

Decision 08-03-021 March 13, 2008

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

Application of CALIFORNIA WATER SERVICE COMPANY (Applicant) (U-60-W), a California corporation, requesting an order from the California Public Utilities Commission (Commission) authorizing Applicant to increase water rates to fully fund its retiree healthcare plan commonly referred to as a 'Postretirement Benefits other than Pension' (PBOP) plan and to adopt a change in accounting as proposed by Applicant for ratemaking.

Application 06-12-025  
(Filed December 21, 2006)

**OPINION AUTHORIZING THE RECOVERY OF THE UTILITY'S REGULATORY  
ASSET FOR POST RETIREMENT BENEFITS OTHER THAN PENSIONS**

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## **OPINION AUTHORIZING THE RECOVERY OF THE UTILITY'S REGULATORY ASSET FOR POST RETIREMENT BENEFITS OTHER THAN PENSIONS**

### **1. Summary**

This opinion authorizes California Water Service Company (Cal Water) to recover over a 15-year period its regulatory asset for post-retirement benefits other than pensions (PBOP). The amount of regulatory asset is \$9.87 million.

This proceeding is closed.

### **2. Procedural Background**

Cal Water filed Application (A.) 06-12-025 for authority to recover its PBOP regulatory asset over a 15-year period. The origin of the regulatory asset is described below. Notice of A.06-12-025 appeared in the Commission's Daily Calendar on December 26, 2006. The Division of Ratepayer Advocates (DRA) filed a protest opposing A.06-12-025. There were no other protests. A prehearing conference (PHC) was held on March 28, 2007.

The Assigned Commissioner's Scoping Memo, issued on April 5, 2007, pursuant to Rule 7.3(a) of the Commission's Rules of Practice and Procedure (Rules), established the scope of this proceeding, determined that evidentiary hearings were necessary, and set a schedule for the proceeding. Two rounds of written testimony were served in October 2007, and two days of evidentiary hearings were held on November 8 and 9, 2007. The proceeding was submitted at the conclusion of the oral argument that was held on March 10, 2008, before a quorum of Commissioners.

As required by Rules 3.2(b), 3.2(c), and 3.2(d), Cal Water provided notice of A.06-12-025 by mail, newspaper advertisements, and bill inserts to specified governmental bodies, the public, and Cal Water's customers. The Commission received several letters and e-mails from customers who opposed A.06-12-025.

In general, these customers wrote that is unfair for them to pay for the medical benefits provided to Cal Water's retirees when these customers had to pay for their own retirement benefits.

### **3. Regulatory Background**

The major issues in this proceeding involve Cal Water's compliance with Commission decisions issued in the early 1990s that addressed Financial Accounting Standard (FAS) 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. Cal Water's PBOP consist primarily of medical benefits provided to retired employees.

FAS 106 requires the use of accrual accounting for PBOP costs for financial reporting purposes. Prior to FAS 106, most companies reported PBOP costs on a pay-as-you-go (PayGo) basis, *i.e.*, when retirees received benefits. The accrual basis requires companies to recognize PBOP costs over the service lives of employees and not when the employees receive the benefits during retirement.

The Commission instituted Investigation (I.) 90-07-037 to analyze the use of FAS 106 for ratemaking purposes. The two main decisions in I.90-07-037 were Decision (D.) 91-07-006 and D.92-12-015. In D.91-07-006, the Commission evaluated different methods for funding PBOP costs, including PayGo, the use of Internal Revenue Code (IRC) Section 401(h) accounts (401(h) accounts), and the use of IRC Section 501(c)(9) Voluntary Employee Benefit Associations (VEBAs). These funding methods are summarized below:

**PayGo:** The PayGo method funds PBOP costs as the benefits are used by retirees. This method was used to set utility rates for PBOP costs in the decades prior to I.90-07-037.

**401(h) account:** This is a subaccount within a pension trust. IRC Section 401(h) permits employers with a "qualified" pension plan to provide PBOP from the pension trust as long

as the contributions to the 401(h) account do not exceed 1/3rd of the pension contributions. There are no income taxes on the earnings from the assets held in the 401(h) account. Under this method, utility rates for PBOP costs would equal their tax-deductible contributions to 401(h) accounts.

**VEBAs:** VEBAs are tax-exempt trusts used to provide employee benefits, including PBOP. In general, there are no income taxes on the earnings from the assets held by VEBA trusts. Under this method, utility rates for PBOP costs would equal their tax-deductible contributions to VEBA trusts.

In D.91-07-006, the Commission authorized, but did not require, utilities to recover their tax-deductible contributions to 401(h) accounts and VEBAs, subject to the condition that utilities use independent trusts for the receipt, investment, administration, and disposition of funds.<sup>1</sup> Cal Water did not participate.

In D.92-12-015, the Commission ordered Cal Water and other cost-of-service utilities to use FAS 106 for regulatory accounting and ratemaking purposes. These utilities were authorized to recover their FAS 106 costs to the extent of their tax-deductible contributions to independent trusts. FAS 106 costs in excess of tax-deductible contributions were to be recorded as a regulatory asset and recovered in future years when tax-deductible contributions exceeded FAS 106 costs.<sup>2</sup>

The Commission first addressed FAS 106 costs for Cal Water in D.93-08-033. In that Decision, the Commission adopted a settlement agreement between Cal Water and DRA that resolved the general rate case (GRC) applications that Cal Water had filed for seven of its 21 districts (Settlement

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<sup>1</sup> D.91-07-006, Ordering Paragraph (OP) 4, 40 CPUC 2d 638, 664.

<sup>2</sup> D.92-12-015, OPs 1, 2, and 4, 46 CPUC 2d 499, 532-33.

Agreement or Settlement).<sup>3</sup> The Settlement allowed Cal Water to recover its FAS 106 costs if it complied with several specified conditions.

