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Decision 08-06-024 June 12, 2008

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the matter of the Application of SAN GABRIEL VALLEY WATER COMPANY (U337W) for Authority to Increase Rates Charged for Water Service in its Fontana Water Company Division by $5,662,900 or 13.1% in July 2006; $3,072,500 or 6.3% in July 2007; and by $2,196,000 or 4.2% in July 2008.	Application 05-08-021 (Filed August 5, 2005)
Order Instituting Investigation on the Commission's Own Motion into the Rates, Operations, Practices, Service, and Facilities of San Gabriel Valley Water Company (U 337 W).	Investigation 06-03-001 (Filed March 2, 2006)

ORDER MODIFYING DECISION 07-04-046, GRANTING LIMITED REHEARING REGARDING ISSUES INVOLVING RULE 1 VIOLATION RELATED TO AFFILIATE TRANSACTION, AND DENYING REHEARING OF THE DECISION, AS MODIFIED, IN ALL OTHER RESPECTS

I. INTRODUCTION

In Decision (D.) 07-04-046 ("Decision") we addressed San Gabriel Valley Water Company's General Rate Case Application (A.) 05-08-021, seeking authority to increase rates charged for water service in its Fontana Water Company Division for test years 2006 – 2007 and escalation years 2007 – 2008 and 2008 – 2009. In summary, the Decision reduces rates by $1,948,900 for Test Year (TY) 2006 – 2007, and reduces rate base as of July 17, 2004 by $2,994,582. The Decision also refunds to ratepayers overcharges since July 17, 2004 in the amount of $522,200 annually, and orders a fine of $60,000 for three violations of Rule 1 of the Commission's Rules of Practice and Procedure.

San Gabriel Valley Water Company ("San Gabriel") timely filed an application for rehearing of D.07-04-046, raising the following allegations of error: (1)

the Decision errs in its allocation of proceeds from a contamination settlement in that it fails to recognize the extraordinary risk confronted by San Gabriel, is inconsistent with past Commission decisions in similar cases, and fails to recognize tax consequences in the calculation of net proceeds; (2) the Decision errs in finding that San Gabriel violated Rule 1 of the Commission's Rules of Practice and Procedure in its GRC showing related to land purchased from an affiliate; and (3) the Decision errs in finding that San Gabriel's sales to California Steel Industries (CSI) will remain closer to historical levels than San Gabriel's projection. Division of Ratepayer Advocates (DRA)[1] filed a timely response to San Gabriel's application. City of Fontana filed a "Joinder" to the DRA response.

City of Fontana, DRA and Fontana Unified School District (Joint Parties) filed a timely application for rehearing of D.07-04-046,[2] raising the following allegations of error: (1) the Commission erroneously failed to conduct a review of projects constructed after 2002;[3] (2) exempting the Sandhill Project from the rate base cap is arbitrary and capricious and not supported by substantial evidence; (3) granting advice letter treatment to the Sandhill Project is arbitrary and capricious and not supported by substantial evidence; (4) findings that San Gabriel has maintained adequate records regarding investment of proceeds from various sources are contradicted by the record and the Decision; and (5) the $2.3 million service duplication award should be allocated to

[1] During the course of the proceedings addressed herein Office of Ratepayer Advocates (ORA) became Division of Ratepayer Advocates (DRA). To avoid confusion, "DRA" is used throughout this order.

[2] Joint Parties' application is titled, "City of Fontana, Division of Ratepayer Advocates, and Fontana Unified School District's Application for Rehearing and Reconsideration of Decision 07-04-046," citing as authority Rule 16.1 of the Commission's Rules of Practice and Procedure (Cal. Code of Regs., tit. 20 § 16.1.) The application is being reviewed as an application for rehearing pursuant to Rule 16.1 and Public Utilities Code section 1732. (Unless otherwise stated, all rule references herein are to the Commission's Rules of Practice and Procedure.)

[3] This argument involves the limited rehearing we granted in San Gabriel's previous General Rate Case ("GRC") (A.02-11-044) to determine, among other things, whether San Gabriel had met its burden of proof regarding its request for a rate increase and whether San Gabriel's proposed construction projects were needed, reasonable and justified. The rehearing was consolidated with the instant GRC proceeding. (*Order Modifying and Granting Limited Rehearing of Decision 04-07-034* [D05-08-041] p. 14, Ordering Paragraph 2.) We issued a decision on the rehearing issues on June 15, 2006. (*Opinion on Limited Rehearing of Decision 04-07-034* [D.06-06-036].)

ratepayers without waiting for further proceedings. San Gabriel filed a response to the application for rehearing.[4]

We have reviewed each and every allegation in the rehearing applications. We grant limited rehearing regarding the issue of Rule 1 violations related to San Gabriel's purchase of real property from an affiliate and the adequacy of its disclosures regarding the affiliate transaction in this GRC proceeding. Further, we provide parties in the next GRC the opportunity to address the reasonableness of projects that have been constructed since 2002. We modify D.07-04-046 in order to further clarify that the Decision did not address future tax consequences related to the Internal Revenue Code section 1033 election regarding proceeds from the Mid – Valley Landfill contamination settlement. We also add and delete findings of fact as discussed herein. Except for the limited rehearing granted on the issues involving the Rule 1 violations, we deny rehearing of D.07-04-046, as modified, in all other respects.

II. DISCUSSION OF ISSUES RAISED BY SAN GABRIEL

A. Allocation of Contamination Settlement Proceeds

On November 10, 1998, San Gabriel entered into a settlement with the County of San Bernardino that resulted in compensation for damages to San Gabriel's property caused by contamination from the Mid-Valley Sanitary Landfill. San Gabriel reported receiving, from 1998 to 2004, $8,559,863 pursuant to the settlement. San Gabriel claims to have reinvested all excess proceeds in section 790 plant infrastructure. (D.07-04-046, pp. 80 - 81, referencing Public Utilities Code section 789, *et seq*. (also referred to as, "section 790" or "Infrastructure Act").)[5] Regarding these funds, we found the settlement damage payment was not a sale of real property, nor did it result in a sale. (D.07-04-046, pp. 82, 125 Finding of Fact (FOF) 76.) We held that, rather than reinvesting the funds in utility plant pursuant to section 790, the net proceeds should be

[4] Joint Parties also filed a petition for modification of the Decision. Those issues were addressed in D.08-04-005.

[5] Unless otherwise stated, all statutory references are to the Public Utilities Code.

allocated 67% to ratepayers and 33% to shareholders. (D.07-04-046, pp. 83, 125. FOF 76.)

1. Statement of Ratepayer Share

San Gabriel alleges that in stating its 67% - 33% allocation of settlement proceeds, the Decision understates the share of proceeds actually allocated to ratepayers. This argument does not challenge our allocation, per se, but asserts that the Decision misstates the allocation ratios it adopts. San Gabriel says that over a 30-year project life it will recover over $8 million of operation and maintenance (O&M) costs from the County of San Bernardino, and that these funds will offset customers' rates. San Gabriel argues this $8 million should be considered in determining the allocation percentages and that, based on a calculation offered in the application for rehearing, the correct statement of the ratepayer share would be 83.1% to ratepayers, rather than 67%. (SG Reh. App., pp. 5 – 6.)

These payments from the County to San Gabriel reimburse the costs of operating and maintaining the Plant F-10 facilities that were needed to remediate the contamination. Consequently, the Decision describes these funds as "revenue neutral for ratemaking purposes."[6] (Decision 07-04-046, p. 80.) It would not be reasonable to conclude, as San Gabriel proposes, that revenue-neutral reimbursements for operation and maintenance costs, to be paid periodically over the next 30 years, should be included in calculating current net proceeds.

Further, in its comments on the ALJ's proposed decision San Gabriel said:

> The compensation the County paid pursuant to this agreement, amounting to about $8.6 million, is the only amount of contamination settlement proceeds at issue in this proceeding.

The accompanying footnote provides the following clarification:

[6] The Decision reports that for the period May 2000 to December 2004 the County reimbursed the costs entirely in the amount of $1,242,057. (D.07-04-046, p. 80.)

> This amount does not include the County's ongoing reimbursement of all O&M costs for the treatment plant, which never have been included in rates.

(*Comments of San Gabriel Valley Water Company on Proposed Decision of Administrative Law Judge Barnett* (February 26, 2007) p. 5 and footnote (fn.) 3.) San Gabriel now argues in its rehearing application that the prospective O&M reimbursements should be included in calculating the allocation percentages. However, we have found the funds to be revenue neutral and San Gabriel's comments in the passage above explain that those funds are not settlement proceeds at issue in the proceeding. The argument does not identify an error in the Decision and is without merit.

