Decision 08-06-022 June 12, 2008

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

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| In the Matter of the Application of SAN GABRIEL VALLEY WATER COMPANY (U337W) for Authority to Increase Rates Charged for Water Service in its Los Angeles County Division by $13,366,100 or 28.0% in July 2008, $3,298,100 or 5.4% in July 2009, and $1,439,600 or 2.2% in July 2010; and in its Fontana Water Company division by $678,200 or 1.5% in July 2008; and in both divisions for advice letter treatment of a capital project. | Application 07-07-003 (Filed July 2, 2007) |

Nossaman, Guthner, Knox & Elliott, LLP, by Martin A. Mattes, Attorney at Law, for San Gabriel Valley Water Company, applicant.
Best, Best & Krieger, LLP, by Kendall H. MacVey, Attorney at Law, for the City of Fontana; Marvin T. Sawyer, for the Fontana Unified School District; and Selina Shek, Attorney at Law, for the Commission's Division of Ratepayer Advocates, interested parties.

# DECISION RESOLVING GENERAL RATE CASE OF SAN GABRIEL VALLEY WATER COMPANY'S LOS ANGELES COUNTY DIVISION AND GENERAL DIVISION

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# DECISION RESOLVING GENERAL RATE CASE OF SAN GABRIEL VALLEY WATER COMPANY'S LOS ANGELES COUNTY DIVISION AND GENERAL DIVISION

## 1. Summary

San Gabriel Valley Water Company (SGV) is authorized to increase rates in its Los Angeles County Division (LA Division) by amounts designed to increase revenue by $3,885,500 or 8.1% in the fiscal year beginning July 1, 2008. SGV is also authorized to establish a $0.006 per hundred cubic feet (Ccf) water surcredit rate in its Fontana Water Company Division (Fontana Division) beginning July 1, 2008. We authorize rates of return on rate base of 9.47% in the fiscal years beginning July 1, 2008, July 1, 2009, and July 1, 2010. The return on common equity (ROE) authorized by this decision is 10.50%.

As a result of the revenue increase granted by this decision, the monthly bill for the average LA Division residential customers using 23 Ccf of water with a 5/8" by 3/4" meter would increase by $4.37 or 8.4% to $56.05 from $51.68 for the fiscal year beginning July 1, 2008.

## 2. Background

SGV provides public utility water service in the counties of Los Angeles and San Bernardino through two operating divisions and a General Division. SGV serves approximately 48,000 customers in the LA Division and an additional 44,000 customers in San Bernardino County through its Fontana Division at the close of 2006. The General Division provides services common to the LA and Fontana Divisions, the costs of which are allocated to these divisions.

On July 2, 2007, SGV filed the above-captioned application to increase rates charged for water service in its LA Division by $13,366,100 or 28.0% in July 2008, $3,298,100 or 5.4% in July 2009, and $1,439,600 or 2.2% in July 2010 to produce a

10.99% overall rate of return on equity for the period 2008 through 2010. SGV also seeks to increase rates charged for water service in its Fontana Division by $678,200 or 1.5% in July 2008 to compensate it for an additional allocated share of General Division expenses and rate base. Finally, SGV seeks advice letter treatment in its LA and Fontana Divisions for the capital cost of its El Monte Office project. This application involves only the LA Division and its general office serving both divisions.

SGV filed its application on the basis that its present LA Division rates are unjust and unreasonable in that they fail to provide a just and reasonable return on investment in utility plant. The application is due to a combination of circumstances, particularly the effect of substantial increases in major expense items such as required water treatment costs to remove contaminants from groundwater supplies and the cost of increasing capital requirements.

Notices of the application were provided to the public through notice by posting and publication, and by mailing notice of the application to each customer and to all cities and public agencies in the service territory. However, there was no notice of the evidentiary hearing other than to persons appearing on the service list.

## 3. Violation of Rule 13.1

Rule 13.1 of the Commission's Rules of Practice and Procedure (Rules) requires water utilities to give notice of a hearing, not less than five nor more than 30 days before the date of a hearing, to entities or persons who may be affected thereby, by posting notice in public places and by publishing notice in a newspaper or newspapers of general circulation in the area or areas concerned, of the time, date, and place of hearing.

To comply with this rule, SGV would have had to post and publish notice of the December 4, 2007 evidentiary hearing between November 4 and November 29, 2007. However, this was not done.

SGV explained that it did provide all notices required by statute and the Commission's Rules in connection with the filing of its application. Since there were no public participation hearings in this proceeding, notice of the evidentiary hearing was inadvertently overlooked. SGV also stated that many other tasks dominated the attention of its general rate case (GRC) team at the time the routine notice should have been provided, including its review of the Division of Ratepayer Advocates' (DRA) prepared testimony, preparation of rebuttal testimony, settlement negotiations, preparation for participation in a prehearing conference (PHC) on its Fontana Division's water action plan, as well as other complex filings. These other complex filings included a preliminary comparison exhibit for this proceeding and a data-intensive advice letter concerning the company's Sandhill project and Facilities Fees revenue.

Unquestioningly, SGV violated Rule 13.1 by not publishing notice of the evidentiary hearing. The question here is whether SGV should be fined for its violation. Decision (D.) 89-12-075 set forth five criteria to be considered in assessing a fine. Those criteria consist of an analysis of the severity of the offense, conduct, financial resources, totality of the circumstances, and the role of precedent.[1]

The severity of an offense is measured by the extent of physical harm, economic harm, and harm to the regulatory process. We find SGV's violation of

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[1] 84 CPUC2d 154, at 182-85.

Rule 13.1 by not posting notice in public places and not publishing notice in a newspaper of its evidentiary hearing to be a serious offense.

SGV's conduct is measured by its action to prevent, detect, to disclose, and to rectify a violation. SGV points out that the notice requirement at issue is not a statutory requirement but rather a provision of the Commission's Rules of Practice and Procedure. As such, it seeks permission to deviate from the notice requirement for good cause, pursuant to Rule 1.2. Good cause was identified to exist because SGV had made positive and substantial efforts with other parties to compromise their interests in order to achieve a timely and fair partial settlement that enabled parties to concentrate on a relatively few contested issues. SGV also explained that its mistake was a one-time error and pledged that it will not allow a recurrence of its mistake.

While Rule 1.2 authorized a deviation from the Commission rules for good cause, the Commission rarely authorizes deviations from its rules on a nunc pro tunc basis. Irrespective, SGV's pledge to prevent a recurrence of its mistake argues in favor of a mitigated fine.

The financial resources of the violator are considered to determine the size of a fine that would deter applicants from future violations without becoming excessive. The financial statements attached to its application showing net worth of approximately $170 million substantiate that the company has the financial resources to pay a penalty. Accordingly, a fine could effectively deter future violations.

The totality of circumstances is measured by the degree of wrongdoing and public interest. The facts of this violation show that SGV's violation of Rule 13.1 was unintentional. In addition, the absence of significant customer correspondence from SGV's mailing notice of its application to each customer and to all cities and public agencies in its service territory allows us to infer that customers did not experience a significant hardship.