Cal Water filed Advice Letter (AL) 1341 on February 24, 1994, to recover its FAS 106 costs pursuant to D.92-12-015 and the conditions of the Settlement Agreement. The Advice Letter stated that (1) Cal Water had established a PBOP trust account<sup>4</sup>; (2) Cal Water's FAS 106 costs in 1993 were \$717,000; (3) the maximum tax-deductible contribution to the trust account for 1993 was \$480,000, which Cal Water had deposited in September 1993; (4) Cal Water's initial PBOP regulatory asset was \$237,000 (\$717,000 - \$480,000), and (5) Cal Water's incremental revenue requirement to fund its tax-deductible contributions was \$214,700.<sup>5</sup> AL 1341 requested authority to recover the \$214,700 via a 12-month surcharge. The Commission Advisory and Compliance Division (CACD) accepted AL 1341 in a letter to Cal Water dated June 10, 1994.<sup>6</sup>

In the years since CACD's acceptance of AL 1341, Cal Water has funded its FAS 106 costs by making the maximum tax-deductible contribution to its 401(h) account, with minor exceptions.<sup>7</sup> Cal Water's FAS 106 expense has exceeded its

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<sup>3</sup> Cal Water had 21 rate districts in 1994. It now has 24 districts.

<sup>4</sup> AL 1341 does not state whether the trust account is a 401(h) account or a VEBA trust. However, the actuarial reports that were attached to AL 1341 plainly indicate that Cal Water had established a 401(h) account. (Cal Water Exhibit 3, Attachments.)

<sup>5</sup> Cal Water's PayGo costs at the time were 265,300 (480,000 - 214,700).

<sup>6</sup> CACD's letter was erroneously dated as June 10, 1993. AL 1341 and CACD's acceptance letter are attached to A.06-12-025 as Exhibit 2.

<sup>7</sup> From 1993 through 2005, Cal Water's maximum tax-deductible funding for its 401(h) account was \$10,660,162. Cal Water contributed \$10,440,436, a difference of \$219,726. The difference was due primarily to a private letter ruling (PLR 2005-500443), which retroactively allowed higher tax-deductible funding in 2004 by \$205,952.

tax-deductible contributions every year since 1993. The FAS 106 costs in excess of contributions were recorded as a PBOP regulatory asset. As of December 31, 2006, Cal Water had a regulatory asset of \$9.87 million, and its 401(h) account had \$5.5 million of assets to pay for future PBOP costs.

#### **4. Summary of A.06-12-025**

In A.06-12-025, Cal Water requests authority under Pub. Util. Code § 454 to recover its PBOP regulatory asset of \$9.87 million over a 15-year period.<sup>8</sup> Cal Water proposes to recover the regulatory asset via a flat monthly surcharge of \$0.12 per customer, although Cal Water does not oppose a consumption-based surcharge. Cal Water intends to roll the surcharge into general rates eventually.

Cal Water admits that it did not follow the formula in D.92-12-015 for calculating its PBOP regulatory asset. That decision set the regulatory asset equal to the cumulative difference between a utility's FAS 106 costs and the amount of FAS 106 costs recovered in rates. However, Cal Water was unable to track the amount of FAS 106 costs recovered in rates because it has different tariffs for each of its districts. Under the Commission's past rate-case plans, Cal Water was prohibited from changing rates in all districts at the same time. Thus, when tax-deductible contributions were updated in a GRC filing, only those districts that were subject to the GRC filing (usually 8 of the 24 districts) would have rates adjusted for the new contributions. The following year 16 districts had the new contributions in rates, and by the third year all 24 districts. The result was that rates always lagged behind contributions.

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<sup>8</sup> All statutory references denoted by the symbol "§" pertain to the California Public Utilities Code unless otherwise indicated.

Another reason Cal Water could not track its FAS 106 costs recovered in rates was that Cal Water and DRA settled most rate cases. FAS 106 costs were typically not identified in the settlements. Rather, these costs were usually embedded in a larger category of expense such as employee benefits, which itself was a compromise amount.

Cal Water explains that because it could not track the amount of tax-deductible contributions recovered in rates, it recorded a regulatory asset equal to its FAS 106 costs less its tax-deductible contributions. This produced a smaller regulatory asset than would have occurred had Cal Water followed OP 4. Cal Water maintains that ratepayers have benefited from the method it used, since it has produced a smaller regulatory asset for recovery in future rates.

Cal Water acknowledges that its decision to use a single 401(h) account prevented full funding of its annual FAS 106 costs due to statutory limitations on tax-deductible contributions to 401(h) accounts. To overcome these limitations, Cal Water has established two VEBA trusts. The two VEBA trusts, together with the existing 401(h) account, will enable Cal Water to henceforth make tax-deductible contributions that are sufficient to cover both its annual FAS 106 expense accrual and its PBOP regulatory asset.

Cal Water's decision to file A.06-12-025 was driven by its external financial auditors. The auditors informed Cal Water that it would have to either (1) demonstrate that the PBOP regulatory asset that Cal Water has accumulated since 1993 is recoverable in future rates, or (2) write-off the regulatory asset. Cal Water chose to file A.06-12-025 in order prove to the auditors that the regulatory asset is recoverable in future rates.



## **5. Issues**

DRA alleges that Cal Water violated OPs 1, 2, and 4 of D.92-12-015 and the Settlement Agreement adopted by D.93-08-033. Based on these allegations, DRA recommends that the Commission deny A.06-12-025 and fine Cal Water \$3 million. Cal Water denies the allegations.

For the reasons set forth below, we conclude that DRA's allegations have no merit and that Cal Water's application to recover its PBOP regulatory asset should be granted.

### **5.1. Compliance with OP 1 of D.92-12-015**

#### **5.1.1. Position of the Parties**

DRA alleges that Cal Water failed to comply with OP 1 of D.92-12-015, which required utilities to use FAS 106 for ratemaking purposes. OP 1 states:

1. [FAS 106] shall be adopted...for regulatory accounting and ratemaking purposes...effective January 1, 1993.

DRA contends that OP 1 required Cal Water to fund its FAS 106 costs, to the maximum extent possible, through tax-deductible contributions to independent PBOP trusts. Cal Water did not comply with OP 1 because it used a single 401(h) account. The statutory limits on contributions to the 401(h) account caused Cal Water to fund only 55% of its FAS 106 costs since 1993. DRA submits that Cal Water could have funded all of its FAS 106 costs if it had established one or more VEBA trusts in 1993.