2. Consideration of Risk

San Gabriel disputes our analysis of the risk associated with contamination of water resources in considering how to allocate the proceeds from the litigation settlement. We said:

> We find in this case, the risk analysis associated with contamination is similar to that of real property and thus believe that a similar allocation of the net proceeds is warranted.

(D.07-04-046, p. 83.) San Gabriel challenges this statement, arguing that the risks in the two contexts are "very different." (SG Reh. App., p. 6.) San Gabriel says the statement "does not make sense," because contamination of groundwater is "a far more serious matter." (SG Reh.App., pp. 7 – 8, citing *Opinion Regarding Allocation of Gains on Sale of Utility Asset* ("*Gain on Sale Decision*") [D.06-05-041] (2006) __ Cal.P.U.C.3d __, p. 45 (slip op.) and *Order Modifying Decision 06-05-041 and Denying Rehearing of Decision, as Modified* ("*Order Modifying D.06-05-041*") [D.06-12-043] (2006) __ Cal.P.U.C.3d __, p. 19, Ordering Paragraph 1.i (slip op.).)

San Gabriel argues that in the gain on sale decisions we based our allocation of gain on the "ordinary" risks of utilities and declined to consider "extraordinary" risks. San Gabriel claims:

> . . . contamination of groundwater resources is just the sort of "extraordinary risk" that the Commission **excluded** from consideration in the gain on sale decisions.

(SG Reh.App., pp. 7 – 8, emphasis in original.)

In D.06-05-041 we discussed risks related to gain on the sale of utility land and assets. (*Gain on Sale Decision* [D.06-05-041], *supra*.)[7] D.07-04-046 notes that we consider contamination proceeds on a case by case basis. The Decision compares groundwater contamination to real property sales for purposes of analyzing risks and gains and explains that its 67% - 33% allocation "mimics" the gain on sale allocation adopted in D.06-05-041 and D.06-12-043. (D.06-12-043 modified the allocation percentages that had been adopted in D.06-05-041.) Regarding extraordinary risks, we said:

> The gain on sale calculus should not take into account extraordinary risks such as the recent California energy crisis or Hurricane Katrina.

(*Gain on Sale Decision* [D.06-05-041], *supra*, at p. 87, FOF 9 (slip op.).)

In summary, San Gabriel disputes the Decision's reference to the gain on sale risk analysis in its consideration of the Mid-Valley settlement proceeds. San Gabriel's arguments are founded on its subjective statement that groundwater contamination is a "far more serious matter" and, consequently, that it is an "extraordinary risk." San Gabriel provides no rationale or specific legal grounds to support its assumption that a "far more serious matter" is equivalent, as a matter of regulatory policy, to an extraordinary risk. To the contrary, the examples of extraordinary risk in D.06-05-041 are exceptional and unique events, i.e., the energy crisis and Hurricane Katrina. In contrast, we have found that water contamination litigation is increasingly frequent.

[7] We said we were not resolving the issue of contamination-related settlement proceeds in the gain on sale rulemaking because they do not involve sales of real property. (D.06-05-041, p. 70 (slip op.).)

In authorizing the memorandum accounts in March of 1998 we noted that "numerous" complaints had been filed in California and also noted the increasing frequency of such actions. (*All Water Utilities. Order Authorizing the Establishment of a Memorandum Account for Water Contamination Litigation Expenses for All Water Utilities,* Resolution No. W-4094, p. 2, FOF 1, 3 (March 26, 1998).) In addition, San Gabriel itself reports that water quality litigation has become an ongoing company responsibility. (D.07-04-046, p. 62, see Exhibit (Ex.) 12 (Whitehead/San Gabriel) for an overview of San Gabriel's responsibility in this area.)

San Gabriel notes that these memorandum accounts and advice letter filing procedures for contamination litigation that we adopted in 1998 were not yet in place when San Gabriel became aware of contamination from the Mid-Valley Landfill in 1997. (SG Reh.App., pp. 8 – 9.) San Gabriel argues that, as a result, it bore the cost and the risk related to "pursuing the polluter," and that it "overcame an extraordinary risk." (SG Reh.App., p. 9.) San Gabriel does not establish that groundwater contamination, or managing a contamination claim in the year before the memorandum accounts were authorized, represents an extraordinary risk along the lines of the energy crisis or Hurricane Katrina. The claim is without merit.

San Gabriel also claims that the Decision does not explain why it considers the risk analysis associated with contamination to be similar to that of real property. (SG Reh. App., p. 6.) In fact, the Decision discusses our reasoning in some detail. (D.07-04-046, pp. 82 - 83.) The claim that we did not explain our analysis on this issue is without merit. However, we note that there is no finding of fact regarding our holding that the risk analysis for contamination proceeds is similar to real property and that a similar allocation is warranted in this case. We will modify the Decision to add such a finding.

San Gabriel also argues that the Decision fails to consider that ratepayers were shielded from the capital costs of the treatment plant and from its operation and maintenance costs, which the polluter will pay for many years. (SG Reh. App., pp. 9 – 10.) However, in summarizing the components of the contamination settlement proceeds the Decision includes, "costs to construct Plant F-10 remediation facilities." (D.07-04-

046, p. 79.) The Decision notes, "[i]n addition, the County promised to pay San Gabriel for the actual costs to operate and maintain the Plant F-10 facilities after they were completed." (D.07-04-046, p. 80.) The claim that the Decision failed to consider these factors is without merit.

San Gabriel argues that assuming the risk and achieving a settlement that protects the ratepayers "fully justifies" reserving the net proceeds for the benefit of the company and its shareholders. As discussed above, the Decision explains the allocation it adopts, noting that allocation of contamination proceeds must be done on a case by case basis, but also saying that the reasoning articulated in the gain on sale decisions is a useful analysis. (D.07-04-046, pp. 82 – 83.) On the question of risk, the Decision is consistent with previous Commission decisions. San Gabriel reargues the evidence and proposes a different outcome, but its claims of error related to our analysis of risk are without merit.

3. Consideration of Previous Commission Decisions

a) *Southern California Water Co*. does not require deferring allocation of the Mid-Valley Landfill settlement proceeds to the gain on sale rulemaking proceeding.

San Gabriel argues that the allocation of settlement proceeds adopted in D.07-04-046 is based on an "incomplete and faulty" reading of a 2004 Commission decision, *Southern California Water Co*. (SG Reh. App., p. 10, citing, *Southern California Water Co*. [D.04-07-031], *supra*.) San Gabriel says that a correct reading of *Southern California Water Co*. should lead us to defer ruling on the allocation of the Mid-Valley Landfill settlement proceeds until we have resolved the policy issues still pending in Phase 2 of the gain on sale rulemaking, R.04-09-003. (SG Reh. App., p. 10.) This argument is without merit.

The *Southern California Water Co*. decision involved two types of proceeds related to groundwater contamination and the two matters were treated differently. First, with regard to proceeds from a settlement that involved conveyance of water rights that were no longer necessary or useful in the provision of water service, the

Commission found section 789 et. seq. to be applicable and ordered the utility to invest the proceeds in infrastructure improvements. (*Southern California Water Co*. [D.04-07-031], *supra*, at pp. 9 – 10, pp. 23 - 24, Ordering Paragraphs 1, 2 (slip op.).)

On the other hand, in considering contamination payments to the utility ordered by the Environmental Protection Agency (EPA) for loss of use of groundwater, the Commission ordered the net proceeds of the payments to be booked for future refund to ratepayers. (*Id.* at pp. 11, 24, Ordering Paragraph 4 (slip op.).) *Southern California Water Co*. also holds that the Commission deals with ratemaking treatment of damage awards in contamination lawsuits and settlements on a "case by case basis." (*Id.* at p. 23, Conclusion of Law (COL) 5 (slip op.).) *Southern California Water Co*. does not hold that contamination settlement proceeds, without a transfer of property rights, is equivalent to a sale, nor does it refer to the gain on sale rulemaking which we had not initiated at that time.

Moreover, the order instituting the gain on sale rulemaking stated that gain from groundwater contamination litigation would not be addressed in that proceeding. (*Order Instituting Rulemaking Regarding Allocation of Gains on Sale by Energy Utilities, Incumbent Local Telecommunications Carriers and Water Companies* [R.04-09-003, at pp. 29 – 30 (slip op)] (2004) __ Cal.P.U.C.3d __.) In explaining that the rulemaking would not address the issue of contamination proceeds, D.07-04-046 cites an earlier decision issued in that rulemaking proceeding, saying:

> We said contamination proceeds do not involve sales of real property, so the Infrastructure Act does not apply, nor are such proceeds gains on sale; such proceeds are outside the scope of that proceeding.