Finally, the precedent that an assessment of a fine may have on other proceedings is considered. Failure to impose a fine in this instance may result in other utilities relaxing their customer notification procedures thereby adversely impacting the ability of customers to provide input to the Commission. Hence, a fine is warranted and should be imposed.

Based on our application of the criteria adopted by the Commission in D.98-12-075 to the facts in this proceeding, a $1,000 fine is warranted pursuant to Section 2107 of the Public Utilities Code. The size of the fine that is being imposed is based on the unique facts and circumstances of SGV's violation and should not be used as a precedent by other utilities.

## 4. Joint Comparison Exhibit

At the August 23, 2007 PHC, the assigned Administrative Law Judge (ALJ) ordered all active parties to participate in settlement discussions subsequent to the tendering of interested parties' testimony and prior to the start of an evidentiary hearing.[2] ALJ Dorothy Duda was assigned as a neutral ALJ to mediate settlement discussions prior to the December 4, 2007 evidentiary hearing.

The parties reported at the beginning of the evidentiary hearing that the mediation process resulted in significant progress on settlement of many of the contested issues between the parties and that the parties would continue to

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[2] Active parties consisted of SGV, the DRA, City of Fontana (City), and Fontana Unified School District (FUSCD). The City and FUSCD restricted their participation in this proceeding to new office buildings being proposed in El Monte and Fontana.

discuss settlement throughout the evidentiary hearing. The parties also reported that they were working on a document that identified settled issues and a comparison table that identified the remaining revenue requirement difference between SGV and the DRA.

Late-filed Exhibit 38 was reserved for a joint SGV and DRA exhibit to be received subsequent to the evidentiary hearing and prior to opening briefs. Exhibit 38 (1) identified and explained settled LA and General Division issues, and (2) provided a comparative test year July 1, 2008 to June 30, 2009 (test year 2008 or test year) results of operation schedule that showed differences between SGV and DRA prior to and subsequent to a partial settlement. Exhibit 38 was received into evidence on December 27, 2007 and included Attachment A to the partial settlement agreement, which has been renamed as Appendix A to this decision.

## 5. Partial Settlement Agreement

A partial settlement filed on January 25, 2008 resulted in SGV reducing its requested LA Division test year 2008 net operating revenue by $1,424,000 to $14,150,000 from $15,574,000 and its rate base by $12,963,000 to $128,773,000 from $141,736,000. DRA increased its recommended test year 2008 net operating revenue for LA Division by $978,000 to $11,863,000 from $10,885,000 and rate base by $10,803,000 to $127,505,000 from $116,702,000. These amounts include allocations of General Division expenses and rate base, as addressed in our General Division discussion in Section 9 of this decision.

The settlement also changed test year 2008 allocation of General Division expenses and rate base to Fontana Division. SGV reduced its test year 2008 allocation of General Division operating expenses to Fontana Division by $691,000 to $2,888,000 from $3,579,000 and rate base by $19,000 to $225,000 from

$244,000. DRA increased its recommended allocation of General Division operating expenses to Fontana Division by $240,000 to $2,736,000 from $2,496,000 and rate base by $48,000 to $225,000 from $177,000.

These revised test year estimates resulted from a review of initial positions, correction of errors, and a better understanding of the other party's estimates. Many of those agreements stemmed from the availability of more recent data to DRA after SGV filed its application.

Upon careful analysis of the record and consideration of reasons for the parties' initial and revised estimates, we find that the partial settlement agreement is a reasonable resolution of the issues, consistent with the law, and in the public interest. Pursuant to Rule 12.5, the adoption of this partial settlement does not constitute approval of any principle or issue in this proceeding and should not be cited as precedent in any future proceeding.

## 6. Cost of Capital

A major issue in this proceeding is the cost of capital. Cost of capital is expressed as an overall rate of return, the result of which is the rate of return on rate base used to determine the revenue requirement in the summary of earnings. Rate of return is based on an adopted capital structure, long-term debt costs and a common equity return. The following tabulation summarizes the adopted capital structure and costs for the test and escalation years, capital structure, long-term debt costs, and common equity return.

| | Capital Ratio | Cost Factor | Weighted Cost |
|---|---|---|---|
| Long-Term Debt | 37.00% | 7.70% | 2.85% |

| | | | |
|---|---|---|---|
| Common Equity | 63.00 | 10.50 | 6.62 |
| Total | 100.00% | | 9.47%[3] |

We discuss the development of these figures in the following sections.

### 6.1. Capital Structure

Capital structure of SGV consists of long-term debt and common equity.[4]

#### 6.1.1. SGV

SGV projected a test year capital structure of 26.10% long-term debt and 73.90% common equity. For escalation year 2009, it projected a 26.81% long-term debt and 73.19% common equity ratio, and for escalation year 2010, a 25.63% long-term debt and 74.37% common equity ratio. The overall weighted average capital structure for the test and escalation years was 26.18% long-term debt and 73.82% common equity.

#### 6.1.2. DRA

Although DRA did not dispute SGV's projected weighted average capital ratio, it recommended adoption of an imputed capital structure consisting of 40.00% long-term debt and 60.00% common equity for the test and escalation years. That capital structure is approximately midway between the average equity ratio of a group of comparable water utilities and SGV's actual equity ratio. It is also the same capital structure adopted in SGV's prior LA Division GRC (D.05-07-044) and prior two Fontana Division GRCs (D.07-04-046 and D.04-07-034).

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[3] Return on rate base.

[4] Debt due within one year, i.e., short-term debt, is excluded.

### 6.1.3. Discussion

SGV proposed to replace its currently authorized imputed capital structure of 40.0% long-term debt and 60.0% common equity with its projected actual capital structure.[5] However, if the Commission found that SGV's adopted equity ratio should be less than its projected actual 73.82% common equity ratio, SGV would agree to an imputed 69% common equity ratio.[6] Given that the burden of proof in GRC applications, such as this proceeding, rests upon the applicant to demonstrate the reasonableness of its request, we first address the method SGV used to arrive at its projected capital structure.

SGV used different time periods to forecast the long-term debt and common equity components of its capital structure.[7] Use of those different time periods resulted in an understatement of its projected capital structure. That is because SGV included only half of its new $10.0 million debt issuance in its test year capital structure consisting of $49.0 million long-term debt (simple average of December 31, 2007 and December 31, 2008 data) and $138.7 million common equity (half of year end 2008 and 2009 data).[8] Its method of forecasting test year

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[5] That imputed capital structure had not changed since first authorized for its Fontana Division on July 8, 2004, pursuant to D.04-07-034.

[6] Exhibit 23, p. 6.

[7] Exhibit 3, pp. 1-3 through 1-8.

[8] The $10 million new issuance is due to expire on July 1, 2008, as shown in Exhibit 3, p. 1-7.

long-term debt was also inconsistent with the method it used to forecast its test year rate base.[9]

If SGV had derived a capital structure consistent with its June 30th fiscal year-end test year and its June 30th fiscal year-end forecast of common equity and rate base, its test year long-term debt would have been increased by $5.0 million to $54.0 million from $49.0 million. That change to long-term debt would result in a test year capital structure of 28.02% long-term debt and 71.98% common equity.[10] Consistent with that change, its weighted average test and escalation years' capital structure would then consists of 26.82% long-term debt and 73.18% common equity.[11] Therefore, SGV's projected capital structures do not reasonably reflect its test and escalation test year's capital structures.