DRA asserts that because Cal Water failed to fully fund its FAS 106 expense as required by OP 1, much of its FAS 106 expense was deferred as a regulatory asset to future years. DRA believes it is unfair to require future ratepayers to pay for the cost-of-service provided to prior generations of

ratepayers, as this would contravene the cardinal principle that only those ratepayers who benefit from an expense should pay for its recovery.

Cal Water responds that D.92-12-015 does not require utilities to fully fund their FAS 106 costs. This is evident in OP 4, which authorizes utilities to record a regulatory asset for the FAS 106 costs they cannot fund due to limitations on tax-deductible contributions. Cal Water states that it acted reasonably in 1993 when it elected to use a 401(h) account as its sole funding vehicle. Cal Water's actuary testified that he believed in 1993 that a 401(h) account would allow Cal Water to fully fund its FAS 106 costs over time. For example, Dominguez Water Corporation, which was acquired by Cal Water in 2000, was able to fund all of its FAS 106 costs with a 401(h) account.

Finally, Cal Water maintains that it notified the Commission in AL 1341 that it intended to use a 401(h) account and record a regulatory asset. Cal Water contends that CACD's acceptance of the Advice Letter demonstrates that Cal Water's actions were approved by the Commission.

### **5.1.2. Discussion**

We agree with DRA that it was the Commission's intent in D.92-12-015 that utilities should fully fund their FAS 106 costs, to the maximum extent possible, through tax-deductible contributions to independent PBOP trusts. However, the requirement to fully fund FAS 106 costs was not absolute. D.92-12-015 provided utilities with some discretion in determining the amount of funding. This is evident from the following statements in D.92-12-015 that emphasized the need for flexibility in determining the amount of PBOP funding:

We used four specific criteria to assess and evaluate various cost recovery mechanisms: assurance, cost, **flexibility**, and equity. Although the criteria were established in 1983, nothing convinces us that the criteria are outdated. Rather

than re-inventing the wheel, we will use the same criteria in this investigation. (46 CPUC 2d 499, 512. Emphasis added.)

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[W]e deem it very **important that the financing mechanism adopted in this order be adaptable.** Consistent with this position, the funding mechanism and payments should be evaluated in each operating utility's GRC or other rate proceeding. (46 CPUC 2d 499, 513. Emphasis added.)

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**The choice of tax-deductible plans is a management decision which should be made by the individual utility.**  
**To provide utility management greater flexibility in funding** and controlling PBOP costs and benefits, the utilities should be granted authority to implement trusts whose earnings may be taxable to the trust or to the employees. (46 CPUC 2d 499, 520. Emphasis added.)

The Commission made it clear in OP 2.d of D.92-12-015 that it would be the final arbiter of what constitutes reasonable funding of FAS 106 costs and the amount of FAS 106 costs that may be recovered in rates. OP 2.d states:

2. Regulated utilities under traditional cost-of-service ratemaking...shall be authorized to recover their PBOP costs associated with the adoption of [FAS 106] and actually paid to independent trusts to the extent that the utilities:
  - d. Incur PBOP costs that the Commission finds are reasonable and necessary to meet funding requirements based on fair actuarial assumptions, contributions, and investments.

The Settlement Agreement adopted by D.93-08-033 set forth the procedures the Commission would use to review and authorize the recovery of Cal Water's FAS 106 costs in accordance with D.92-12-015. Cal Water implemented the Settlement by filing AL 1341. The Advice Letter indicated that Cal Water intended to use a 401(h) account and to record a regulatory asset. The

Advice Letter also included the following documents: (1) copies of all trust agreements and actuarial valuations; and (2) work papers showing the derivation of the revenue requirement for FAS 106 costs.

CACD approved AL 1341 in June 1994, stating:

**The Commission has accepted the utility's proposal in Advice Letter No. 1341** for recovery of expenses related to the Post Retirement Benefits other than Pensions (PBOP) **in accordance with Decision Nos. 92-12-015 and 93-08-033.**  
(A.06-12-025, attached Exhibit 2. Emphasis added.)

CACD had everything it needed to make an informed decision on whether Cal Water's proposed accounting, funding, and recovery of FAS 106 costs were reasonable and complied with D.92-12-015 and D.93-08-038. We decline to second guess, 14 years after the fact, CACD's decision to approve AL 1341.

DRA received a copy of AL 1341 but did not protest the Advice Letter. Furthermore, D.92-12-015 encouraged DRA "to continue monitoring and reviewing the reasonableness of the utilities' PBOP cost activities."<sup>9</sup> Since then, DRA has had an opportunity in several GRCs to contest whether Cal Water's funding of FAS 106 costs complied with D.92-12-015, but DRA never did so. It is simply too late for DRA to undo its inaction in prior years.

For the preceding reasons, we conclude that CACD acted properly when it approved AL 1341 and, therefore, that Cal Water did not violate OP 1.

In its comments on the proposed decision, DRA argues that CACD had no authority under General Order (GO) 96 to approve rate increases unless they

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<sup>9</sup> D.92-12-015, 46 CPUC 2d 499, 515.

were minor in nature. DRA contends that the rate increase requested in AL 1341 was not minor and, therefore, could not be approved by CACD.

We disagree. AL 1341 requested a rate increase of \$214,700. Cal Water's gross operating revenue at the time was \$127 million.<sup>10</sup> Thus, the rate increase requested by AL 1341 amounted to 0.17% of Cal Water's operating revenue. We consider this to be minor and within CACD's authority to approve under GO 96.

## **5.2. Compliance with OP 2 of D.92-12-015**

### **5.2.1. Position of the Parties**

DRA alleges that Cal Water did not comply with OPs 2.a and 2.d of D.92-12-015, which state as follows:

2. Regulated utilities under traditional cost-of-service ratemaking...shall be authorized to recover their PBOP costs associated with the adoption of the Statement and actually paid to independent trusts to the extent that the utilities:
  - a. Establish and use independent trusts for the receipt, investment, administration, and disposition of PBOP.
  - d. Incur PBOP costs that the Commission finds are reasonable and necessary to meet funding requirements based on fair actuarial assumptions, contributions, and investments.