(D.07-04-046, p. 76, citing *Gain on Sale Decision* [D.06-05-041] *supra*, at pp. 70, 91, FOF 44 (slip op.).) For the above reasons, San Gabriel's argument that allocation of its Mid-Valley Landfill settlement proceeds should be deferred to the gain on sale rulemaking is without merit.

b) The Decision's allocation of the Mid-Valley settlement proceeds is not based on *Southern California Water Co*.

San Gabriel argues that the allocation of the contamination settlement proceeds adopted in D.07-04-046 is "based on" an "incomplete and faulty" reading of *Southern California Water Co*. and that the circumstances in that case are different from the instant Mid-Valley settlement matter and that it, therefore, "creates no precedent." (SG Reh. App., pp. 10, 11.) These arguments mischaracterize the Decision's reference to *Southern California Water Co*. The Decision observes:

> Following *Southern California Water Co.*, we could award all the gain from damages received from contamination suits to the ratepayers, but we believe the better course is to allocate the net proceeds between ratepayers and shareholders.

(D.07-04-046, p. 82.) In other words, we explicitly did not follow *Southern California Water Co*. Further, both *Southern California Water Co*. and D.07-04-046 state our policy of allocating contamination proceeds on a case by case basis. (D.07-04-046, pp. 82 – 83; *Southern California Water Co*. [D.04-07-031], *supra,* at p. 23, Ordering Paragraph 5 (slip op.).) San Gabriel's claim of erroneous reliance on *Southern California Water Co*. is without merit.

c) *Southern California Water Co*. does not support San Gabriel's argument that proceeds from a groundwater contamination settlement are subject to Public Utilities Code section 789 *et seq*.

San Gabriel cites *Southern California Water Co*. for the proposition that contamination damage claims are "part and parcel" of the value of real property when sold and that the proceeds of such sales are subject to Public Utilities Code section 789 *et seq*. (SG Reh. App., pp. 11, 12.) This holding from *Southern California Water Co*. explicitly refers to a situation in which damage claims were "part and parcel of the sale" of the water rights. (*Southern California Water Co*. [D.04-07-031], *supra,* at p. 9 (slip op.).)

In the instant case there was no sale of real property or water rights. However, San Gabriel cites *Southern California Water Co*., apparently as support for its claim that discharging contaminants, even when there is no accompanying sale of the affected property, constitutes inverse condemnation. Related to this argument, San Gabriel claims that the settlement proceeds at issue here are subject to reinvestment in utility plant pursuant to section 790. Because there was no sale in this case, reliance on *Southern California Water Co*. is misplaced and the argument is without merit.

San Gabriel notes that we designated the Phase Two gain on sale proceeding to consider, among other things, whether inverse condemnation is equivalent to a sale. (SG Reh. App., p. 12.) However, we did not designate the proceeding to consider a situation such as that of the Mid-Valley Landfill settlement situation, which involves damages paid for water contamination when there is no sale. As noted above, we specifically excluded from the rulemaking, "[s]ettlement proceeds paid to water utilities in connection with contamination of water supplies."(*Gain on Sale Decision* [D.06-05-041], *supra*, at pp. 70, 91, Finding of Fact (FOF) 44 (slip op.).)

Consistent with this, in D.07-04-046, we rejected San Gabriel's argument that contamination of its water supply constituted inverse condemnation and that the proceeds from the settlement are subject to reinvestment in utility plant pursuant to section 790. We dismissed the claim, saying:

> San Gabriel's argument is without merit. Its contamination lawsuit was a claim for damages; the settlement damage payment was not a sale of real property nor did it result in a sale.
>
> In the case before us there is no sale of water rights (or any other property.)

(D.07-04-046, p. 82.) San Gabriel's claim of error related to this holding is without merit.

San Gabriel also challenges our statement:

> San Gabriel's ratepayers have paid maintenance, depreciation and return on facilities made useless by the contamination.

(SG Reh. App., p. 10, citing D.07-04-046, p. 82.) San Gabriel questions the Decision's statement that facilities were made useless by the contamination, saying:

> The Decision does not specify to what facilities it refers, but the only facilities "made useless" by the Mid-Valley Landfill were restored to use by the installation of wellhead treatment facilities constructed by San Gabriel at Plant F-10 . . . .

(SG Reh. App., p. 11.) San Gabriel witness Whitehead stated in prepared testimony that the County "had in effect taken the company's property by causing some of the company's wells and water rights to be rendered useless because of high levels of VOC groundwater contamination . . . ." (Ex. 17, p. 15 (Whitehead/San Gabriel).) Further, the Decision notes that San Gabriel said no plant assets had to be retired because of the water contamination. (D.07-04-046, p. 80, emphasis added.) The challenged statement in the Decision is consistent with San Gabriel's own testimony and does not require further clarification. The claim of error is without merit.

d) Previous Commission Decisions Involving Allocation of Proceeds

San Gabriel argues that, if we are "unwilling to defer ruling" regarding the settlement proceeds, we "should at least consider" precedents that support a more even allocation of benefits. (SG Reh. App., p. 13.) Significantly, San Gabriel does not claim we were required to follow one or all of these decisions, but that we should consider them.

Each of the three decisions San Gabriel cites includes language cautioning against relying on it as precedent. (See: *Re Great Oaks Water Co*. [D.93-09-077] (1993) 51 Cal.P.U.C.2d 366, 368; *Opinion on Bakman Water Company's General Rate Case for Test Year 2000* [D.03-10-002] (2003) __ Cal.P.U.C.3d __, p. 15 (slip op.); Re *Southern California Gas Company* [D.94-05-020] (1994) 54 Cal.P.U.C.3d 391, 405.) Because the decisions cited by San Gabriel each includes an explicit caution against applying its

outcome in future proceedings, and because San Gabriel does not argue that we were legally required to follow these decisions, the argument that we should have considered these decisions does not identify grounds for granting rehearing.

4. The Commission did not err in refusing to deduct tax liability before allocating the Mid-Valley settlement proceeds.

San Gabriel challenges the Decision's holding that there is no tax liability on the gains related to the Mid-Valley settlement proceeds. (SG Reh. App., pp. 15 - 16.) San Gabriel elected to take advantage of Internal Revenue Code (IRC) section 1033, which permits in the case of involuntary conversions, that when property is converted into similar property, no gain shall be recognized. (D.07-04-046, p. 96, citing Int.Rev. Code, § 1033(a)(1).) The Decision reports that San Gabriel took advantage of this "tax avoidance provision . . . to the full extent permissible for its gains from contaminations and involuntary conversions," and notes that the purpose of IRC section 1033 is "to relieve the taxpayer of unanticipated tax liability."[8] The Decision holds further:

> [I]t follows that San Gabriel, having no tax liability, cannot charge the ratepayers for phantom taxes. The IRS has not challenged the tax liability; nor should we. We find <u>there is no tax liability on the gains</u> San Gabriel achieved from involuntary conversions and contaminations.

(D.07-04-046, pp. 96 - 97, emphasis added.) We stated our reliance on the evidentiary record[9] to determine whether taxes had been paid, holding "on the facts of this case we are not deducting taxes." (D.07-04-046, p. 98.) Regarding the contamination settlement

[8] Under the heading, "Income Taxes," the Decision addresses gains from various sources, however, in its Application for Rehearing, San Gabriel questions only taxes related to the Mid – Valley Settlement.

[9] In its opening brief DRA addressed the tax issue saying: "DRA does not recommend that the net gain be reduced for income taxes. <u>There is no evidence that taxes have been paid</u>, and it is Commission policy to use flow-through accounting for income taxes . . . DRA recommends that the Commission policy to use flow-through accounting for income tax purposes be adopted and zero taxes be reflected as an offset to the gain to be reflected as CIAC." (Opening Brief of the Division of Ratepayer Advocates, March 24, 2006, p. 94, emphasis added.)

proceeds, based on the evidence developed in the proceeding, we concluded, "[t]here is no income tax." (D.07-04-046, pp. 98 - 99.)

It does not appear that San Gabriel is challenging the Decision's holding that, based on the evidence, San Gabriel did not pay or owe income tax on the gain before the allocation was calculated. Rather, San Gabriel explains:

> In order not to pay federal and state income taxes immediately, San Gabriel must elect tax deferral, invest 100% of the net proceeds in replacement property, and reduce the tax basis of that property, thereby reducing the tax depreciation expense deduction in its future income tax returns.[10]

(SG Reh. App., pp. 16 – 17, emphasis added.) Thus, San Gabriel's claims on this topic address future tax liability.[11] San Gabriel claims, "[t]he effect of IRC section 1033 is not a permanent tax exemption or avoidance, but merely a deferral of federal and state income taxes on the gain." (SG Reh. App., p. 16.)