We next address the merits of adopting SGV's projected capital structure over an imputed capital structure. SGV's arguments for adopting its projected capital structure are similar to the arguments it testified to in 2003 and resulted in the adoption of its currently authorized imputed capital structure.[12] Those

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[9] In order to determine the average fiscal year balances of rate base components, SGV added half of the two consecutive year end average balances, as detailed in Exhibit 8, p. 56.

[10] As a result of that $5.0 million addition to long-term debt, its total capital structure of $187.7 million would also increase by $5 million to $192.7 million. Hence, its long-term debt ratio would be 28.02% ($54.0 million divided by $192.7 million total capital). That 28.02% long-term debt ratio would result in a 71.98% common equity ratio (100.00% minus 28.02%).

[11] A simple average of SGV's test year capital structure adjusted to reflect the additional $5.0 million of long-term debt and both escalation years' forecasted capital structure.

[12] D.04-07-034 (2004) *mimeo.*, p. 52.

arguments are that SGV, as a relatively small, privately held water utility facing substantial capital needs, requires a strong equity position to be able to sell bonds on reasonable terms to finance expected and unexpected investments in a timely manner. An imputed capital structure should only be adopted when there is compelling evidence that the company's actual capital structure is inefficient, not least cost.

In regards to that latter argument, SGV cited a recent Valencia Water Company (Valencia) GRC decision which found that in the absence of evidence of a utility manipulating its capital structure to achieve an artificially high rate of return, basing a rate of return calculation on its actual capital structure is consistent with a goal of ratemaking to approximate the economic returns that a regulated company would achieve in a competitive environment.[13]

Although there was no comparison of the Valencia decision to SGV in this proceeding, we did review the Valencia decision. We found that there were more dissimilarities than similarities between the two water companies. While Valencia's long-term debt ratio was higher, 31.05% versus 25.63%, Valencia was substantially smaller in size. A rate base comparison of Valencia to only the LA Division showed that Valencia was 30% of the size of that division in rate base, and a customer comparison of Valencia to both of SGV's operating division showed that Valencia was also only 30% of size of SGV.[14]

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[13] D.07-06-024 (2007) *mimeo.*, p. 17.

[14] Valencia's rate base was $38.4 million in comparison to SGV's LA Division $128.0 million. Valencia had approximately 28,000 customers in comparison to SGV's 92,000 customers, of which LA Division had 48,000 and Fontana Division 44,000. We did not compare Valencia's and the total SGV rate base because Fontana Division's rate base was not identified in this record.

The Valencia decision was applicable only to Valencia and based on the facts presented in that proceeding. It should not be considered precedent-setting for all regulated water companies. Absent a meaningful comparison between SGV and Valencia, which was not provided, we have no basis to apply the results of the Valencia decision to SGV.

In regards to SGV being a relatively small, privately held water utility, the company relied on the same 1975 academic study used in the Valencia proceeding to support a higher equity ratio. The study which concluded that among unregulated firms, lower equity ratios are generally associated with larger companies. By inference, SGV would need higher equity ratios to offset higher financial and business risks.[15] However, the results of that study are not applicable in this proceeding because it studied only *unregulated* entities and was completed more than 30 years ago. Even if that study could be deemed pertinent to regulated entities, its conclusion does not hold when the substantially smaller Valencia with a 69% equity ratio is compared to a larger SGV with a projected 74%.

SGV further cited two publications from financial experts in support for adoption of its actual capital structure. Both of these publications recommended that water utilities that strengthen the shareholders' equity stake by increasing their equity ratios. These publications were not based on current information as they were both issued well before our 2004 adoption of SGV's imputed capital structure. One was published in the summer of 1994 and the other June 2000.[16]

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[15] D.07-04-024 (2007) *mimeo.*, p. 16 and Exhibit 14, p. 48.

[16] Exhibit 3, pp. 2-17 and 2-18.

Further, strengthening shareholders' equity does not necessarily result in strengthening of ratepayers interests. Absent a balance between the interests of shareholders and ratepayers, a high ratio of equity may be both inefficient and burdensome to ratepayers through excess rates.

Finally, SGV contends that it has more financial risks than publicly traded companies because it is a private company whose borrowings through private placements with insurance companies are not rated by rating agencies. As a result, institutional lenders consider its long-term debt financing to be more speculative. Again, its testimony was similar to the proceeding in which we first adopted an imputed capital structure of 60.0% equity.[17]

Common equity financing is more costly than debt financing because of its higher risk. Because debt financing is less costly and is tax-deductible, ratepayers benefit from the use of debt financing, or leverage. As debt ratios are increased and equity ratios are correspondingly lowered, financial risk for equity investors increases, requiring greater returns on equity. Additional leverage is advantageous to ratepayers up to the point that overall capital costs begin to increase as a result of increased cost of equity caused by greater financial risk and increased cost of debt. Therefore, the sole reason for adopting a utility's capital structure should not be based on an absence of evidence that a utility is manipulating its capital structure.

As previously stated, the burden of proof in a GRC rests with the utility. The utility has the duty to substantiate that its capital structure balances the interest of both shareholders and ratepayers. SGV's reliance on the Valencia

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[17] *Id.*, pp. 2-14 through 2-18 and Application (A.) 02-11-044, Exhibit 3, pp. 2-12 through 2-17.

decision, dated studies, and a proposal to accept an imputed capital structure equal to Valencia's does not satisfy that duty.

As proposed by SGV, we could reflect impacts of financial and business risks through the adoption of both SGV's projected actual capital structure and a 90 basis point risk premium on its return on equity.[18] However, the impact of those risks has traditionally been reflected in the authorized common equity return and we should continue to do so. Absent evidence that SGV's projected capital structure is an appropriate balance between shareholder and ratepayer interest, we again adopt an imputed capital structure. We recognize that SGV, as a privately held company, does not have access to the financial markets that public companies do. As such, we adopt a 37.0% long-term debt and 63.0% common equity capital structure, which approximates midway between the average equity ratio of the comparable water utilities used by the parties in this proceeding and SGV's actual equity ratio.[19]

### 6.2. Long-Term Debt Costs

SGV projected its test year long-term debt costs at 7.76% based on a simple average of actual 7.70% year end 2007 and forecasted 7.81% year end 2008 long-term debt costs.[20] That forecasted long-term debt included a $10 million issuance of new long-term debt in 2008 at a 7.72% interest rate. The 7.72% interest rate was based on an average of long-term Treasury bond rates plus a spread of

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[18] Exhibit 14, p. 47.

[19] Exhibit 27, p. 2-8.

[20] Exhibit 3, Table B.