Cal Water has used a 401(h) account as its sole PBOP funding vehicle since 1993. The account is part of a pension plan, and its maximum funding limit is a fixed percentage of the pension funding. DRA argues that because a 401(h) account is not a stand-alone PBOP trust, Cal Water did not comply with the requirement in OP 2.a to "use independent trusts for the receipt, investment, administration, and disposition of PBOP."

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<sup>10</sup> D.93-08-033, 50 CPUC 2d 526, at 528.

DRA also argues that Cal Water's has not complied with OP 2.d, which limits the recovery of FAS 106 costs to those "that the Commission finds are reasonable and necessary to meet funding requirements." DRA contends that the Commission never found that Cal Water's FAS 106 costs are reasonable and necessary, which is why Cal Water had to file A.06-12-025.

Cal Water responds that the Commission was aware of the characteristics of 401(h) accounts, as they are mentioned repeatedly in D.91-07-006 and D.92-12-015. If the Commission did not want utilities to use a 401(h) account, the Commission would have said so in D.92-12-015.

Cal Water also disputes DRA's claim that the Commission never found Cal Water's FAS 106 costs to be reasonable and necessary. Cal Water states that the Commission made this exact finding when CACD accepted AL 1341.

### **5.2.2. Discussion**

There is no merit to DRA's assertion that Cal Water's 401(h) account is not allowed by OP 2.a. In D.91-07-006, the Commission explicitly authorized utilities to use 401(h) accounts as a funding vehicle for PBOP costs.<sup>11</sup> In D.92-12-015, the Commission held that utilities should continue to use the funding vehicles authorized by D.91-07-006, which included 401(h) accounts.<sup>12</sup>

As DRA knows, a 401(h) account is part of a qualified pension trust. IRC Sections 401(a)(1) and (2) require the assets of a qualified pension plan to be held in an independent trust. The 401(h) account is used to segregate assets held

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<sup>11</sup> D.91-07-006, OP 4.a., 40 CPUC 2d 638, 664.

<sup>12</sup> D.92-12-015, 46 CPUC 2d 499, 516.

in the trust for PBOP purposes from the assets held for pension purposes. Thus, a 401(h) account is equivalent to an independent trust and complies with OP 2.a.

We also disagree with DRA's assertion that the Commission never found Cal Water's FAS 106 costs to be reasonable and necessary as required by OP 2.d. Cal Water requested authorization to recover its FAS 106 costs in AL 1341, which was approved by CACD. Since then, there have been several GRCs in which the Commission authorized Cal Water to (1) recover its FAS 106 costs based on its tax-deductible contributions to its 401(h) account, and (2) record a regulatory asset for the FAS 106 costs in excess of contributions. These actions by CACD and the Commission constitute, at the very least, an implicit acknowledgement by the Commission that Cal Water's FAS 106 costs were reasonable and necessary.<sup>13</sup> The prior Commission decisions approving Cal Water's accounting, funding, and recovery of FAS 106 costs are presumptively reasonable.<sup>14</sup> DRA has provided no credible evidence that the Commission's decisions were flawed.

### **5.3. Compliance with OP 4 of D.92-12-015**

#### **5.3.1. Position of the Parties**

DRA contends that Cal Water did not comply with OP 4 of D.92-12-015, which states as follows:

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<sup>13</sup> Section 454 provides that a utility cannot increase its rates except upon a showing by the utility and a finding by the Commission that the higher rates are justified.

<sup>14</sup> The FAS 106 costs adopted by the Commission in prior GRC proceedings were often embedded in Cal Water's GRC applications and DRA's settlement agreements with Cal Water. DRA's repudiation of its settlement agreements is inconsistent with Rule 12.5, which states that the Commission's "adoption of a settlement is binding on all parties to the proceeding in which the settlement is proposed."

4. The utilities shall establish and maintain a regulatory asset pursuant to [FAS 71] and as discussed in this order. The recovery of such regulatory asset in future rates shall begin during the year when tax-deductible limits exceed PBOP costs and shall continue until the regulatory asset has reached a zero balance.

FAS 71 authorizes utilities to record past and current expenses as a regulatory asset if they have “regulatory assurance” that the expenses will be recovered in future rates. DRA maintains that this proceeding would be moot if Cal Water had complied with OP 4, as there would be no need for Cal Water to have filed A.06-12-025 to request authority to recover its PBOP regulatory asset.

DRA argues that Cal Water failed to comply with the requirement in OP 1 to fully fund its FAS 106 costs with tax-deductible contributions. Those costs that Cal Water failed to recover were recorded as a regulatory asset. DRA reasons that because the regulatory asset consists of costs that Cal Water failed to recover in violation of OP 1, the regulatory asset also violates OP 4. If Cal Water had complied with OP 4, DRA believes that Cal Water’s auditors would not have expressed concern about Cal Water’s flawed accounting practices for the regulatory asset that led Cal Water to file A.06-12-025.

Cal Water responds that it has fully complied with OP 4. As intended by OP 4, Cal Water has recorded a regulatory asset equal to the cumulative difference between its FAS 106 costs and its tax-deductible contributions.

Cal Water takes strong exception to DRA’s argument that Cal Water should be barred from recovering its regulatory asset because Cal Water has not funded enough of its FAS 106 costs. Cal Water states that in the several GRCs since D.92-12-015, it would typically request PBOP costs equal to the maximum tax-deductible contributions allowed by its 401(h) account. DRA would usually



recommend less than what Cal Water had requested. Most GRCs were settled by DRA and Cal Water, and the FAS 106 costs included in rates was a compromise amount. Cal Water submits that it is disingenuous for DRA to now argue that Cal Water should have requested higher FAS 106 costs in prior GRCs when DRA sought to reduce the costs that Cal Water requested at the time.