Based on the evidentiary record, the Decision refuses to deduct an amount for taxes because San Gabriel had not paid such taxes. The Decision addresses the pre-allocation time period. We did not address the matter of who will pay future taxes related to tax depreciation expense deductions in future income tax calculations.

San Gabriel's discussion of the tax issue is largely a policy argument that seems to assume a prior unfavorable ruling on the question of future tax liability. San Gabriel argues that its shareholders will be faced with "a negative economic impact" that "will be astonishing," and that shareholders are left to pay 100% of the future income tax

[10] San Gabriel includes the following footnote at this point in the text: "This begs the question of whether the Commission's treatment of the property as a contribution in aid of construction means there is no depreciable basis whatsoever and no resulting tax deductions at all – thereby leaving San Gabriel with the tax bill on all the proceeds." (SG Reh. Ap., p. 17, fn. 6.) San Gabriel does not state a position or base an allegation of error on this point.

[11] In comments on the proposed decision San Gabriel explained its position as follows, "[t]he fair approach is to recognize the eventual income tax liability and . . . to allocate tax liability consistently with allocation of the net proceeds themselves . . ." (Comments of San Gabriel Valley Water Company on Proposed Decision of Administrative Law Judge Barnett, February 26, 2007, p. 7, emphasis added.)

liability. San Gabriel also claims shareholders will pay an "out-of-pocket cost of $7.75 for every $100 recovered from polluters." (SG Reh. App., p. 17.) San Gabriel does not offer specific grounds for finding error related to these claims, but appears to base its arguments on an unstated assumption that ratepayers will not pay any part of future income tax payments related to the depreciable replacement property. It appears these arguments are based on an interpretation that the Decision has ruled on future tax consequences related to the IRC section 1033 election. The Decision does not include a ruling to that effect. Therefore, the argument is without merit.

San Gabriel's claims about future tax consequences do not identify an error in the Decision because the Decision does not address future treatment of future tax consequences. To avoid any possible confusion on this point, we will modify the Decision to state explicitly that it does not address future tax consequences of the section 1033 election.

San Gabriel also argues, in apparent acknowledgement that these tax matters can be addressed in future proceedings, that the "only question" is when ratepayers should pay their share. (SG Reh. App., p. 18, emphasis added.) This statement seems to acknowledge that Commission ratemaking procedures provide an appropriate forum for addressing tax matters when they arise.

San Gabriel argues:

> "[i]f the ratepayers' obligation is deferred, those ratepayers who enjoy the benefit of the gains now will not be the same ratepayers who must, over the life of the reinvestment, cover the Company's income tax liability."

(SG Reh. App., p. 18.) San Gabriel provides no grounds for finding error based on this policy argument. We found that San Gabriel had not paid taxes and consequently we did not deduct taxes before allocating the proceeds. San Gabriel disagrees with our decision and wants us to deduct future taxes before the proceeds are allocated. As a basis for identifying error in the Decision, the above argument is without merit

San Gabriel also argues that our refusal to deduct future tax consequences conflicts with the recent gain on sale decision, which provided for allocation of after-tax gains and losses. (SG Reh. App., p. 18, citing *Gain on Sale Decision* [D.06-05-041], *supra*, p. 102, OP 25 (slip op.).) This argument misrepresents D.06-05-041, which provides the following explanation of after-tax gains:

> The OIR proposed that any rule we develop here apply only to after-tax gains. In this way, if a sale caused a taxable gain, we would only allocate the net proceeds after taxes were paid.

(*Id.* at p. 46 (slip op.) emphasis added.) Thus, we do not include projected future tax obligations in our consideration of "after-tax gains." Decision 07-04-046 holds, and San Gabriel acknowledges, that it did not pay taxes on the gain. The phrase "after taxes were paid" does not apply to this fact situation, in which San Gabriel did not pay or owe taxes on the gain, or to San Gabriel's proposal to "allocate" tax liability before the taxes have been paid. The two decisions are not in conflict.

Further, questions related to contamination proceeds were explicitly excluded from the gain on sale proceeding. Even if D.06-05-041 supported San Gabriel's argument about deducting future income taxes from gains on sale (which it does not do) the gain on sale rulemaking proceeding explicitly did not address the matter of allocating contamination proceeds. As discussed above, it is our policy to consider contamination proceeds on a case by case basis. Again, the argument that D.07-04-046 conflicts with D.06-05-041 is without merit.

B. Rule 1 Violations

The Decision finds three violations of Rule 1 of the Commission's Rules of Practice and Procedure based on San Gabriel's failures to inform the Commission of material facts regarding the inclusion into rate base of land acquired for a new headquarters building. San Gabriel purchased the land, known as the "Tokay Avenue property," from an affiliate, Rosemead Properties, Inc. The Decision holds:

> We find the company in violation of Rule 1 for three acts of omission: 1) San Gabriel did not disclose that the land they were seeking to include in ratebase was purchased from an

> affiliate, 2) San Gabriel did not disclose that the purchase price of the land they were seeking to place in ratebase was not based on a market price but rather based on an appraisal performed by an appraiser hired and paid for by the company, and 3) San Gabriel did not disclose the fact that the price paid by the utility was significantly above the price paid by the affiliate when it purchased this land only a year and a half earlier. For each of the three violations of Rule 1 of the Commission's Rules of Practice and Procedure we impose a fine of $20,000 for a total or $60,000.

(D.07-04-046, p. 126, FOF 88.)

San Gabriel argues that because the Commission stated the three Rule 1 violations for the first time in the final decision, it has been deprived of its right to due process. (SG Reh. App., p. 25.) There is merit in this argument. Upon reviewing the procedural history related to these violations, we are not satisfied that our procedures were sufficient regarding these issues.

Therefore, we grant a limited rehearing to consider whether San Gabriel violated Rule 1 by failing to disclose adequately in its GRC submittal, information related to its purchase of real property from an affiliate. The limited rehearing will also consider appropriate penalties if violations are found. Because we are granting rehearing, we will delete the Decision's discussion of these matters.

San Gabriel requests refund of the $60,000 in penalties that it submitted, pursuant to D.07-04-046. (D.07-04-046, p. 129, Ordering Paragraph 8.) Because a limited rehearing is being granted, this penalty amount will be subject to refund, depending on the outcome of that proceeding. Disposition of these funds will be addressed in the limited rehearing

C. Sales to CSI

San Gabriel challenges the Decision's reliance on DRA testimony regarding future sales to California Steel Industries (CSI) claiming that it is arbitrary and unlawful. (SG Reh. App., pp 33 – 35.) San Gabriel assumed in its showing that, because CSI was rehabilitating a well in order to produce its own water, it would utilize the full

1,300 acre feet of water to which it has water rights. (Ex. 10, p. 14 (McGraw/SG).) Saying that San Gabriel had not produced persuasive evidence regarding CSI's water demand, the Decision adopted DRA's recommendation to reduce by 50% San Gabriel's projected reduction in sales to CSI. (D.07-04-046, pp. 5 - 6; Ex. 45, p. 2 – 4 (DeRonne/DRA).)

San Gabriel argues that the evidentiary record does not support the Decision's adoption of DRA's proposed adjustment. (SG Reh. App., p. 34.) San Gabriel references DRA witness DeRonne's testimony in which she stated that San Gabriel had not "provided any support for the assumption that CSI will utilize its full 1,300 acre feet of water rights," and that "no information has been provided regarding the projected amounts CSI intends to self provide." (Ex. 45, pp. 2-2 – 2-3 (DeRonne/DRA).) San Gabriel argues the recommended adjustment was "arbitrary and unsubstantiated." (SG Reh. App, p. 34.)

San Gabriel cites testimony in which its General Manager recounted a meeting with CSI and characterized CSI's statements in the meeting as explaining "a business decision . . . to pump and produce their own water and utilize their 1300 acre-feet of . . . water rights." (Ex. 10, p. 14 (McGraw/SG).) San Gabriel also cites rebuttal testimony in which another San Gabriel witness testified:

> There is no reason to believe they will abandon their plan after having spent nearly one million dollars to redevelop their wells.

