cal Water's employees, to provide the ESP service.[97] If CWSUS chooses not to employ independent contractors to offer the ESP service, then Cal Water must demonstrate that any preference provided CWSUS is not unjust or undue by demonstrating that it is offering its affiliate access to its assets and personnel at cost or fair market value. Cal Water can also readily address compliance with Section 453(a) by ensuring that all goods and services provided by the utility to CWSUS for the ESP service are made generally available by the utility to all interested non-affiliated companies through tariffed offerings or an open, competitive bidding process. This would conform to energy utilities' requirements.

Because DRA did not request monetary penalties or sanctions against Cal Water for violating Section 453(a) and we are not making a finding as to whether Cal Water violated Section 453(a) here, we do not find it appropriate to

[97] An example of an energy affiliate providing a service similar to the ESP service is the "Customer Premises Electrical Repair Service" provided by Edison's unregulated affiliate Edison Select between 1996 to 2000. This service used independent electrical contractors, chosen through a competitive bidding process, to provide minor types of electrical repair service in a customer's home. The service was provided under rules applicable to energy affiliates, not under Edison's revenue sharing mechanism or the provisions of Rule VII.

impose penalties under the specific facts presented here. The Commission undertook a full review of the ESP service on its own initiative and Cal Water cooperated by providing additional information and testimony. We find that Cal Water acted in good faith in its reliance that the ESP service had been authorized under D.00-07-018 and that this is an issue of first impression as to whether this type of service is authorized under the excess capacity rules.[98]

#### 5.5.4. Next Steps for the ESP Service

In this decision, we conclude that the excess capacity rules adopted in D.00-07-018 are not applicable to affiliates. We also find that the ESP service does not qualify as a non-tariffed utility service under the excess capacity rules. Lastly, we determine that the ESP service as currently offered, may not comply with Section 453(a).

If Cal Water chooses to continue to provide the ESP service to its utility customers, it may do so in one of two ways. First, the utility itself can provide ESP as a regulated tariffed service. Using a tariffed service would remove concerns that ratepayers were subsidizing a shareholder competitive venture, and would provide additional utility revenues to offset the cost of utility service. A tariffed service would be priced under the utility's cost of service methodology, thereby ensuring the prices paid by Cal Water's customers for ESP service are "just and reasonable" under the standards of Public Utilities Code Section 451.

[98] If Cal Water does not timely comply with changing or withdrawing the ESP service based on the findings and directives of this decision, the Commission could consider possible fines for noncompliance in a subsequent proceeding.

The second alternative is for the ESP service to continue to be provided by CWSUS, an unregulated affiliate, under terms and conditions that conform to its affiliate transaction rules and applicable statutes, if Cal Water is able to offer this service under the other provisions of its affiliate transaction rules. This would require that Cal Water not give CWSUS any undue or unjust preference. Also, any utility services provided must be fully compensated under the arms-length standard. Cal Water should make this showing under its affiliate transaction rules and the applicable laws we have discussed here.

We acknowledge that there may be a third option for Cal Water here. Cal Water could potentially file an application to offer ESP as an unregulated utility service pursuant to terms and conditions different that that established under the excess capacity revenue sharing mechanism. If that is done, Cal Water would need to show in its proposal:

- Cal Water service personnel and assets are available to provide this service without affecting the cost, quality, or reliability of basic utility service to customers;
- The non-tariffed service will be marketed with minimal or no incremental ratepayer capital, minimal or no new forms of liability or business risk, and no undue diversion of utility management attention;
- Using Cal Water's monopoly utility power to provide the ESP service would not interfere with the development of a competitive market for the service;
- Ratepayers would not be subsidizing a shareholder competitive venture; and
- Ratepayers would be paying a price for the service that is just and reasonable.

We do not judge here the merits of a potential application for such an offering, but we acknowledge that this may be another avenue that Cal Water may elect to pursue.

If Cal Water chooses to offer the ESP service under one of these options, it should file an application within 30 days of the effective date of this decision that sets forth the terms and conditions of service, consistent with the findings of this decision. Cal Water should also establish a memorandum account to track all costs and revenue of the ESP service until the Commission issues a decision determining how the costs and revenue of the ESP service should be allocated. Cal Water and CWSUS should also cease to advertise the ESP service until its application is approved.