246 basis points.[21] [22] The overall weighted cost of debt for test and escalation years was 7.79%. DRA accepted SGV's 7.79% overall cost of debt.[23]

In this instance, an agreement on an appropriate interest rate by the parties does not necessarily constitute reasonableness of SGV's forecasted long-term debt costs. Here, SGV used a calendar year end date to forecast its long-term debt costs while it used its test year fiscal year to forecast rate base. This difference is compounded by SGV's use of a simple average of different time periods and sources to forecast new long-term debt costs. The time periods and sources consisted of a December 2006 Blue Chip consensus, February 23, 2007 Value Line Quarterly, and March 2007 Global Insight and U.S. Economic Outlook.[24] That simple average of different time periods and sources further compounds a difference between the time periods used for forecasting long-term debt and use of October 2007 escalation rates adopted for the test year's results of operations accounts.

This inconsistent use of time periods for estimating long-term debt costs does not substantiate the reasonableness of SGV's and DRA's agreed-upon weighted average test and escalation years' 7.79% long-term debt costs. Other than a statement that SGV had experienced a historical 246 basis point premium

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[21] Although SGV testified that the $10 million new long-term debt issuance was issued in 2007, p. 1-1 of Exhibit 3, Table B to that exhibit shows that its debt was actually projected to be issued in 2008 and is reflected in its 2008 average long-term debt costs.

[22] One basis point equals 0.01%.

[23] Exhibit 27, p. 1-1.

[24] Exhibit 3, p. 1-1.

above long-term Treasure rates for its new issuances, there was neither evidence nor support for a continued use of that premium in this proceeding.[25]

Absent evidence to justify adoption of SGV's long-term debt costs, we must turn to informed judgment to arrive at a weighted average test and escalation years' long-term debt costs. SGV had year-end 2007 embedded long-term debt costs of 7.70% and that $10,000,000 of new debt would be issued in the test year. It is also general knowledge that long-term treasury rates have dropped since SGV's use of forecasted long-term treasury rates. For example, one of the long-term treasury forecast sources relied on by SGV was Global Insight.[26] The March 2007 Global Insight rate of 5.27% used by SGV dropped 36 basis points to 4.91% in its September 2007 forecast.[27] Based on these facts and application of informed judgment, we arrive at a 7.70% weighted average long-term debt costs.

### 6.3. Common Equity Return

The legal standard for setting a fair common equity return has been established by the United States Supreme Court in the *Bluefield* and *Hope* cases.[28] The *Bluefield* decision states that a public utility is entitled to earn a return upon the value of its property employed for the convenience of the public and sets

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25 *Id*.

26 Exhibit 14, Table 11.

27 Official notice is taken of Global Insight's September 2007 forecast. See, e.g., Exhibit 65 of A.07-05-003 et al.

28 *Federal Power Commission* v. *Hope Natural Gas Company*, 320 U.S. 591 (1944) and *Bluefield Water Works & Improvement Company* v. *Public Service Commission of the State of Virginia*, 262 U.S. 679 (1923).

forth parameters to assess a reasonable return.[29] Such return should be equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings attended by corresponding risks and uncertainties. The return should also be reasonably sufficient to ensure confidence in the financial soundness of the utility, and adequate, under efficient management, to maintain and support its credit and to enable it to raise the money necessary for the proper discharge of its public duties.

The *Hope* decision reinforces the *Bluefield* decision and emphasizes that such returns should be sufficient to cover operating expenses and capital costs of the business. The capital cost of business includes debt service and stock dividends. The return should also be commensurate with returns available on alternative investments of comparable risks. However, in applying these parameters, we must not lose sight of our duty to utility ratepayers to protect them from unreasonable risks including risks of imprudent management.

We must set the equity return at the lowest level that meets the test of reasonableness.[30] At the same time, our adopted equity return should be sufficient to provide a margin of safety to pay interest, pay reasonable common dividends, and allow for some money to be kept in the business as retained earnings. To accomplish this objective, we have consistently evaluated analytical financial models as a starting point to arrive at a fair equity return.

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[29] *Hope* held that the value of a utility's property could be calculated based on the amount of prudent investment minus depreciation.

[30] 46 CPUC2d 319 at 369 (1992), 78 CPUC at 723 (1975).

### 6.3.1. Financial Models

The financial models commonly used in equity return proceedings are the Discounted Cash Flow (DCF) and Risk Premium Model (RPM). Detailed descriptions of these financial models are contained in the record and are not repeated here. The results of these financial models are used to establish a range from which parties apply risk factors and individual judgment to determine a fair equity return.

Although the parties agree that the models are objective, the results are dependent on subjective inputs. The parties used the same proxy group of six Class A water companies. However, they used different subjective inputs such as time periods, risk-free rates, market risk premiums, and growth rates. The application of these subjective inputs results in a difference of common equity returns being recommended by the parties, as shown by the results of their DCF and RPM models. From these subjective inputs, the parties advanced arguments in support of their respective analyses and in criticism of the input assumptions used by the other parties. SGV even went so far as to recalculate DRA's financial modeling based on selective changes.[31] The following tabulation summarized the results of the individual financial models used by SGV and DRA, including the simple range of the DCF and RPM model results, overall average of the models and recommended equity return.

| | | | | Recommended |
|---|---|---|---|---|

[31] Exhibit 23, pp. 6 – 10.

| | DCF | RPM | AVERAGE | Equity Return |
|---|---|---|---|---|
| SGV[32] | 11.6% - 11.7% | 10.7% - 11.6% | 11.2% | 12.1%[33] |
| DRA[34] | 10.2 | 10.2 - 10.6 | 10.3 | 10.3 |

The subjective nature of the financial model results was shown by SGV's recalculation of DRA's financial modeling results based on selective changes. These selected changes resulted in a 40 basis point increase in DRA's financial models overall average of 10.3% to 10.7%, still 50 basis points lower than SGV's overall average. In the final analysis, it is the application of judgment, not the precision of these models, which is the key to selecting a specific equity return within the range predicted by analysis. We affirmed this view in D.89-10-031, which established equity returns for GTE California, Inc. and Pacific Bell, noting that we continue to view the financial models with considerable skepticism.

We find no reason to exclude or adopt the financial modeling results of any one party. Therefore, we establish an equity range based on the model results and informed judgment. After considering the evidence on interest rate forecasts, quantitative financial models based on subjective inputs, risk factors, recently authorized equity returns on California Class A water utilities, and applying our informed judgment, we conclude that a subjective equity return

32 Exhibit 14, Table 19.

33 SGV added a 90 basis point premium to its average to reflect additional risks not reflected in the financial model results.

34 Exhibit 27, Table 2-8.

range deemed fair and reasonable for the test and escalation years is 10.5% to 11.0%.[35]

#### 6.3.2. Additional Risk Factors

SGV added a 90 basis point premium to the results of its financial models on the basis that company-specific risks make SGV a riskier investment than the benchmark group of publicly traded water utilities used in the financial models. SGV did not specify how much of this additional premium resulted from each of its individual company-specific risks. These individual risks fell into three categories: financial, business, and regulatory risks.