(Ex. 21, p. 3 (LoGuidice/SG).) However, the McGraw testimony also revealed that San Gabriel was trying to retain CSI as a "full-use customer." He testified:

> As explained . . . in the meeting, the company is considering options and alternatives available in order to retain CSI as a full-use customer. . . . Further discussions will take place between the company and CSI on this matter.

(Ex. 10, p. 15 (McGraw/SG).) Consistent with this, in a follow-up letter after the meeting with CSI, Mr. McGraw stated:

> As Mr. LoGuidice explained Fontana Water Company remains ready, willing, and able to continue meeting all of CSI's water service needs and the company maintains sufficient water supply resources to supply water in the quantities and at the rates of flow that CSI normally requires.

(Ex.10, Attachment J (McGraw/SG) emphasis in original.)

On cross-examination, witness DeRonne explained DRA's recommendation, saying:

> . . . we don't dispute the entire adjustment. We do reflect in our recommendation that CSI will begin - - the assumption is that they will begin producing and using some of their own water from their own well. Our dispute is the amount that CSI will begin to use and produce for its own consumption is unknown at this point.

(R.T., vol. 4, p. 367 (DeRonne/DRA.)

San Gabriel asserts that the DRA adjustment was arbitrary and unsubstantiated and "in clear conflict with the facts in evidence," and also that the DRA witness ignored certain factual information. (SG Reh. App., p. 34, 35.) This argument is without merit. Even if a party's testimony were arbitrary or in conflict with certain evidence, that would not be grounds for finding legal error in a Commission decision. In exercising our expertise, we weighed the evidence in the record and determined the relative merit of the evidence. In this case, we adopted DRA's recommended adjustment. Based on the evidence, we reached the conclusion that, "San Gabriel has not produced persuasive evidence regarding CSI water demand . . ." (D.07-04-046, p. 6.) As itemized above, the record reveals some uncertainty about CSI's future water demands. The claim of legal error is without merit.

San Gabriel also argues that the Decision inaccurately paraphrases DRA testimony when it says that a CSI officer contacted by DRA "could not give clear-cut information regarding amounts CSI intends to self-provide," when the witness actually said, "no information has been provided regarding the projected amounts CSI intends to self provide as compared to its owned water rights." (SG Reh. App., p. 34, citing D.07-

04-046, pp. 5 – 6; Ex. 45, p. 2 – 3 (DeRonne/DRA).) We will modify the Decision to conform more closely to the DRA testimony; however, the error is harmless and, as grounds for rehearing, is without merit. Modifying the statement will not alter the Decision's outcome on this issue because the Decision cites the overall lack of "persuasive evidence," as the reason for adopting DRA's estimate. (D.07-04-046, pp. 5 - 6.) The Decision's reference to CSI does not constitute grounds for granting rehearing.

III. DISCUSSION OF ISSUES RAISED BY JOINT PARTIES

A. The Commission did not fail to provide a procedure for review of projects constructed after 2002.

Joint Parties allege procedural errors related to review of San Gabriel's post 2002 construction projects. They argue that we failed to provide an opportunity to review projects that San Gabriel constructed "pursuant to the rate base cap" adopted in the previous GRC and that the alleged failure violates the "constitutional demand of due process." (Joint Reh. App., pp. 4, 6, 7.) Joint Parties claim that we provided "no direction" regarding review of the reasonableness of San Gabriel's post 2002 construction projects, that Joint Parties did not know when to submit an analysis of the projects in light of the limited rehearing of issues from the previous GRC and that when they learned the instant GRC was the correct place for this review, the hearings had concluded months earlier. Joint Parties (acting individually) then sought to reopen the proceeding, asserting then as now that they had not reviewed San Gabriel's post 2002 construction and that we had not provided "direction" about such review. (Joint Reh. App., pp. 4 - 7.)

Joint Parties base the above arguments on their apparent assumption that the outcome of the limited rehearing of D.04-07-034 from San Gabriel's last GRC, A.02-11-044, was a prerequisite to reasonableness review of construction projects in the instant GRC. The specific issue to be considered on rehearing was whether San Gabriel's proposed construction projects, approved subject to a 10% rate base cap for rate making purposes, were needed, reasonable and justified. (*Order Modifying and Granting Limited Rehearing of Decision 04-07-034* ("*Rehearing Order*") [D.05-08-041] (2005) __

Cal.P.U.C.3d __, pp. 10, 14, Ordering Paragraph 2 (slip op.).) Joint Parties describe the post 2002 construction projects as, "constructed pursuant to the rate base cap," and they refer to the review of the projects constructed after 2002 as a "critical issue in the rehearing." (Joint Reh. App., pp. 4, 6.)

However, subsequent projects would not be constructed "pursuant to" the cap. Rather, the utility would exercise its discretion about construction projects and would not be required to limit its actual construction to 10%. The 10% cap was a limit on the estimate of plant additions for the purpose of setting rates. The construction projects would then be subjected to review in a subsequent proceeding.

We reviewed the relationship of these two different GRC functions in D.04-07-034, which became the subject of limited rehearing. DRA objected that the cap would be ill-advised if it allowed San Gabriel "carte blanche" to construct whatever it wanted without Commission review. (D.04-07-034, p. 14.) We explained:

> [DRA] misconceives the nature of the cap. When the Commission approves a projection of plant additions in setting rates there is a presumption that the utility's investment in the planned capital projects is reasonable. However, this does not bar staff from challenging the inclusion of such investments in rate base in a later proceeding once the investments have been made. The same rule should apply if the Commission sets a cap on rate base additions instead of approving a specific set of projects.

(*Opinion Authorizing Increase in Revenue* ("*Test Year (TY) 2004 Decision*") [D.04-07-034] (2004) __ Cal.P.U.C.3d __, p. 14 (slip op.), emphasis added.) We intended the phrase "in rate base in a later proceeding," to be a reference to a later GRC proceeding because that is the established venue for determining rate base. There was no substantive or procedural need to delay the review of the actual construction projects simply because the earlier ratemaking estimate had become the subject of a limited rehearing, nor did we provide for any procedural delay. Managing the limited rehearing and the next GRC in a consolidated docket did not require additional or exceptional procedures. Therefore, we proceeded with the two parallel matters.

Joint Parties claim the scoping memo did not give direction that there would be a review of the construction projects in the GRC. (Joint Reh. App., p. 4.) However, that scoping memo included the following issues:

> 1. What revenue requirements, rate design, and rates should be ordered for San Gabriel's Fontana Water Company Division for Test Year 2006/2007 and Escalation Years 2007/2008 and 2008/2009?
>
> 2. What figures should the Commission adopt for the standard components underlying its adopted revenue requirement and rate design . . .?

(*Scoping Memo and Ruling of Assigned Commissioner* ("Scoping Memo") of October 20, 2005, p. 2.) Because rate base is a major component underlying revenue requirement and because analyzing whether prior construction is necessary and useful is a factor in determining rate base, parties should have understood that review of post 2002 construction projects necessarily would be included in the TY 2006 – 2007 GRC. There was no substantive or procedural reason to wait for the outcome of the limited rehearing because, as mentioned above, completing the review of the 10% rate base cap adopted for ratemaking purposes in the previous GRC had no bearing on the reasonableness review of the construction projects in the TY 2006 – 2007 GRC. The scoping memo did not state that any issue would be deferred because of the rehearing.

Further, at the prehearing conference on the consolidated proceeding, that included the limited rehearing of the TY 2003 Decision and the TY 2006 – 2007 GRC, the Administrative Law Judge ("ALJ") notified the parties that they should not wait for the outcome of the rehearing before proceeding with the new GRC. He said:

> If you believe that there's going to be a decision on the rehearing in time for it to affect this case in any material – the new rate case in any material way, I don't think that is a reasonable assumption. And I don't work on that assumption.
>
> I am going to have this on two tracks, one of which is the rehearing track, the briefs, and I will get a decision out. And I will do it I think reasonably promptly, but I can't speak for the Commission. And <u>we just can't wait</u> for the Commission

> to decide the rehearing issues before we get into the new rate case.

(R.T., vol. PHC 2, p. 62.) However, DRA's prepared testimony revealed that it expected the results of the rehearing to have an impact on the GRC issues. It said:

> Potential impacts of the rehearing have not been reflected in SGVWC's filing, or in this report, as the outcome of the rehearing is unknown at this time. Depending on the outcome of the rehearing, many areas of the general rate case calculations may be impacted. At this time, any estimates of the outcome of the rehearing would be speculative.

(Ex. 45, p. 1 – 2 (Schultz/DeRonne/DRA).)