If Cal Water chooses instead to not conform its ESP service to our rules and statutes, it should file within 30 days of the effective date of this decision a compliance filing that contains a timetable for notifying its customers that the ESP service is being discontinued.

DRA also contends that Cal Water has violated the reporting requirements of Section 2.62 of the Settlement Agreement to A.04-09-028. DRA claims that Cal Water may have failed to comply with its agreement in A.04-09-028 to provide detailed information on unregulated affiliates in all future GRC filings. We have addressed the ESP offering here and we can examine other affiliate programs in future GRC proceedings. DRA can also raise the issue of a full audit of all Cal Water's non-regulated activities in future proceedings.

We recognize that Cal Water's affiliate transaction rules currently do not allow it to directly offer any unregulated services, and therefore, Cal Water may not be able to offer services under our excess capacity rules. If Cal Water chooses, it may file a petition to modify its holding company decision,

D.97-12-011, to amend its affiliate transaction rules so that it will be able to offer unregulated services under our excess capacity rules.[99]

## 6. True-Up of Interim Rates Adopted in D.07-06-028

In D.07-06-028, we found it in the public interest to grant interim rate relief to Cal Water for the eight districts in this GRC proceeding. Consistent with Section 455.2, the interim rate increase is based on the rate of inflation as compared to existing rates for each district, is subject to refund, and will be adjusted upward or downward, back to July 1, 2007, based on the final rates adopted by the Commission in this decision.[100]

Based on our decision today, there will be a surcharge for each district for the period since July 1, 2007. Cal Water should calculate this surcharge amount based on the actual loss or gain in each district's revenue, determined by applying the rate differential to the actual quantities of water sales and the actual number of customers.[101] Cal Water should recover the surcharge for each district over the following 12 months and should earn interest at the 90-day commercial paper rate on the surcharge balance.

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[99] We recognize that under our Rule 16.4 of our Rules of Practice & Procedure, Cal Water will need to explain why the petition could not have been presented within one year of the effective date of the decision. Given the facts raised in this proceeding, we believe that Cal Water should be able to make this showing.

[100] The rate of inflation is to be calculated using the most recent Consumer Price Index maintained by the U.S. Department of Labor.

[101] Westlake District's reclaimed water usage is not subject to the interim rate or the surcharge. A refund should be provided for any interim rate increase paid.

## 7. Comments on Proposed Decision

The proposed decision of the assigned ALJ was mailed to the parties in accordance with Section 311 of the Public Utilities Code and Rule 14.2(a) of the Commission's Rules of Practice and Procedure. Opening comments were timely filed by Cal Water, DRA, and North Ranch and reply comments by DRA. Clarifying language and technical corrections are made in response to these comments.

## 8. Assignment of Proceeding

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

## Findings of Fact

1. This decision resolves Cal Water's GRC applications filed on July 26, 2005, for the Bakersfield, Dixon, King City, Oroville, Selma, South San Francisco, Westlake, and Willows districts.

2. On February 26, 2007, Cal Water and DRA filed a partial settlement for the eight districts, attached to this decision as Attachment 1.

3. The scope of this proceeding does not include development of IBRs. At the request of Cal Water, this issue was removed from this proceeding and is being addressed in I.07-01-022.

4. The Revised Rate Case Plan adopted in D.07-05-062 requires each GRC application filed on or after July 1, 2008 to contain a long-term, 6-10 year Water Supply and Facilities Master Plan to identify and address aging infrastructure needs, and requires that this plan be consistent with the GAO's March 2004 Report, GAO 04-461.

5. The planning studies authorized in this GRC proceeding do not meet the GAO criteria. Cal Water does not plan to meet the GAO criteria until the time of its 2009 GRC filings.

6. The Commission's Water Action Plan, adopted December 2005, encourages the deployment of AMR equipment.

7. In the Bakersfield district, the settlement authorizes $8,190,000 over the coming GRC period for the installation of new meters for residences that are un-metered. The record shows that the meter installation program will not include advanced metering, AMR equipment.

8. We find Cal Water should conduct a more thorough analysis of advanced water metering before it installs new meters in Bakersfield.