Finally, Cal Water notes that its PBOP regulatory asset is less than what it was allowed to record pursuant to OP 4, which directed utilities to record a regulatory asset equal to the difference between their FAS 106 expense accrual and the amount of FAS 106 costs collected in rates. Cal Water was unable to track the amount of FAS 106 costs recovered in rates for the reasons stated previously in this opinion, and instead recorded a regulatory asset equal to the difference between its FAS 106 expense and its tax-deductible contributions to its 401(h) account. The regulatory asset recorded by Cal Water is less than what it would have recorded had Cal Water used the formula specified in OP 4.

### **5.3.2. Discussion**

DRA argues that the Commission should deny Cal Water's request to recover its regulatory asset because Cal Water never had authority to record the regulatory asset. We disagree. Cal Water requested authority in AL 1341, which was approved by CACD. Since then, Cal Water has recorded a regulatory asset for the difference between its funding of FAS 106 costs and its FAS 106 expense accrual. We find that Cal Water's actions comply with the intent of OP 4.

Cal Water's Application is not an admission, as DRA asserts, that Cal Water did not comply with D.92-12-015.<sup>15</sup> To the contrary, A.06-12-025 requests recovery of the regulatory asset in accordance with OP 2.d of D.92-12-015, which requires utilities to obtain Commission authorization to recover FAS 106 costs in rates.

Although Cal Water complied with the intent of OP 4, Cal Water and DRA agree that Cal Water did not use the correct formula for calculating its PBOP regulatory asset. DRA and Cal Water agree that the PBOP regulatory asset recorded by Cal Water is less than what it would have been had Cal Water used the formula specified in OP 4.<sup>16</sup> Cal Water does not request recovery of this undercollection. In light of these circumstances, we conclude that no purpose is served by finding that Cal Water has violated OP 4 when it has used a method for recording its regulatory asset that benefits ratepayers.

#### **5.4. Compliance with D.93-08-033**

##### **5.4.1. Position of the Parties**

###### **5.4.1.1. DRA**

The Settlement Agreement approved by D.93-08-033 authorized Cal Water to recover its FAS 106 expenses in accordance with D.92-12-015, but only after six conditions ("Conditions") were satisfied. The six Conditions were:

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<sup>15</sup> Cal Water's auditors, KPMG, never accused Cal Water of using "flawed accounting practices" as suggested by DRA. (DRA Exhibit 100, p. 13.) KPMG agreed with Cal Water's accounting, as demonstrated by KPMG's unqualified opinions of California Water Service Group's financial statements for the years 1993 - 2006.

<sup>16</sup> DRA roughly estimates that Cal Water's PBOP regulatory asset was understated by \$1 million through December 31, 2006.

**Condition 1:** "PBOP compliance filing must be made within a date certain, must be comprehensive (i.e., include all workpapers and documentation), and must clearly demonstrate that Cal Water has complied with all ordering paragraphs of D.92-12-015. (See Attachment A.)" Attachment A listed the following work papers and documents that Cal Water was to provide: Complete copies of all trust agreements and actuarial valuations for PBOP; work papers showing the derivation of the revenue requirements for PBOP accruals; workpapers showing the derivation of the revenue requirement allocations to each district; and workpapers showing the working cash amounts are consistent with the schedule for tax deductible contributions to PBOP trusts.

**Condition 2:** "Only prospective PBOP accruals can be reflected in this compliance filing and recovered in rates. No PBOP accruals attributable to periods prior to the date of Cal Water's PBOP compliance filing shall be reflected in this filing and recovered in rates."

**Condition 3:** "Cal Water's PBOP compliance filing must include a schedule showing dates certain for tax-deductible contributions to PBOP trusts and must contain Working Cash calculations that exactly reflect this contribution schedule."

**Condition 4:** "Cal Water's PBOP compliance filing must include complete workpapers showing the allocation of PBOP costs to each of Cal Water's 21 districts."

**Condition 5:** "DRA be authorized to file a request for a Prehearing Conference to schedule Phase II hearings to litigate any and all compliance issues stemming from Cal Water's PBOP compliance filing. This request shall be filed within 15 working days of Cal Water's PBOP compliance filing. Should DRA find that this compliance filing clearly demonstrates that Cal Water is a) in compliance with all ordering paragraphs of D.92-12-015 and b) satisfies all conditions set forth in this DRA Statement of Understanding, then DRA shall inform Commissioners and ALJ Bennett that there is no need for a Prehearing Conference and recommend that Cal Water be granted authority to include certain specific PBOP accruals in rates."

**Condition 6:** “A decision must be issued authorizing Cal Water to submit an Advice Letter filing for PBOP accruals prior to Cal Water receiving any and all rate recovery for PBOP accruals. Such a decision or ruling shall be made in response to satisfaction of all of the conditions set forth in item no. 5, above.”

DRA claims that Cal Water did not attempt to demonstrate in AL 1341 that it had complied with all the ordering paragraphs of D.92-12-015 as required by Condition 1. DRA also states that D.92-12-015 required a reasonableness review as a prerequisite for rate recovery, which never occurred with respect to the FAS 106 costs requested by Cal Water in AL 1341.

DRA next argues that AL 1341 failed to comply with the requirement in Conditions 1 through 4 to provide the work papers, documents, and information specified by these Conditions. DRA asked Cal Water to provide all of this material in the instant proceeding, but Cal Water was unable to do so because much of the material is missing. In light of the missing material, DRA asserts that Cal Water has failed to prove that AL 1341 complied with Conditions 1-4.

DRA further argues that AL 1341 did not comply with Condition 5, which directed DRA to either request a PHC to initiate litigation on Cal Water’s Compliance Filing or, alternatively, notify the Commission that (1) the Compliance Filing complied with D.92-12-015 and the Conditions of the Settlement Agreement, and (2) Cal Water should be authorized to recover its requested FAS 106 expense in rates.

DRA has no record or memory of having requested a PHC or providing the notice required by Condition 5. DRA states that the requirement to request a PHC or provide notice was contingent on Cal Water having first given the Compliance Filing to DRA. DRA has no record or memory of having received

AL 1341. Therefore, the condition precedent for DRA to submit either the PHC request or the notice never materialized.