Financial risk is tied to a utility's capital structure. The proportion of its debt to permanent capital determines the level of financial risk that a utility faces. SGV contends that it has less financing flexibility as a private company than publicly traded companies**.** However, as a utility's debt ratio increases, a higher equity return may be needed to compensate for that increased risk. SGV's low debt ratio (actual and imputed) equates to lower financial risk. A low debt ratio enables it to access the financing markets through private placements and mitigates its financial risks in comparison to publicly traded companies having higher debt ratios.

Business risk pertains to uncertainties resulting from competition and the economy. That is, a utility that has the most variability in operating results has the most business risk. An increase in business risk can be caused by a variety of

[35] This range of equity return is 20 basis points higher than DRA's financial models' overall average and 20 basis points lower than SGV's.

events that include poor management, and greater fixed costs in relationship to sales volume.

Risks related to contaminated water supplies and a 1994 Commission finding that SGV faces a higher risk than other water utilities with respect to its source of water fall into this category. However, contaminated water supplies are not unique to SGV. As stated by SGV, risk results from uncertainty related to anticipated stringent requirements to treat contaminated water, such as new state arsenic requirements.[36] However, these new requirements will be imposed on all California water utilities, including the two California water utilities included in the financial models' proxy group. To an extent, increased risks due to contaminated water supplies have already been factored in via the financial models. The Commission finding, approximately 14 years ago, that SGV faces higher risk than other water utilities was actually limited to its Fontana Division. SGV did not provide evidence in this proceeding to enable us to affirm that the finding is still valid or that it is applicable to the LA Division.

Regulatory risk pertains to new risks that investors may face from future regulatory actions that we and other regulatory agencies might take. SGV has rated its regulatory risk to be high on the basis that Value Line advises its investors that regulatory risk in California is higher than other western states and changes in the Rate Case Plan (RCP) related to the three-year GRC cycle and use of a standard sales forecast model have increased the risk that SGV will be able to earn a fair rate of return.

[36] Exhibit 8, p. 18.

However, the below average regulatory rating from Value Line does not pertain to water companies, it pertains to energy companies.[37] DRA identified a host of regulatory mechanisms that reduce regulatory risks. These mechanisms include the inclusion of construction work in progress in rate base, a rate design that enables SGV to recover 50% of its fixed costs irrespective of sales, balancing accounts, and memorandum accounts. Irrespective of SGV's perceived regulatory risks, such risks were already reflected in the financial models. Two of the six water companies, California Water Service and San Jose Water Corporation, both used in the financial models' proxy group, are California utilities experiencing the same regulatory environment as SGV.

These additional risks mitigated by regulatory mechanisms do not warrant a premium to the overall 10.50% to 11.00% equity range found reasonable in this proceeding. We adopt a 10.50% ROE, the lower end of the equity range found reasonable in this proceeding. This ROE is sufficient to provide a margin of safety to pay interest on long-term debt, pay reasonable dividends to the equity holders, and allow a reasonable amount of funds to be kept in the business as retained earnings.

While this authorized ROE is higher than the ROEs granted other Class A water utilities that litigated ROEs since 2000, it reflects DRA and SGV's recognition that SGV faces increased equity risk in comparison to other Class A water utilities. For example, as shown in Exhibit 25, DRA's 10.30% recommended ROE for SGV was 70 basis points higher than its 9.55% average ROE recommendation for other Class A water utilities that litigated an ROE.

[37] Reporter's Transcript vol. 2, p. 27.

SGV's 12.10% recommended ROE was 68 basis points higher than the 11.42% average ROE recommended by other Class A water utilities that litigated an ROE.[38]

### 7. Escalation Rates

SGV and DRA used DRA's Energy Cost of Service Branch (ECSB) forecasted labor and non-labor inflation factors to increase various expenses from recorded year to test year 2008 and escalation years 2009 and 2010.[39] However, their estimates were based on different time periods. SGV used March 2007 ECSB inflation factors for its July 2007 application and updated October 2007 ECSB inflation factors for its November 16, 2007 rebuttal testimony. DRA used June 2007 ECSB inflation factors.

Although there was a dispute between SGV and DRA on whether the ECSB inflation factors used by SGV in its rebuttal testimony or used by DRA in its direct testimony should be adopted, both parties concurred not to object to the use of the latest ECSB inflation factors used by SGV or DRA, or a more current version.[40]

Inflation factors commonly change from the time a utility prepares a GRC application to the time an evidentiary hearing is held. In this instance, approximately six months passed from the time SGV filed its application and an

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[38] SGV's 12.10% recommended ROE was based on the results of its financial models plus its premium for additional risks.

[39] ECSB prepares monthly labor and non-labor inflation factors to inform division management of the trends in the general price level of utility wage contracts and non-labor expenses.

[40] Section II. (D) 4 of Exhibit 38.

evidentiary hearing was held. During that period, ECSB updated its inflation factors six times on a monthly basis. Hence, it is appropriate to adopt the most recent version of ECSB inflation factors. However, it is not appropriate to adopt, as SGV and DRA tacitly support, a more recent version of ECSB published inflation factors that are not in this record and were issued subsequent to submittal of this matter. Regardless of inflation's direction, October 2007 ECSB inflation factors are the most recent inflation factors in the record and should be adopted.

Minor differences in forecasted operating revenues and operating expenses resulted from SGV's and DRA's use of different versions of ECSB inflation factors. The adoption of October 2007 ECSB inflation factors resolves those minor differences in forecasted operating revenues and expense accounts. Other test year differences between SGV and DRA are not due to different inflation factors. The October 2007 ECSB inflation rates of 3.2% for labor and 3.0% for non-labor are adopted for the test year.[41]

## 8. Los Angeles Division

The impact of test year 2008 LA Division issues upon which the parties could not agree are reflected in the following table and discussed in the remainder of this decision. Those issues include operating revenues, operating expenses, rate base, and return on rate base.

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[41] Exhibit 18, p. 14.

**(Dollars in Thousands)**[42]

| Category | SGV | DRA | Difference |
|---|---|---|---|
| Operating Revenues | $56,650 | $49,870 | $6,780 |
| Operating Expenses | 42,500 | 38,007 | 4,493 |
| Net Operating Revenue | 14,150 | 11,863 | 2,287 |
| Rate Base | 128,773 | 127,505 | 1,269 |
| Return on Rate Base | 10.99% | 9.30% | 1.69% |

### 8.1. Operating Revenues

The $6,780,000 difference in test year operating revenues resulted from different recommended returns on rate base, addressed in our prior rate of return discussion, and SGV reducing its forecasted operating revenues for water sales losses due to its introduction and implementation of enhanced water conservation programs. SGV and DRA concur on the number of customers by customer class and in the basic water consumption patterns of customers.

#### 8.1.1. Impact of Enhanced Conservation Programs

SGV proposed to implement enhanced conservation programs in partnership with the Central Basin Municipal Water District (CBMWD) and the Upper San Gabriel Valley Municipal Water District (SGVMWD). Those programs would mainly be for education and replacement of plumbing fixtures and appliances with water efficient plumbing fixtures and appliances.