9. Cal Water and DRA did not update the interest rate forecasts for the coming GRC period prior to reaching a settlement. The updated forecasts in the record would lower DRA's risk premium model's ROE by 0.19% to 0.48%.

10. The new plant projects being authorized for later rate recovery under the AL filing process represent the largest dollar increases requested by Cal Water for each district.

11. Due to the magnitude of the potential AL rate increases authorized by the settlement, Cal Water should provide direct notice to customers of the AL process.

12. With the inclusion of refinements for master planning, meter installation, and customer notice, as discussed in this decision, we find the settlement as an integrated agreement is reasonable in light of the whole record and in the public interest.

13. For the Westlake district, the Commission has consistently established reclaimed water rates in the context of the entire system's costs.

14. We find it reasonable to maintain Westlake District's present reclaimed water rates, both service charge and volumetric rate. These customers will continue to be subject to AL filings in the coming GRC period, both to reflect changes in wholesale purchased costs for reclaimed water and for any facilities additions authorized here that are deemed used and useful for fire protection services. Reclaimed water customers should not be subject to the interim rate increase. They will be subject to the 2009-2010 attrition adjustment.

15. Cal Water should provide a detailed proposal for reclaimed water for the Westlake district in its next GRC proceeding.

16. We find the DGS policy on vehicle replacement reasonable.

17. We find a memorandum account rather than a balancing account is appropriate for Cal Water's conservation expenses, with a cap of 1.0% of revenues for the 2007 test year, and 1.5% for the 2008 and 2009 years. These caps are specific to this proceeding and should not be construed as a precedent or statement of policy.

18. Cal Water should file a conservation budget and measurement and evaluation proposal for each district within 90 days of the effective date of this decision and then make on-going reports and budget proposals on at least an annual basis.

19. For working capital, we find reasonable a 93 average lag-day calculation for federal income taxes and California Corporation Franchise Tax.

20. A marketing brochure for the ESP service offered to Cal Water customers by Cal Water's non-regulated affiliate CWSUS is attached to this decision as Attachment 2.

21. Cal Water's ESP service does not meet the definition of a maintenance contract. The common definition of maintenance is the upkeep, repair, and

preservation of existing facilities. The excavation and replacement of a water service line goes well beyond this definition.

22. Cal Water did not submit the ESP service to the Commission for review prior to entering an Inter-Company Service Agreement with CWSUS, did not request approval of its prices, and did not provide cost studies or market power analyses.

23. Cal Water's affiliate transaction rules state that "[u]nregulated services, including pertinent contracts, that are performed by the Utility shall be transferred to the appropriate affiliate as soon as the requisite consents are obtained." (D.97-12-011, Settlement, Section XII (A), 1977 Cal. PUC LEXIS 1212, *14.)

## Conclusions of Law

1. We grant the petitions to intervene of North Ranch and the SFPUC.

2. The standard of review for the settlement is set forth in Rule 12.1(d) of our Rules of Practice and Procedure. This rule provides, in general, that, prior to approval, the Commission must find a settlement "reasonable in light of the whole record, consistent with the law, and in the public interest."

3. Cal Water and DRA's settlement, with refinements in three areas, meets our standard of review and should be adopted. The areas of refinement are:

   a. Cal Water should examine if the master plan process currently underway for the Bakersfield, Selma, and King City districts can be augmented, either by a revised Request for Proposal or with in-house resources, to meet the 2004 GAO criteria for comprehensive asset management planning;

   b. Cal Water should conduct a more thorough analysis of advanced water metering before it installs new meters in Bakersfield; and

c. Cal Water should provide direct notice to customers of the AL rate offset filings, as provided under GO 96-B general rule 4.2, rather than the lesser notice allowed under Water Industry Rule 3.1.

4. The settlement should not be construed as precedent or policy of any kind in this or future proceedings.

5. The Commission has constitutional and statutory responsibilities to ensure that water utilities provide water that protects the public health and safety.

6. We find no evidence to indicate any violations of applicable water quality standards by Cal Water in the eight districts since the last GRC proceeding in each district.

7. We should adopt the rate tables and tariff sheets attached to this decision at Attachment 3. Cal Water should file a compliance filing within five days of this decision removing from the revenue requirement and rate tables the ESP service costs and revenues and adjusting the Westlake reclaimed water rates.