Finally, DRA claims that AL 1341 failed to comply with Condition 6, which directed Cal Water to file an advice letter for recovery of its FAS 106 costs after the Commission had issued a decision or ruling that (1) authorized Cal Water to file an advice letter, and (2) found that Cal Water had complied with Condition 5. The Commission never issued the decision/ruling contemplated by Condition 6, which means that Cal Water lacked authority under Condition 6 to file AL 1341. DRA argues that CACD's acceptance of AL 1341 does not demonstrate compliance with D.92-12-015 or the Conditions of the Settlement. Only the Commission had authority to make this determination, which never occurred.

DRA concludes that the numerous flaws in AL 1341 means that Cal Water never obtained legitimate Commission authorization for the PBOP regulatory asset set forth in the Advice Letter. Because Cal Water never had valid authority for its PBOP regulatory asset, DRA urges the Commission to deny Cal Water's request to recover the \$9.8 million regulatory asset.

#### **5.4.1.2. Cal Water**

Cal Water responds that contrary to DRA's accusations, AL 1341 complied with D.92-12-015 and the Conditions of the Settlement Agreement adopted by D.93-08-033. The Advice Letter provided all of the material required by Conditions 1-4, which is demonstrated by the fact that AL 1341 lists the documents and work papers that were attached. AL 1341 states:

The accompanying workpapers contain the documentation requested in Appendix A, Attachment A as follows:

- 1) copies of all trust Agreements for PBOP trust accounts,
- 2) copies of all Actuarial Valuations for PBOP, 3)

workpapers showing the derivation of revenue requirement for PBOP accruals, 4) workpapers showing the derivation of revenue requirements for each district, and 5) workpapers showing that working cash amounts are consistent with the schedule for tax-deductible contributions to PBOP trusts. (AL 1341, p. 3.)

Although many of the documents and work papers listed in AL 1341 are now missing, the Cal Water officer responsible for filing AL 1341 testified that he has personal knowledge that all the documents and workpapers listed in AL 1341 were, in fact, submitted with the Advice Letter.

Cal Water also believes that it can be inferred that AL 1341 provided the material required by Conditions 1-4 because the Advice Letter set new rates for each of Cal Water's districts to recover FAS 106 costs. These rates were based on a four-factor formula that was used to allocate FAS 106 costs to each district. The costs assigned to each district were further allocated based on usage and the number of service connections to compute the new rates for metered and flat-rate customers. The rates also reflected Cal Water's lead-lag calculation for tax-deductible calculations. Cal Water believes it would have been impossible for CACD to derive the tariff rates for each district without the workpapers attached to AL 1341. In Cal Water's experience, CACD would not have approved new rates without workpapers showing their derivation.

Cal Water maintains that there is no credible evidence that AL 1341 was not properly filed or did not contain all necessary documents. Nor is there any credible evidence that CACD did not properly review AL 1341. Cal Water says it has relied upon the validity of AL 1341 since 1994. The Commission has issued several decisions in GRCs that follow the accounting, funding, and ratesetting procedures in AL 1341, thereby ratifying the effectiveness of the Advice Letter.

#### **5.4.2. Discussion**

DRA argues that AL 1341 failed to comply with D.92-12-015 and D.93-08-033. DRA's accusation is contradicted by CACD's letter dated June 10, 1994, which accepted AL 1341. The letter states:

The Commission has accepted the utility's proposal in Advice Letter No. 1341 for recovery of expenses related to the Post Retirement Benefits other than Pensions (PBOP) in accordance with Decision Nos. 92-12-015 and 93-08-033.<sup>17</sup>

CACD was acting on behalf of the Commission when it accepted AL 1341 in accordance with D.92-12-015 and D.93-08-033. CACD's acceptance of AL 1341 was presumptively reasonable, and DRA has the burden of proving otherwise. For the following reasons, we conclude that DRA has failed to prove that CACD's acceptance of AL 1341 was unreasonable.

DRA asserts that AL 1341 did not comply with OP 2.d of D.92-12-015, which required a reasonableness review as a prerequisite for rate recovery. DRA asserts that a reasonableness review never occurred for the FAS 106 costs requested by Cal Water in AL 1341. DRA also claims that Cal Water did not attempt to demonstrate in AL 1341 that it had fully complied with all the ordering paragraphs of D.92-12-015, as required by Condition 1.

We find no merit in DRA's assertions. AL 1341 and its accompanying documents and workpapers described exactly how Cal Water intended to comply with the ordering paragraphs of D.92-12-015. The Advice Letter indicated that Cal Water intended to make the maximum tax-deductible contributions allowed by its 401(h) account, recover this amount in rates, record

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<sup>17</sup> CACD letter, p. 1. CACD's letter is attached to A.06-12-025 at the end of Exhibit 2.

a regulatory asset for the difference between its FAS 106 costs and its contributions, and recover the regulatory asset in future years as authorized by the Commission. The Advice Letter provided all of the material necessary to demonstrate that Cal Water's proposed accounting, funding, and ratemaking for FAS 106 costs complied with the ordering paragraphs of D.92-12-015. This material included actuarial reports, trust agreements, and other documents and work papers required by the Settlement.

Although DRA is correct that D.92-12-015 required a reasonableness review of FAS 106 costs as a prerequisite for rate recovery, DRA ignores Conditions 5 and 6 of the Settlement Agreement which clearly indicate that the required reasonableness review was to occur when Cal Water filed AL 1341 using the material provided by the Advice Letter. These Conditions state:

**Condition 5:** "DRA [is] authorized to file a request for a Prehearing Conference to schedule Phase II hearings to litigate any and all compliance issues stemming from Cal Water's PBOP compliance filing. This request shall be filed within 15 working days of Cal Water's PBOP compliance filing. Should DRA find that this compliance filing clearly demonstrates that Cal Water is a) in compliance with all ordering paragraphs of D.92-12-015 and b) satisfies all conditions set forth in this DRA Statement of Understanding, then DRA shall inform Commissioners and ALJ Bennett that there is no need for a Prehearing Conference and recommend that Cal Water be granted authority to include certain specific PBOP accruals in rates."