SGV forecasted that the enhanced conservation programs would result in water sales losses of approximately 148 acre-feet for the test year, half of its

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[42] Amounts under $500 are rounded to the nearest thousand. For example, $500 is rounded up to $1,000. There are also minor differences due to rounding.

forecasted annual water sales losses due to a start up of enhanced conservation programs. It forecasted additional water sales losses of 296 acre-feet for escalation year 2009 and an additional 206 acre-feet for escalation year 2010 due to the enhanced conservation programs.[43]

SGV derived its water sales losses by multiplying a stated amount of water savings for individual water efficient plumbing fixtures and appliances times the number of plumbing fixtures and appliances to be installed in the test and escalation years. Those per unit water savings were based on California Urban Water Conservation's Council (Council) Best Management Practice (BMP) computation formulas.

SGV did not address the accuracy of those BMP computation formulas. It also did not address customers cancelling water savings from plumbing fixtures and appliances by increasing other water uses, such as additional landscaping, new pools, or hot tubs. Appropriate methods to forecast water sales losses are a policy issue that should be resolved on an industrywide basis. The September 6, 2007 scoping memo and ruling excluded a conservation rate design and water revenue adjustment mechanism (WRAM) from this proceeding. Revenue adjustment mechanisms are under consideration in both the water conservation investigation (Investigation (I.) 07-01-022) and in applications filed by California-American Water Co., including both GRC and a separate application for its Monterey district. We have declined to separately address revenue adjustment mechanisms. (*See* D.07-06-024, 2007 Cal. PUC LEXIS *70-71.) We will direct SGV to file a conservation rate design application, including WRAM, modified cost

[43] Reporter's Transcript vol. 2, pp. 112 and 113.

balancing account and conservation memorandum account proposals, for its LA and Fontana Divisions within 90 days of the issuance of this decision. We will coordinate SGV's conservation rate design proposal for its Fontana district with its July 2008 GRC and may consolidate the conservation rate design application with I.07-01-022. DRA's water sales forecast should be adopted.

### 8.2. Operating Expense

The differences in test year 2008 operating expense forecasts between SGV and DRA were in: (1) purchased water and assessments; (2) payroll, pension, and benefits; (3) uncollectible; (4) franchise fees; (5) insurance; (6) administrative expenses transferred; (7) allocated common expenses; (8) payroll taxes; and (9) income taxes, as shown in the following tabulation.

**(Dollars in Thousands)**[44]

| Category[45] | SGV | DRA | Difference |
|---|---|---|---|
| Purchased Water & Assessments | $6,913 | $6,953 | -$40 |
| Payroll, Pension & Benefits | 6,022 | 4,798 | 1,224 |
| Uncollectibles | 50 | 44 | 6 |
| Franchise Fees | 551 | 485 | 66 |
| Insurance | 231 | 194 | 37 |
| Administrative Expense Transferred | -562 | -606 | 44 |
| Allocated Common Expenses | 3,487 | 3,262 | 225 |
| Payroll Taxes | 501 | 317 | 184 |
| Income Taxes | 7,497 | 4,748 | 2,749 |
| Net Operating Expense Difference | | | $4,493 |

#### 8.2.1. Purchased Water & Assessments

The $40,000 differences in purchased water and assessments resulted from the use of different sales forecasts. There was no dispute on the unit cost per acre-foot of purchased water or on the various assessments by the CBMWD and SGVMWD. Agreed-upon unit costs per acre-foot of purchased water and assessments should be applied to the sales forecast being adopted in this proceeding.

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[44] Amounts under $500 were rounded to the nearest thousand. For example, $500 was rounded up to $1,000. There were also minor differences due to rounding.

[45] Attachment A.

#### 8.2.2. Payroll, Pension & Benefits

The $1,224,000 difference in test year payroll, pension and benefits between SGV and DRA resulted from different forecast methods.

SGV's forecast was based on April 2007 actual salary levels for all existing positions in the LA, Fontana, and General Divisions as a salary base. To that base, SGV added all new positions being requested in this proceeding. It also assumed that all vacant positions would be filled by the beginning of the test year. Bi-annual step increases for entry level positions were also factored in for all new and recently hired non-exempt employees. That total amount was annualized and escalated to the test year based on ECSB inflation factors. SGV then allocated that total escalated company payroll to its LA Division based on the proportional total recorded year 2006 data of the LA Division to the total company. SGV used the same method to forecast related vacation, holiday, and sick leave costs (employee benefits) separate from payroll costs.

DRA's forecast was based on 2006 recorded gross payroll data for individual employees of the LA Division. Employee benefits were included in that forecast. DRA reduced the base amount of payroll and employee benefits by approximately $980,000 for payroll included in the LA division stores clearing, transportation clearing, and construction work in progress accounts which are cleared to other expense or capital accounts.[46] No adjustment was made to the payroll and benefit base for filling vacant positions or step increases from the 2006 recorded year to test year 2008. DRA then applied ECSB's inflation factors to that base payroll and benefits amount. From that amount, DRA excluded the

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[46] Exhibit 26, pp. 3 and 9.

salary of a half year Water Treatment Operator I position included in the 2006 recorded payroll amount and excluded all new test year positions.

There are five basic differences between SGV's and DRA's forecasting methods. The differences are applicable equally to forecasted payroll and employee benefits. These differences are in: (1) payroll base, (2) vacant positions, (3) step increases, (4) current positions, and (5) new positions.

#### 8.2.2.1. Payroll Base

We do not agree with the payroll base approach used by both SGV and DRA. SGV's forecast is based on total company payroll (LA, Fontana, and General Divisions) and allocated to the LA Division based on recorded 2006 payroll ratios. This method inappropriately assumes that individual divisions' 2007 and test year 2008 payrolls would change in the same proportion as recorded 2006 payroll. For example, the 2006 allocation method would over-allocate salary to the LA Division if six senior level LA Division employees retired in 2007 and were replaced with six new employees at entry level salary or if some of those positions remained vacant. Further, Fontana Division has experienced substantial growth and General Division's engineering department spends the majority of its time on projects for the Fontana Division.[47]

We also do not agree with the payroll base approach used by DRA because its use of an unadjusted 2006 recorded LA Division payroll does not capture the most recent effect of payroll changes that occurred throughout the year or during 2007. As an example, if an employee earning $5,000 a month received a $1,000 a month salary increase on December 1, 2006, SGV would not be able to recover

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[47] Exhibit 9, p. 21.

$11,000 of that employee's salary in test year 2008. This is because the recorded 2006 payroll base reflects only $61,000 of payroll ($5,000 x eleven months and $6,000 x one month) for that employee and understated the employee's 2007 salary of $72,000 ($6,000 x 12 months). Also, DRA reduced the payroll base by amounts cleared to other expense and capital accounts without adding those amounts in its forecast of those expense and capital accounts.[48] Such a reduction, without including it in forecasts for other expense and capital accounts, precludes SGV from recovering reasonable payroll costs.

While we disagree with SGV's use of total company payroll base to derive test year payroll for its LA Division, its approach provides a more realistic result than DRA's use of recorded 2006 payroll as discussed above. We adopt SGV's April 2007 actual salary levels to calculate an annualized base payroll, adjusted to reflect adopted ECSB inflation factors and further adjusted to reflect the impact of the following discussion on vacant positions and step increases.[49]

#### 8.2.2.2. Vacant Positions

SGV included in its payroll base the salaries for 12 vacant positions.[50] These positions were included on the basis that they would be filled prior to the beginning of the test year. SGV also made no allowance for vacant positions whether caused by unfilled positions, employee departures, separations, or

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48 Exhibit 17, p. 20.