8. We should adopt a memorandum account rather than a balancing account for Cal Water's conservation expenses, with a cap of 1.0% of revenues for the 2007 test year, and 1.5% for the 2008 and 2009 years.

9. Cal Water may be violating Public Utilities Code Section 453(a) because it appears to be granting undue and unjust preference to CWSUS for the ESP service. Monetary penalties against Cal Water should not be imposed under the specific facts presented here, and because this case presents an issue of first impression as to the type of service authorized under D.00-07-018.

10. The excess capacity rules for water utilities, adopted in D.00-07-018 do not apply to affiliate transactions.

11. The excess capacity rules adopted in D.00-07-018 do not apply to Cal Water offering the ESP service as a non-tariffed utility service because the

assets used to provide the service are not excess capacity and Cal Water does not make the required showing that the ESP service does not violate any law, regulation, or Commission policy regarding anti-competitive practices. Specifically:

a. the utility assets used to provide the ESP service are not excess capacity;

b. we have no record to determine whether the manner in which the ESP service is being offered interferes with the development of a competitive market for the service;

c. we do not have a record to determine whether ratepayers are subsidizing a shareholder competitive venture; and

d. we do not have a record to determine whether ratepayers are paying a price for the service.

12. If Cal Water chooses to continue to provide the ESP service to its customers, it may do so either as a regulated utility service or as an affiliate service under the terms and conditions of Cal Water's affiliate transaction rules, and applicable statutes. In either case, Cal Water should file an application within 30 days of the effective date of this decision that sets for the terms and conditions of service.

13. If Cal Water wishes to continue offering the ESP service, but does not want to provide it as a regulated utility service or as an affiliate service pursuant to its affiliate transaction rules, then Cal Water shall file an application within 30 days that contains a detailed description of its proposed terms and conditions of the revised ESP service. The application should make the showing addressed in this decision and include a section describing how the proposed service offering complies with applicable law.

14. If Cal Water continues to offer the ESP service, then Cal Water should set up a memorandum account tracking all costs and revenue associated with the

ESP account until the Commission determines how those funds should be allocated.

15. If Cal Water chooses to not conform its ESP service to our rules and statutes, it should file within 30 days of the effective date of this decision a compliance filing that contains a timetable for notifying its customers that the ESP service is being discontinued.

16. Cal Water may file a petition to modify D.97-12-011, its holding company decision, to modify its affiliate transaction rules so that it may directly offer an unregulated service under our excess capacity rules. Cal Water may make this filing even though more than one year has passed since the effective date of D.97-12-011.

17. The surcharge to true-up the interim rates authorized in D.07-06-028 shall be based on the methodology set forth in D.07-06-028 and should be filed by compliance letter within 10 days of the effective date of this decision.

## O R D E R

**IT IS ORDERED** that:

1. The California Water Service Company (Cal Water) and the Division of Ratepayer Advocates settlement at Attachment 1 is adopted subject to the refinements discussed in the Findings of Fact and Conclusions of Law above.

2. The rate tables and tariff sheets at Attachment 3 are adopted.

3. Cal Water is authorized to file in accordance with General Order (GO) 96-B, and to make effective on filing, tariffs containing the 2007/2008 test year increases for its eight districts as provided in Attachment 3 to this decision. The revised rates shall apply to service rendered on and after the tariff's effective date.

4. On or after May 1, 2008, Cal Water is authorized to file in accordance with GO 96-B, a Tier 1 advice letter, with appropriate supporting workpapers, requesting an escalation adjustment to be calculated in conformance with the RCP and Attachment 3. The filing should include the remainder of the Selma rate phase-in and changes in water mix in Bakersfield as agreed in the adopted settlement. Cal Water should file a lesser increase in the event that the rate of return on rate base, adjusted to reflect the rates then in effect and normal ratemaking adjustments for the 12 months ending March 31, 2008, exceeds the lesser of (a) the rate of return found reasonable by the Commission for Cal Water for the corresponding period in the most recent rate decision, or (b) the rate of return found reasonable in this case. The advice letter shall be reviewed by the Commission's Water Division for conformity with this decision including the applicable provisions of the settlement and shall go into effect upon five days notice, not earlier than July 1, 2008. The tariffs shall be applicable to service rendered on or after the effective date.