Joint Parties cite a passage from D.06-06-036, the opinion resolving the rehearing issues related to D.04-07-034:

> We need not authorize specific projects. The construction budget, and rate base, will get a third review in the current GRC, A.05-08-021. In that third review, we will have the opportunity to determine the reasonableness of what actually has been constructed since 2002. To the extent that construction was unneeded, it will be found to be unjustified and therefore unreasonable. Because current rates are subject to refund, any finding in A.05-08-021 will have the same effect and finding in this rehearing. The difference is palpable: rather than forecasting that a project is or is not necessary, we have the benefit of hindsight to review whether the project was, in fact, needed. This is the lesson of all rate cases which are based on a forecast year.

(*Opinion on Limited Rehearing of Decision 04-07-034* [D.06-06-036], *supra*, at p. 20 (slip op.).)

We went on to explain:

> Issues regarding rate base are always subject to being raised in a general rate case. When a party suspects a plant in rate base is not used and useful, or is not accurately recorded on the company's books, those issues should be raised as early as possible. Rate base issues were left open in D.04-07-034 to be resolved in A.05-08-021. We are reviewing D.04-07-034 based solely on its record. We are not reviewing A.05-08-

> 021 and the issues raised, or which might be raised, in that proceeding. DRA's request is premature and, therefore, denied.

(*Id.* p.28 (slip op.) emphasis added.) These passages describe the matters to be considered in each of the two concurrent proceedings with regard to the post 2002 construction projects. Joint Parties apparently interpreted the language as a promise of an additional separate proceeding in which to conduct a review. The evidentiary hearings in A.05-08-021 were completed by the time D.06-06-036 issued, and Joint Parties say they had not been aware the reasonableness of the post 2002 construction projects were within the scope of the A.05-08-021 GRC proceeding. (Joint Reh. App., p. 7.)

Although both the Commission and the ALJ provided contemporaneous explanations as referenced above, the parties' confusion persisted. We accept Joint Parties' claims of procedural confusion at face value. However, in light of the explanations and the routine nature of the involved proceedings, claims that we violated Joint Parties due process rights by failing to provide a procedural forum for review of San Gabriel's post 2002 construction projects or that we failed to provide notice that the issue would be included in the GRC proceeding do not identify an infirmity in our procedures and are without merit.

We caution parties that they have a responsibility to specify any significant omissions from their underlying analysis, if those omitted topics may appear to have been reviewed and accepted without issue. Failure to explicitly inform the ALJ that they were deferring review of some post 2002 construction projects until a later time created the appearance that a review had been done and, thus, failed to trigger a clarifying explanation from the ALJ or the Assigned Commissioner. An inquiry or a clear disclaimer would have elicited immediate clarification about the scope of the instant proceeding and would have prevented any lingering confusion about where and when the issues should be addressed. Whatever its intent, the qualifying statement, quoted above, from DRA's report was too vague to provide useful information about the scope of the DRA review.

Joint Parties also allege legal error based on the claim that there are no findings of fact regarding post 2002 construction projects. (Joint Reh. App., p. 7.) This claim is incorrect. Findings of Fact ("FOF") 38, 39, 41 and 42 address the Sandhill plant and the upgrade project. (D.07-04-046, pp. 117 - 118, FOF 38, 39, 41, 42, 43.) The Decision also includes findings of fact related to land that San Gabriel purchased from an affiliate company for construction of a new office/warehouse. (D.07-04-046, pp. 118 - 119, FOF 48 – 51.) The claim that the Decision has no findings of fact regarding post 2002 construction projects is without merit.

Although Joint Parties' claims do not reveal legal error, they have now asserted that they (including DRA) "did not address whether projects constructed since 2002 were justified." (Joint Reh. App., p. 5.) The assertion that these parties did not review certain construction projects constructed "pursuant to the 10% rate base cap" raises questions about the adequacy of the underlying review.

Based on the foregoing, we will permit parties in the next GRC to address the reasonableness of post 2002 construction projects that are not addressed in D.07-04-046. Parties may not address issues that are resolved in the Decision.

B. Sandhill Project

San Gabriel's construction budgets included an upgrade to the Sandhill plant to allow it to treat State Water Project (SWP) water and to enhance its capacity to treat water from Lytle Creek. We discussed the purpose and need for the project, found the project to be needed and reasonable and held that it "should be completed." (D.07-04-046, pp. 39, 40.)

We had previously adopted the approach of limiting San Gabriel's rate base growth to 10% per year, referred to as a "rate base cap." (*TY 2004 Decision* [D.04-07-034], *supra*, at pp. 14 – 15 (slip op.) D.07-04-046 allows rate base treatment of the year 2005 Sandhill project investments and allows succeeding years' investments to be added

to rate base by advice letter filings. We capped the costs of the Sandhill project at $35 million and exempted it from the rate base cap.[12] (D.07-04-046, p. 41.)

1. The exemption of the Sandhill Project from the rate base cap is not arbitrary or capricious and it is supported by substantial evidence.

a) Joint Parties' Policy Arguments

Joint Parties dispute, on policy grounds, the exemption of the Sandhill project from the 10% rate base cap. They argue that it is arbitrary to have a cap and then to permit an exemption "that represents up to half of pre-existing rate base." (Joint Reh. App., p. 8.) They also argue that the concept of a cap is to "give discretion and impose restraint on managerial decision-making," but that in the case of the Sandhill Project, "the exception swallows up the rule and undermines that rationale." (Joint Reh. App., pp. 8, 14.) Joint Parties do not provide authority, or other specific grounds for these policy statements.[13]

The Decision reviews the purpose and need for the project, including a thorough account of the available water supply and the technical water quality issues related to the current plant and the Sandhill upgrade project. (D.07-04-046, pp. 34 – 38.) We concluded, "[w]e find the Sandhill treatment facility to be needed and building it is reasonable." (D.07-04-046, p. 40.) The Decision says the most difficult issue regarding the Sandhill project is how the costs should be passed into rates. We explained the basis for exempting the Sandhill Project from the rate base cap, saying:

> . . . [W]e exempt the ratebase increases caused by investment in the Sandhill facilities from this cap. We do this because this investment is a large single investment that will necessarily go into ratebase over multiple years.

[12] We said we would reevaluate the rate base cap in the next GRC to determine whether it "is an effective ratemaking tool." (D.07-04-046, p. 34.)

[13] However, Joint Parties explain the underlying math by which they reach the "up to half" conclusion. (Joint Reh. App., p. 8, fn. 1.)

(D.07-04-046, pp. 40 - 41.) Joint Parties' argue that the project's size should preclude granting an exemption from the rate cap. We found, to the contrary, the size of the project (along with the fact that it will go into rate base over multiple years) was the reason to exempt it from the cap. Joint Parties disagree with our conclusion; however, disagreement with the outcome does not establish that it is arbitrary.

The Decision explains the issues related to the Sandhill project and the reasons for exempting the project from the rate base cap. Exempting the project from the cap is a policy determination appropriate for exercise of the Commission's discretion. For these reasons, the claims of arbitrariness are without merit.

b) Joint Parties Arguments Based on Cross-examination Testimony

Joint Parties argue that exempting the Sandhill project from the cap is arbitrary because the project "has so little going for it in the context of the contradictory and ad hoc presentations given by San Gabriel in its defense," and also because the Decision does not discuss "all of the pertinent history." (Joint Reh. App., pp. 8 - 9.) Joint Parties provide an example, seemingly in support of both allegations, claiming that San Gabriel,

> . . . decided to push a much more expensive version of Sandhill without Commission review or meaningful internal review of the costs/benefits while at the same time trying to convey the impression that such Commission and internal review had already occurred.

(Joint Reh. App., p. 9.) In support of this argument, Joint Parties include a passage from the hearing transcript that includes a witness' inconsistent statements on cross-examination regarding whether we had previously approved the current Sandhill project. (Joint Reh. App., p. 10, citing R.T., vol.2, pp. 134 - 135 (Diggs/SG).)