49 Since SGV used April 2007 actual salary levels, annualized ECSB's 2007 payroll inflation factor is not applicable for the test year. However, it is appropriate to apply ECSB's 2008 and 2009 payroll inflation factors to the adopted base payroll for the escalation years.

50 Exhibit 10, p. 6.

retirements on the basis that it would be fully staffed. SGV explained how it fills vacant non-supervisory field or office positions. First, SGV posts a vacancy notice at all SGV locations for one week so that current employees may apply if interested. If there are internal applicants, they are evaluated and a replacement is selected, usually within two weeks. If there are no internal applicants or no qualified internal applicants, SGV looks outside of the company to fill those vacant positions, which takes up to two months.

We have previously rejected SGV's forecast of fully staffed positions given that most, if not all utilities, have vacant positions.[51] We again question whether SGV can fill all of its vacant positions by the beginning of the test year and remain fully staffed throughout the test year. Vacancies result from a multitude of reasons including unplanned departures and retirements. The evidence confirms that vacancies will continue. SGV had one less vacancy, 11 versus its current 12, in its 2005 Fontana Division GRC.[52] Since the filing of this GRC, SGV has filled several of its vacant positions but had six new terminations during that same time period.[53] Even if SGV fills vacant positions from within its company, the process would result in those employees' positions being vacant. Based on this evidence we can only conclude that there will be comparable vacancies throughout the test and escalation years. We again reject SGV's assumption that it will be fully staffed through the test year and we remove the 12 vacant positions from SGV's forecasted payroll.

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[51] See, e.g., D.05-07-044, *mimeo.*, p. 10.

[52] D.07-04-046, *mimeo.*, p. 15.

[53] Exhibit 20, p. 4.

#### 8.2.2.3. Step Increases

SGV included step increases in its payroll forecast for new and recently hired non-exempt employees.[54] SGV explained that it did so because it does not pay new employees at the full pay rate scale for their positions when they are first hired. As the employee becomes fully trained and experienced, the rate of pay is gradually increased in scheduled, periodic steps until the employee reaches full pay scale for the position. For example, a meter reader has a scale rate of pay of $26.14 per hour, but the starting rate of pay is $18.16 per hour. There are seven pay steps from that starting pay to the top pay achievable through satisfactory performance appraisals. Over the past three calendar years, 96 SGV employees were eligible for a total of 282-step increases. Of those, only six-step increases were delayed and seven were granted early. SGV concluded that step increases should be included because they are a regular occurrence and predictable.

We excluded step increases in LA Division's prior GRC. There was no showing that test and escalation years would have a high level of entry level step increases compared to a recorded base year, or that the recorded base year had an unusually low number. SGV did not discuss offsetting adjustment for the possible effects of higher paid senior employees "topping out" in the salary brackets or for savings due to their departure.[55] Although SGV identified specific employees eligible for step increases in this proceeding, it again failed to include offsetting adjustments for the possible effects of departure and

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[54] The monthly step increase rate for 2007 was $187.00, 2008 was $189.81, and 2009 was $194.17.

[55] D.05-07-044, *mimeo*., p. 10.

retirement of higher paid senior employees. We exclude step increases from forecasted payroll.

#### 8.2.2.4. Current Positions

DRA excluded two Water Treatment Operator I positions (approximately $53,000 each) that were filled in 2004 from its base payroll. These positions were excluded on the basis that SGV did not provide actual justifications for the positions.[56] However, a review of the record substantiated that SGV explained these positions in response to DRA's Master Data Request and provided job records for both positions.[57] The two Water Treatment Operator I positions should be included in the test year payroll forecast.

#### 8.2.2.5. New Positions

SGV included two new positions in its test year payroll forecast. Those positions are a Customer Serviceman/Conservation Specialist and a Water Treatment Operator III.

##### 8.2.2.5.1. Customer Serviceman/Conservation Specialist

SGV requested authority to include a new Customer Serviceman/Conservation Specialist position in LA Division test year expenses. This position was requested so that SGV could comply with the Commission's Water Action Plan (WAP) and California Urban Water Conservation Council's BMP. This position would be used to satisfy BMP No. 1 which requires SGV to directly contact not less than 20 percent of its single-family and multi-family

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[56] Exhibit 26, p. 3-10.

[57] Exhibit 20, p. 10 and Attachments B and C.

residential units during the reporting period and perform water use surveys on 15 percent of its single-family and multi-family residential units within ten years.[58]

DRA excluded this position from its test year payroll and benefits forecast on the basis that: (1) the status of the position was uncertain; (2) SGV does not have a Conservation Coordinator in place to design a comprehensive conservation program; (3) SGV forecasted only $1,991 of conservation expense to be used for materials and supplies; and (4) the more aggressive conservation program involving a $650,000 annual expense to the LA Division addressed in our Operating Revenues discussion would be administered primarily by CBMWD and SGVMWD.[59]

Although SGV does not yet have a Conservation Coordinator in place, such a position is approved by this decision based on DRA's concurrence that General Division should be authorized to include such a position. Irrespective of whether the aggressive conservation program may be administered by two municipal water districts, the Customer Serviceman/Conservation Specialist position will be responsible for implementing the BMP No.1 surveys. These surveys equate to approximately 40 customer contacts and 3 actual residential survey and audits per workday, an ambitious schedule.[60] A new Customer Serviceman/Conservation Specialist position should be included in the test year payroll forecast.

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[58] Exhibit 10, p. 4.

[59] Exhibit 26, p. 3-10.

[60] Exhibit 10, p. 4.

#### 8.2.2.5.2. Water Treatment Operator III

SGV also requested authority to include a new Water Treatment Operator III position in test year expenses. This position was actually filled in January 2008 due to a significant increase in monitoring and maintenance required for major new treatment facilities that have been added since April 2006. Those additions included a new treatment facility at Plant B5; new reservoirs and booster pumps at Plant M2; new wells at new Plants B25 and B26; and new wells, reservoirs, booster pumps, and chlorinators at the new Plant B24. Additional monitoring and maintenance will be required due to the approval of two new wells, three new booster stations, four new reservoirs, and six emergency generators in this GRC proceeding.[61]

DRA excluded this new position from its test year forecast for two reasons. First, this position fell within the last GRC cycle and the Commission had already adopted a level of payroll expenses for that time period. Second, SGV should explore the possibility of having polluters fund the position in part or full because the duties of that position would include plant sites where certain operation and maintenance expenses are reimbursable by polluters and other public funds.[62]

DRA's reason for excluding this position on the basis that it was added within the last GRC cycle has nothing to do with the need for this new position. As such, DRA's argument is unconvincing. Also, DRA's second reason does not justify exclusion of the position given that it asserts that the position should be

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[61] *Id*.