5. On or after May 1, 2009, Cal Water is authorized to file in accordance with GO 96-B, a Tier 1 advice letter (AL), with appropriate supporting workpapers, requesting an escalation adjustment to be calculated in conformance with the RCP and Attachment 3. The filing should include changes in water mix in Bakersfield as agreed in the adopted settlement. The AL shall be reviewed by the Commission's Water Division for conformity with this decision including the applicable provisions of the settlement and shall go into effect upon five days notice, not earlier than July 1, 2009. The tariffs shall be applicable to service rendered on or after the effective date.

6. Cal Water is authorized to file Tier 1 ALs to request amortization of the balancing and memorandum accounts adopted in Sections 5.4 and 5.5 of the settlement.

7. Cal Water shall make a compliance filing within 30 days to include the water conservation memorandum account ordered in this proceeding in its preliminary statement.

8. Cal Water is authorized to file a Tier 3 AL rate base offsets to recover the reasonable capital costs of the improvements enumerated in the settlement, Attachment 1, Section 3. Attachment 1, Section 3 includes the approved description and scope of each project, the estimated cost, and the cap on project costs allowable in the advice letter filing. The Water Division shall use these factors in its review of each AL. Cal Water shall notice these ALs under GO 96-B general rule 4.2. rather than the lesser notice allowed under Water Industry Rule 3.1.

9. Cal Water shall make a compliance filing within 90 days of a final decision in this proceeding on the status and scope of possible revisions to its proposed Bakersfield, Selma, and King City master plans.

10. Cal Water shall make a compliance filing within 90 days of the effective date of this decision discussing whether the $8,190,000 in funding for meter installation will be spent on new meters that are compatible with future deployment of advanced metering technology and, specifically, with the advanced metering being deployed by PG&E in the Bakersfield district.

11. Cal Water shall file a conservation budget and measurement and evaluation proposal for each district within 90 days of the effective date of this decision and then make ongoing reports and budget proposals on at least an annual basis.

12. We adopt the Department of General Services policy on vehicle replacement.

13. We adopt a memorandum account rather than a balancing account is for Cal Water's conservation expenses, with a cap of 1.0% of revenues for the 2007 test year, and 1.5% for the 2008 and 2009 years.

14. We adopt for working capital a 93 average lag-day calculation for federal income taxes and California Corporation Franchise Tax.

15. Cal Water shall file within five days of the effective date of this decision a compliance filing to remove the Extended Service Protection (ESP) costs and revenues from the revenue requirement and rate tables we adopt here and to conform the Westlake district's reclaimed water rates to our decision.

16. Cal Water shall file an application within 30 days of the effective date of this decision that contains the terms and conditions of the revised ESP service if it chooses to continue to provide the ESP service to its customers, as a regulated utility service or as an affiliate service under the terms and conditions of Cal Water's affiliate transaction rules and applicable statutes.

17. If Cal Water elects to continue offering the ESP service, but chooses not to provide it as a regulated utility service or as an affiliate service under the terms and conditions of Cal Water's affiliate transaction rules, then Cal Water shall file an application within 30 days with a detailed description of the terms and conditions of the proposed revised ESP service. The application shall include the showing addressed here and a section describing how the proposed service offering complies with applicable law.

18. If Cal Water elects to continue offering the ESP service, Cal Water shall set up a memorandum account tracking all costs and revenue associated with the

ESP service until the Commission determines how those funds should be allocated.

19. Cal Water shall file within 30 days of the effective date of this decision a compliance filing that contains a timetable for notifying its customers that the ESP service is being discontinued if it chooses to not conform its ESP service to our rules and statutes.

20. The surcharge to true-up the interim rates authorized in D.07-06-028 shall be based on the methodology set forth in D.07-06-028 and shall be filed by compliance letter within 10 days of the effective date of this decision.

21. Application (A.) 06-07-017, A.06-07-018, A.06-07-019, A.06-07-020, A.06-07-021, A.06-07-022, A.06-07-023, and A.06-07-024, are closed.

This order is effective today.

Dated December 20, 2007, at San Francisco, California.

MICHAEL R. PEEVEY
President
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
TIMOTHY ALAN SIMON
Commissioners