The testimony, on its face, does not support Joint Parties' claim that it was an effort to mislead the Commission. The testimony may simply reveal the witness' uncertainty regarding the implications of the previous decision. In any case, the prior decision and the underlying record in the previous GRC would resolve any dispute about

whether the greatly expanded project was considered or approved in that earlier proceeding. Joint Parties seemingly claim also that the passage is an example of San Gabriel's "contradictory and ad hoc presentations," and, further, that it is "pertinent history," and the lack of a reference to it reveals arbitrariness in the Decision. This brief series of responses on cross-examination and the fact that they are not referenced in the Decision do not demonstrate an inferior showing by San Gabriel or arbitrariness in the Decision. Joint Parties do not provide any specific grounds for finding legal error in the Decision related to the passage of cross-examination testimony. These arguments are without merit.

c) Cost-benefit Study (Context)

In support of the claim that exempting the Sandhill project from the rate base cap is arbitrary and capricious, Joint Parties argue that the Decision relies "principally on San Gabriel's cost-benefit study to justify approving Sandhill," but that the Decision does not discuss, "the context of this study." (Joint Reh. App., pp. 10 - 11.) Joint Parties itemize a number of factors that they include in their "context" category and imply criticism of the director who conducted the study and San Gabriel's assignment of the task to him. However, Joint Parties do not assert that the director was insufficiently qualified to conduct the study. Joint Parties also imply criticism of basing the study on the San Gabriel engineer's assumptions and not verifying the assumptions or obtaining outside review of the study. The final point identified as context is the fact that the cost/benefit study was prepared after San Gabriel signed contracts for the Sandhill project one week before it submitted the study as part of its GRC application. (Joint Reh. App., pp. 10 - 11.)

Joint Parties suggest that we were required to address these context points in the Decision; although they do not claim, or provide grounds for finding, that there is error in the cost-benefit study or the Decision stemming from any of these factors. (Joint Parties take issue with some of the assumptions used in the study, as discussed in the

following section.) The "context" points are not in dispute and the director who conducted the cost-benefit study readily acknowledged their accuracy.[14]

The witness provided additional context on some points. For example, he testified that, although he had not done a cost/benefit study for an employer since the 1980's, he had done such studies in classes he was teaching. (R.T., vol.4, p. 329 (Dell'Osa/SG.) He also testified that doing the study shortly before the GRC submittal improved the validity of the study with later and more accurate information. (Ex. 20, p. 7 (Dell'Osa/SG).) Joint Parties' context points are not material in determining whether the cost/benefit study provides reliable information. Further, the fact that the Decision does not recount every argument made by parties does not establish that the outcome is arbitrary or capricious. Joint Parties' claim that the exemption to the ratebase cap is arbitrary and capricious because the Decision does not address these items of context related to the cost benefit study, is without merit.

In discussing the "context" information, Joint Parties assert that the Decision relies "principally" on the cost-benefit study to justify the Sandhill project. It should be noted that we discuss a number of factors that support the decision in favor of the project. The cost-benefit study is not the only factor considered in the Decision. For example, the Decision discusses the need for and the advantages of the project and notes that it will permit San Gabriel to make maximum use of Lytle Creek surface water as well as State Water Project water purchased through San Bernardino Valley Municipal Water District while minimizing the cost of power for pumping the water to the point of use. (D.07-04-046, pp. 34 – 39, 117, FOF 38, 39.) On the question of cost effectiveness, the Decision considers the cost-benefit study and provides analysis of various assumptions as well as the sensitivity study. (D.07-04-046, pp. 38 – 41, 118, FOF 42.) As discussed below, there is substantial evidence in the record to support the Decision on these points.

[14] Except, the cross-examination did not address the witness' mathematical error while calculating an answer on the witness stand. (R.T., vol. 4, pp. 329 – 345.)

Further, Joint Parties' claim that the Decision "approves" the project is misleading. The Decision finds it reasonable to proceed with the project and exempts it from the rate base cap. However, the revenue increases associated with the project and included in rates via advice letter will be subject to refund pending a reasonableness review in the next GRC. (D.07-04-046, p. 41.)

d) Cost-benefit Study (Reliability)

In further support of their claim that exempting the Sandhill project from the rate base cap was arbitrary and capricious and not supported by substantial evidence, Joint Parties argue that San Gabriel's cost-benefit study was unreliable. These arguments are identified and addressed below.

The record is extensive on the matter of the cost-benefit study, which was addressed in prepared testimony, rebuttal testimony, and on cross-examination as well as in briefs and comments. DRA argued in comments that we should not afford any weight or consideration to the cost/benefit analysis, saying that San Gabriel failed to refute the issues raised by DRA and the City. (Comments of the Division of Ratepayer Advocates to Commissioner John Bohn's Alternate Decision (February 26, 2007) p. 8.) After weighing the competing evidence and the arguments, we held:

> We find the evidence of the cost-effectiveness of the plant to be compelling when compared to the cost of the alternative of additional production of water from Chino wells.

(D.07-04-046, p. 39.)

Joint Parties now are renewing their attack on the study, by raising numerous arguments to support their claim that it is unreliable. (See: Joint Reh. App., pp. 11 - 14.) In resolving the issues before us we consider all of the available evidence. There is evidence in the record addressing the points Joint Parties' raise to support their claims of unreliability. In brief review, the discussion below identifies evidence on the points raised by Joint Parties. Issues related to the Sandhill upgrade project were litigated

extensively.[15] We included a thorough discussion about the need for and the advantages of the project. The Decision analyzes matters related to cost-effectiveness at some length. (D.07-04-046, pp. 37 – 41.) There is evidence in the record to support our finding that the Sandhill project is cost effective and that it is reasonable to construct it. (D.07-04-046, p. 118, FOF 42.)[16] Joint Parties have not identified any issue on which the evidentiary record requires us to find that the cost-benefit study is unreliable. Claims that the cost-benefit study is unreliable and that, as a result, the decision to exclude the Sandhill project from the rate base cap is arbitrary and capricious are without merit.

Joint Parties also make the policy recommendation that in the reasonableness review of the Sandhill project San Gabriel be required to "show that Sandhill has performed as promised" by the cost-benefit study. (Joint Reh. App., p. 14.) Joint Parties provide no grounds for the claim that the cost-benefit study is a "promise" of future performance. The suggestion does not identify an error in the Decision and is without merit.

2. Affording advice letter treatment for the Sandhill Project is not arbitrary or capricious.

Joint Parties challenge the advice letter treatment for costs related to the Sandhill project. They claim that advice letter treatment is inappropriate for "large controversial projects" and should be applied only to ministerial matters. (Joint Reh. App., p. 14, citing (D.98-12-048; *Order Denying Rehearing of Resolution W-4556 and Ordering an OIR* ("*Rehearing Order re R. W-4556*") [D.05-12-048] (2005) __ Cal. P.U.C.3d __.)

The argument mischaracterizes our approach. The Decision directs staff to review the advice letter for conformance with "the Rate Case Plan, this order, [and] other

[15] The record relating to the cost benefit study includes all or portions of the following: R.T., vol. 4, pp. 329-345, (Dell'Osa/SG); Ex. 8, pp. 34-40, Attachment B (Dell'Osa/SG); Ex. 20, pp.6-9 (Dell'Osa/SG).

[16] In conjunction with their record argument, Joint Parties include a footnote containing a vaguely worded statement about burden of proof standards. (Joint Reh. App., p. 13, fn. 4) Joint Parties provide no analysis of the record or explanation of the statement.

Commission decisions. (D.07-04-046, p. 128 – 9, Ordering Paragraph 3.) We have already found that it is reasonable to construct the Sandhill upgrade. (D.07-04-046, p. 118, FOF 42.) Therefore, the staff's review of the advice letter filings will not require staff to decide a "controversial" matter - which would require the exercise of the Commission's discretion. Rather, staff will review the advice letter filings for compliance with the terms of Commission decisions.

Rehearing Order re R. W-4556 [D.05-12-048], cited by Joint Parties, considered whether it was appropriate to permit a Class A water utility to file its GRC by advice letter on an experimental basis. (*Id.* at p. 5 (slip op.).) We held that we should open an order instituting rulemaking to decide the question. In considering the question, we cited with approval an earlier decision, which held that the advice letter process is not well suited for deciding complex factual findings and legal conclusions, holding instead:

> The advice letter process is for ministerial actions implementing previously approved Commission policy.

(*Id.*, , citing *Order Instituting Rulemaking on the Commission's Own Motion to Evaluate Existing Practices and Policies for Processing General Rate Cases and to Revise the General Rate Case Plan for Class A Water Companies* [D.04-06-018 (2004) __ Cal.P.U.C. 3d __, pp. 14 – 15 (slip op.).) In the instant matter, the staff will be implementing previously approved Commission policy, thus, it is an appropriate use of the advice letter procedure. The claim of arbitrariness is without merit.

Joint Parties further claim that San Gabriel requires "heightened – not reduced – scrutiny," and argue that the advice letter procedure amounts to less scrutiny. This argument also mischaracterizes the procedures that we have adopted. Again, we have decided the policy issues related to the Sandhill project. The reasonableness of the construction costs will be determined in a subsequent proceeding. Staff's role in reviewing the advice letters will be to implement previously approved Commission policy, not to make policy or rule on questions of reasonableness. The claim of arbitrariness is without merit.