**Condition 6:** "A decision must be issued authorizing Cal Water to submit an Advice Letter filing for PBOP accruals prior to Cal Water receiving any and all rate recovery for PBOP accruals. Such a decision or ruling shall be made in response to satisfaction of all of the conditions set forth in item no. 5, above."



DRA never fulfilled its obligation under Condition 5 to review AL 1341 and the reasonableness of the FAS 106 costs requested by Cal Water.<sup>18</sup> However, CACD did review AL 1341 and found that it complied with D.92-12-015. Based on the preceding, we conclude that AL 1341 complied with Condition 1.

DRA next argues that AL 1341 failed to comply with the requirement in Conditions 1- 4 to provide the workpapers, documents, and information specified by these Conditions. DRA asked Cal Water to provide all of this material in the instant proceeding, but Cal Water was unable to do so because much of the material is missing. In light of this missing material, DRA asserts that Cal Water has failed to prove that AL 1341 complied with Conditions 1-4.

We are not surprised that much of the material that was provided with AL 1341 in 1994 was missing 13 years later when DRA requested the material in 2007. Regardless, Cal Water has offered convincing evidence that all of the material required by Conditions 1-4 was provided in 1994. AL 1341 listed the documents and work papers that were provided with the Advice Letter. The list includes everything that Cal Water was required to provide by Conditions 1-4. Further, the Cal Water officer responsible for filing AL 1341 testified that he is certain that AL 1341 included all of the material listed in the Advice Letter.<sup>19</sup> We also believe that CACD would not have accepted AL 1341 if it did not include the material required by Conditions 1-4 (and which AL 1341 explicitly identified as having been provided with the Advice Letter). For the preceding reasons, we conclude that AL 1341 complied with Conditions 1-4.

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<sup>18</sup> Cal Water Opening Brief, p. 36; DRA Opening Brief, p. 35.

<sup>19</sup> Ferraro/Cal Water, 1 RT 111: 14-26 and Cal Water Exhibit 5.

DRA suggests that it did not receive a copy of AL 1341 and had no opportunity to review the Advice Letter in accordance with Condition 5. Contrary to DRA's suggestion, the evidence shows that DRA did receive a copy of the Advice Letter. Cal Water offered as contemporaneous evidence a stamped copy of AL 1341 from Commission records. The Advice Letter shows that two managers in DRA (John Yager and Han Ong) received copies of AL 1341 with the attached documents and work papers.<sup>20</sup> Further, the Cal Water officer responsible for filing AL 1341 testified that he is certain that DRA received copies of AL 1341.<sup>21</sup> Based on this evidence, we conclude that Cal Water did provide AL 1341 to DRA as required by Condition 5, that DRA had an opportunity to review AL 1341, and that DRA declined to protest AL 1341.

Finally, DRA claims that AL 1341 failed to comply with Condition 6, which directed Cal Water to file an advice letter for recovery of its FAS 106 costs after the Commission had issued a decision or ruling that (1) authorized Cal Water to file the advice letter, and (2) found that Cal Water had complied with Condition 5. However, the Commission never issued the decision or ruling contemplated by Condition 6.

DRA fails to recognize that one of the purposes of AL 1341 was to serve as the Compliance Filing intended by Conditions 1-4 of the Settlement Agreement. This is evident from the following statement in AL 1341:

As part of the [Settlement Agreement]...Cal Water agreed to **submit a compliance filing** which address the ordering paragraphs of (D.) 92-12-015. The accompanying

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<sup>20</sup> AL 1341, p. 3. The Advice Letter is attached to A.06-12-025 as Exhibit 2.

<sup>21</sup> Ferraro/Cal Water, 1 RT 111: 14-26; 1 RT 137: 22 - 37; and Cal Water Exhibit 5.

workpapers contain the documentation requested in [the Settlement Agreement]. (AL 1341, p. 3. Emphasis added.)

Because AL 1341 was the Compliance Filing, there was no requirement that Cal Water obtain Commission authority under Condition 6 prior to filing the Advice Letter. CACD had no trouble recognizing AL 1341 as the Compliance Filing, perhaps because AL 1341 provided all the information, documents, and work papers required of the Compliance Filing by the Conditions 1-4.

DRA is correct, however, that Condition 6 called for a Commission decision or ruling that (1) found Cal Water's accounting, funding, and ratemaking for FAS 106 costs complied with D.92-12-015, and (2) authorized Cal Water to file an advice letter to recover its FAS 106 costs. The Commission was to issue its decision or ruling after DRA had reviewed AL 1341 and notified the Commission of the results of its review. DRA never did so.

DRA's inaction left the Commission in limbo. CACD filled the void with its letter dated June 10, 1994, that accepted AL 1341 "in accordance with Decision Nos. 92-12-015 and 93-08-033."<sup>22</sup> This indicates that CACD reviewed AL 1341 to determine if it complied with D.92-12-015 and D.93-08-033, found that it did, and accepted the Advice Letter. DRA provided no evidence that CACD did not review AL 1341 for compliance with D.92-12-015 and D.93-08-033, and we are not going to assume that CACD failed to do its job.

The Commission apparently concurred with CACD's decision to accept AL 1341. In D.94-09-032, the Commission determined that all issues in the proceeding in which D.93-08-033 had been issued were resolved and that the

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<sup>22</sup> CACD letter, p. 1. A copy of CACD's letter is attached to A.06-12-025 as Exhibit 2.

proceeding could be closed.<sup>23</sup> It is unlikely that the Commission would have found that no issues remained if it believed that the Conditions of the Settlement Agreement adopted by D.93-08-033 were unfulfilled or that CACD's acceptance of AL 1341 was improper.

### **5.5. Alleged Harm and Proposed Remedies**

DRA alleges that Cal Water violated D.92-12-015 and D.93-08-033, resulting in \$4.26 million of harm to ratepayers. DRA proposes several remedial actions, including a fine of \$3 million.

Today's opinion, *supra*, finds that Cal Water complied in all substantial respects with D.92-12-015 and D.93-08-033. Consequently, there is no need to consider DRA's proposed remedies.