Joint Parties assert without further explanation or comment, that granting advice letter treatment to the Sandhill project is not supported by substantial evidence. (Joint Reh. App., p.14.) This argument is misplaced. As discussed above, there is evidence in the record to support our finding that it is reasonable to construct the project. The determination to allow advice letter treatment for Sandhill project costs, with guidance to staff regarding the nature of the review, is a procedural decision and is within the expertise and discretion of the Commission.

C. The record supports Findings of Fact 80 and 82.

Joint parties argue that the record does not support findings of fact 80 and 82, regarding San Gabriel's record keeping of proceeds from property transactions and contamination settlements, and also assert that the record contradicts the findings. (Joint Reh. App., pp. 15 - 18.) These findings state:

> San Gabriel has maintained detailed records necessary to document its investment in utility plant of the net proceeds of property sales, contamination recovery, and involuntary conversion.

(D.07-04-046, p. 125, FOF 80) and:

> The records San Gabriel kept were adequate to show the receipt of funds and the expenditure of funds. However, we will require a memorandum account to record all transactions that result in gains from sale of real property, or gains from condemnations, service duplication, or contamination claims.

(D.07-04-046, p. 125, FOF 82.)

Joint Parties dispute these findings on policy grounds and clearly disagree with the Decision's outcome. However, the record is extensive on these record-keeping questions[17] and the Decision discusses the disputed issues at length. Because the issues

[17] The record relating to record keeping issues includes all or portions of the following exhibits: (Ex. 6 (Batt/SG); Ex. 14 (Batt/SG); Ex. 15 (Dell'Osa/SG); Ex. 16 (Snow/SG); Ex. 17 (Whitehead/SG); (Ex. 26) Batt/SG); Ex. 27 (Dell'Osa/SG); EX. 28 (Snow/SG); Ex. 29 (Whitehead/SG); Ex. 63 (Loo/DRA) Ex. 64; (Loo/DRA); Ex. 78 (Macvey/City).

were strenuously contested, there is evidence that contradicts the parties' competing positions and, of course, evidence that contradicts our final resolution of the issues. It is our responsibility to consider and resolve contradictory positions by weighing the evidence in light of the entire record. The existence of contradictory evidence does not identify an error in the Decision. Further, Joint Parties claim that the record is insufficient on these issues has no merit.

Joint Parties state that their principal concern, other than lack of record support, is:

> the Commission is putting its stamp of approval on improper record keeping . . .

(Joint Reh. App., pp. 15 - 16.) Joint Parties take issue with the Decision's statement:

> We agree with DRA that San Gabriel could only pay $40.9 million in dividends by using the gain proceeds. But San Gabriel's dividend did not affect its ability to serve. No harm was done. . . . to the extent that Section 790 applies to this case, we have found that San Gabriel's records meet the test of Section 790. DRA's recommendation is denied.

(D.07-04-046, pp. 92-93.) Parties argue:

> It would be unfortunate to imply, as the decision inadvertently does, that it is permissible to use gains from such transactions to help pay dividends.

(Joint Reh. App., p. 16.) Joint Parties address this and other examples of practices that "cannot be reconciled with finding proper record keeping." (Joint Reh. App., pp. 17 - 18.)

These policy arguments about "proper record keeping" do not constitute grounds for finding error in the Decision. Joint Parties want us to provide additional specific guidance for future application to record keeping issues. This is a policy recommendation and does not provide grounds for granting rehearing of the decision.

D. Deferring the issue of service duplication proceeds to the gain on sales proceedings does not constitute legal error.

Joint Parties challenge our decision to defer to the gain on sale rulemaking proceeding treatment of $2,314,538 received by San Gabriel in an inverse condemnation service duplication case. Joint Parties argue that we "need not await these proceedings." (Joint Reh. App., p. 18.)

The Decision addresses the issue of the $2,314,538 resulting from a service duplication claim and recounts the opposing positions of the parties. This sum is included with other proceeds San Gabriel received "from various transactions during the years 1996 to 2004," totaling $27,811,312. (D.07-04-046, p. 72.) The Decision explains that the regulatory treatment of these items is being considered in another proceeding. The Decision says:

> In Phase II of Rulemaking (R.) 04-09-003, we are examining the regulatory treatment of gains that result from the disposition of property as a result of condemnation, sales under threat of condemnation, and proceeds from inverse condemnations. We will defer judgment on the regulatory treatment and the application of Section 789-790 to these proceeds to that proceeding.

(D.07-04-046, p. 73.) In specifically addressing the service duplication category the Decision holds:

> This issue is before us in R.04-09-003 and we will defer judgment on how to deal with these types of condemnations to that proceeding.

(D.07-04-046, p. 79.)

Joint Parties say San Gabriel believes "legal expenses associated with service duplication litigation should be shifted to ratepayers." (*Ibid*., citing D.07-04-046, pp. 12 – 13.) Joint Parties argue the record does not reveal that San Gabriel made "any effort to request a downward adjustment in rate base," related to these expenses and they assert further:

> San Gabriel has taken the position it can use ratepayer resources to pay legal fees to recover $2.3 million in service

> duplication damages that presumably damage rate base without making any downward adjustment to rate base. The ratepayers take the risks – San Gabriel takes the benefits.

(Joint Reh. App., p. 19.) Joint Parties argue that San Gabriel's position is inconsistent with the risk compensation approach applied previously by the Commission. Joint Parties claim that, although the gain on sale proceeding will address the "general and abstract question" of how to allocate service duplication awards, the issue regarding this particular service duplication situation is not abstract and should be treated as independent from those policy considerations.

In fact, Joint Parties' assert the arguments they would make if the matter were being litigated in this proceeding, saying that the benefits "must be allocated to ratepayers." (Joint Reh. App., p.19.) These claims related to risk assessment and equity do not address our decision to defer these issues to the rulemaking.

Deferring an issue to a rulemaking proceeding that has been designated as the forum to address such issues is a reasonable approach. The statement that we "need not await" the gain on sale proceeding does not constitute grounds for granting rehearing. Joint Parties do not identify a basis for finding the deferral constitutes legal error and their objection to deferring the issue is without merit.

IV. CONCLUSION

For the reasons discussed above, D.07-04-046 is modified as specified herein. Limited rehearing will be granted to consider whether San Gabriel violated Rule 1 by failing to disclose certain information in its GRC submittal related to its purchase of real property from its affiliate Rosemead Properties, Inc. Parties in the next San Gabriel GRC for the Fontana Water Company Division will be permitted to address post 2002 construction projects. We will modify the Decision to clarify that it does not address possible future tax consequences related to the Internal Revenue Code section 1033 election. We will modify the Decision to add and delete findings of fact for purposes of clarification. Except as to the Rule 1 issues upon which we grant limited rehearing, rehearing of the Decision, as modified, is denied in all other respects.

THEREFORE, IT IS ORDERED that:

1. Limited rehearing of D.07-04-046 is granted to consider whether San Gabriel violated Rule 1 by failing to disclose certain information in its GRC submittal related to its purchase of real property from its affiliate Rosemead Properties, Inc and, if so, whether penalties should be imposed. The Assigned Administrative Law Judge is directed to issue a ruling which will notify parties regarding the procedure and schedule for this limited rehearing.

2. Parties in the next San Gabriel Water Company GRC for the Fontana Water Company Division will be permitted to address the reasonableness of post 2002 construction projects. Parties may not revisit issues that are explicitly addressed and decided in D.07-04-046.

3. D.07-04-046 is modified as follows:

a. The last sentence starting on page 5 and continuing onto page 6, beginning with the phrase "DRA's witness testified," is deleted and replaced with the following:

> "DRA's witness testified that no information has been provided regarding the projected amounts CSI intends to self provide as compared to its owned water rights.

b. After the last full paragraph on page 97, before heading number "3" a new sentence is added as follows:

> "This decision does not address future tax consequences of the section 1033 election."

c. In the first sentence of the third full paragraph on page 104 the word the word "do" is deleted and replaced by the words "appear to."

4. Beginning with the second full paragraph on page 105 and continuing through page 109 just before the heading, "XVI," inclusive, the text is deleted.

d. A new Finding of Fact is added to read:

> "The risk analysis for contamination proceeds is similar to real property and a similar allocation is warranted in this case."

e. Findings of Fact 86, 87 and 88 are deleted.

6. Other than the limited rehearing ordered in Paragraph 1, above, rehearing of D.07-04-046, as modified herein, is denied in all other respects.

This order is effective today.

Dated June 12, 2008, at San Francisco, California.

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