### **5.6. Approval of A.06-12-025**

We conclude that Cal Water complied with D.92-12-015 and D.93-08-033. Therefore, we will grant A.06-12-025. Cal Water shall file tariffs within 20 days from the effective date of this opinion to recover over a 15-year period its \$9.87 million PBOP regulatory asset. The tariffs shall be effective pending disposition by Commission staff.

The regulatory asset shall be recovered initially via a usage-based surcharge that is the same for all customers. Cal Water's tariff filing shall include work papers showing the derivation of the surcharge. The surcharge for each district shall begin with the first full billing cycle for the district following the

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<sup>23</sup> D.94-09-032, 56 CPUC 4, 8, and 19.

date that Cal Water files its tariffs. Cal Water may roll the surcharge into the general rates for each district in future GRC proceedings.<sup>24</sup>

As required by D.92-12-015, all funds that Cal Water collects in rates for its PBOP regulatory asset shall be used to provide PBOP or returned to ratepayers.<sup>25</sup>

## **6. Category and Need for Hearings**

In Resolution ALJ 176-3185, the Commission preliminarily determined that that the category for this proceeding is ratesetting and that there was no need for an evidentiary hearing. The Assigned Commissioner's Scoping Memo and Ruling issued on April 5, 2007, affirmed that the category for this proceeding is ratesetting, but reversed the preliminary determination that there was no need for an evidentiary hearing. As required by Rule 7.5, the full Commission in Resolution ALJ-201, issued on May 3, 2007, ratified the Assigned Commissioner's determination that an evidentiary was needed.

## **7. Comments on the Proposed Decision**

The proposed decision of the Administrative Law Judge (ALJ) in this matter was mailed to the parties in accordance with § 311 and Rule 14.3. Timely opening and reply comments on the proposed decision were filed by Cal Water and DRA. These comments have been reflected, as appropriate, in the final decision adopted by the Commission.

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<sup>24</sup> Cal Water has a request pending in A.07-07-001 for full recovery of its FAS 106 expense accrual. Granting Cal Water's request in that proceeding would eliminate any further additions to its PBOP regulatory asset. Today's opinion does not prejudge any aspect of A.07-07-001. Cal Water's requested FAS 106 costs in A.07-07-001 may be granted or denied, in whole or in part, depending on the facts, law, and circumstances presented in that proceeding.

<sup>25</sup> D.92-12-015, OP 3.

## **8. Assignment of the Proceeding**

John A. Bohn is the assigned Commissioner and Timothy Kenney is the assigned ALJ in this proceeding.

### **Findings of Fact**

1. In A.06-12-025, Cal Water requests authority to recover its \$9.87 million PBOP regulatory asset over a 15-year period via a surcharge and to roll the surcharge into general rates eventually.

2. AL 1341 set forth Cal Water's proposed accounting, funding, and ratemaking for FAS 106 costs. The Advice Letter indicated that Cal Water intended to (i) establish a 401(h) account as its sole funding vehicle for FAS 106 costs, and (ii) establish a regulatory asset for FAS 106 costs in excess of tax-deductible contributions to the 401(h) account.

3. AL 1341 was the Compliance Filing required by the Conditions of the Settlement Agreement adopted by D.93-08-033. AL 1341 provided all the documents, work papers, and information required by these Conditions.

4. Cal Water provided a copy of AL 1341 to DRA. DRA did not fulfill its obligation under Condition 5 of the Settlement Agreement to review the Advice Letter and report its findings to the Commission.

5. AL 1341 provided all the information necessary for CACD to make an informed decision on whether the FAS 106 accounting, funding, and ratemaking proposed by Cal Water in AL 1341 complied with D.92-12-015 and the Conditions of the Settlement Agreement adopted by D.93-08-033.

6. CACD reviewed AL 1341 and accepted the Advice Letter in June 2004 in accordance with D.92-12-015 and D.93-08-033.

7. Cal Water has followed the accounting, funding, and recovery of FAS 106 costs set forth in AL 1341. In the years since CACD's acceptance of AL 1341, the Commission has repeatedly authorized Cal Water to recover FAS 106 costs in a manner consistent with AL 1341.

### **Conclusions of Law**

1. Cal Water has complied with D.92-12-015 and D.93-08-033.
2. CACD's acceptance of AL 1341 was reasonable.
3. Cal Water has justified its request pursuant to § 454 to implement new rates to recover its PBOP regulatory asset over a 15-year period. Cal Water should initially recover its regulatory asset via a usage-based surcharge that applies to all customers. Cal Water should be authorized to roll the surcharge into general rates in future GRC proceedings.
4. D.92-12-015 requires that all funds collected in rates to fund PBOP to be used for that purpose or returned to ratepayers.
5. The following order should be effective immediately so that Cal Water may begin recovery of its PBOP regulatory asset as soon as possible.

## **O R D E R**

### **IT IS ORDERED** that:

1. Application 06-12-025 is granted.
2. California Water Service Company (Cal Water) is authorized to recover its regulatory asset for post-retirement benefits other than pensions (PBOP) over a 15-year period.

3. All funds that Cal Water collects in rates for its PBOP regulatory asset shall be used to make tax-deductible contributions to independent PBOP trusts or returned to ratepayers with interest. The assets in the PBOP trusts shall be used to provide PBOP or returned to ratepayers.

4. Within 20 days from the effective date of this order, Cal Water shall file tariffs to recover its PBOP regulatory asset over a 15-year period via a usage-based surcharge that is the same for all customers in all rate districts. Cal Water shall concurrently file work papers showing the derivation of the surcharge. The tariffs shall be effective pending disposition by Commission staff.

5. The surcharge for each district shall begin with the first full billing cycle for the district following the date that Cal Water files its tariffs. Cal Water may roll the surcharge into general rates in future General Rate Case proceedings.

6. Application 06-12-025 is closed.

This order is effective today.

Dated March 13, 2008, at San Francisco, California.

MICHAEL R. PEEVEY

President

DIAN M. GRUENEICH

JOHN A. BOHN

RACHELLE B. CHONG

TIMOTHY ALAN SIMON

Commissioners