[62] Exhibit 26, p. 3-10.

funded in part, or in full, by polluters. DRA's funding position convinces us that this new position is needed to undertake additional monitoring and maintenance of new facilities placed in service to mitigate adverse impacts from polluters. We concur with DRA that, to the extent SGV may be reimbursed, any reimbursement from polluters and other public funds should be used to offset the cost of this position. However, it is not in ratepayers' interest to postpone the additional monitoring and maintenance functions required of these new facilities until it can be determined whether polluters will reimburse SGV. SGV has substantiated that its proposed position for additional monitoring of new facilities. A new Water Treatment Operator III position should be included in the test year payroll forecast.

#### 8.2.3. Uncollectibles

The $6,000 difference in uncollectibles resulted from the use of different operating revenue estimates. SGV and DRA both used a 0.0877% rate to calculate their individual estimates. The 0.0877% uncollectible rate should be applied to the operating revenue estimates being adopted in this proceeding.

#### 8.2.4. Franchise Fees

The $66,000 difference in franchise fees resulted from the use of different operating revenue estimates. SGV and DRA both used a 0.9734% rate to calculate their individual estimates. The 0.9734% franchise fee rate should be applied to the operating revenue estimates being adopted in this proceeding.

#### 8.2.5. Insurance

The $37,000 difference in test year insurance resulted from a disagreement between SGV and DRA on umbrella insurance. SGV negotiated a single umbrella policy covering SGV and its affiliated companies in order to achieve greater buying power and lower overall premium cost for SGV and each of its affiliates.[63] Although the policy covers all of SGV affiliates, each affiliate is separately billed by an insurance agent.

SGV pays approximately 65% of the total umbrella premium and its affiliates pay the remaining 45%. DRA contends that SGV overpaid for its umbrella insurance and should only pay 55% of the total umbrella insurance premium. DRA derived 55% by allocating the total umbrella insurance premium to SGV and its Arizona Water Company (AWC) affiliate based on the number of vehicles, number of employees, and assets.[64]

This is not a new issue. The Office of Ratepayer Advocates (ORA), DRA's predecessor, unsuccessfully raised this same issue in the 2002 Fontana Water Company GRC proceeding**.** ORA's position was rejected by the Commission in D.04-07-034. Irrespective, we will revisit the issue.

An insurance company assesses risks and decides what the premium will be based in part on location. From that assessment of risks and assignment of premium, an insurance agent bills each SGV affiliate for the premium applicable to its own separate coverage. A review of SGV's master umbrella insurance policy pertaining to premiums applied to motor vehicles owned by SGV and AWC affiliate substantiates SGV's position that the assessed risks and premium allocated to each affiliate are different. For example, both SGV and its AWC affiliate had umbrella liability insurance for a 2005 Ford F-250 classified to operate in a radius of 50 miles with a primary rating factor of a 1.00. Although

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[63] Affiliated companies include Arizona Water Company, Utility Investment Company, Rosemead Properties, Inc., and United Resources, Inc.

[64] Exhibit 29, p. 50.

there is only a $139.00 difference between the original cost of SGV vehicle CA137 having an original cost of $28,139 and that of a similar vehicle AZ13 of AWC having an original cost of $28,000, the difference in liability insurance was $351.00. The liability premium on the SGV vehicle was specifically identified to be $674.00 and the liability premium on the AWC vehicle was $323.00.[65]

There is no evidence of improper allocation or billing of umbrella liability insurance to SGV. The umbrella insurance estimate of SGV should be adopted.

#### 8.2.6. Administrative Expense Transferred

The $44,000 difference in test year 2008 Administrative Expense Transferred resulted from a difference between SGV and DRA on the percentage of overhead that should be recovered from SGV affiliates.

Pursuant to D.93-09-036, SGV developed a written service agreement to recover costs for its services being provided to its affiliated companies. That agreement provided for monthly billing for all services rendered by SGV to its affiliates, including charges for time devoted by SGV employees to affiliate activities, corresponding fringe benefits, related overheads and general office supplies.

Consistent with its past practice, SGV used a 10% rate to forecast its test year recovery of overhead costs associated with the services SGV provides to its affiliates. SGV demonstrated that the Commission has consistently found that the cost allocation *method* between SGV and its affiliates was reasonable. However, SGV could not answer whether the Commission specifically

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[65] Exhibit 20, Attachment D.

determined that its 10% overhead rate was reasonable or how the 10% overhead rate was developed.[66]

DRA used a 15% overhead rate on the basis that the overhead rate used by SGV was arbitrary. DRA used a higher overheard rate based on its belief that a 10% overheard rate ignored recovery of certain unidentified costs and that the rate should be increased.[67]

We find no support for the use of either a 10% or a 15% overhead rate in this proceeding. However, consistent with the Commission's affiliated transaction rules and the service agreement of SGV, there should be an allocation of SGV overhead to its affiliates for work SGV performs for its affiliates. Given a minor difference in the test year estimate between SGV and DRA, we will adopt a 10% overheard rate for this proceeding only. SGV shall prepare and complete a study prior to its next LA Division and General Division GRC that justifies an overhead rate to be applied for recovery of its overhead costs associated with its direct services being provided to its affiliated companies.

#### 8.2.7. Allocated Common Expenses

Allocated common expenses consisted of General Division operating expenses common to both the LA and Fontana Divisions. The largest components of General Division operating expenses were executive and management payroll along with related payroll costs such as pensions, benefits, and payroll taxes.

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[66] Reporter's Transcript vol. 2, pp. 125 through 127.

[67] *Id*.

The $224,000 difference in test year allocated common expenses resulted from differences in forecasting payroll, Chairman of the Board's salary, a current position, and new General Division positions, as addressed in our payroll, pension and benefits and General Division discussions. Test year allocated common expenses should be as set forth in our General Division Section 9 discussion.

#### 8.2.8. Payroll Taxes

Payroll taxes include Federal Insurance Contribution Act (FICA) tax applicable to Social Security and Medicare, Federal Unemployment Tax Assessment (FUTA), and State Unemployment Tax Assessment (SUTA). The statutory tax rate for Social Security is 6.2% on the first $102,000 of each individual's annual wages for Social Security plus 1.45% of each individual's total annual wages for the Medicare. The statutory tax rate for FUTA is 0.8% and for SUTA, 1.8%. The FUTA and SUTA tax rates are applied to the first $7,000 of each individual's annual wages.

The $184,000 differences in test year payroll taxes resulted from the use of different payroll estimates. Differences in payroll estimates for escalation years 2009 and 2010 resulted from both the use of different payroll estimates and from the use of different individual base payroll limit subject to a 6.2% Social Security tax. DRA used a statutory $102,000 base payroll limit subject to Social Security taxes for both escalation years whereas SGV increased that individual payroll limit for the escalation years based on inflation factors.

Payroll taxes should be based on the statutory tax rates and the payroll estimates being adopted in this proceeding. Absent evidence that the federal government will increase its statutory base payroll limit in the escalation years or that statutory increases will be based on a labor inflation factor, we reject the use of inflation factors to increase payroll tax rates for the test and escalation years. Those statutory tax rates applicable to this GRC are: 6.2% on the first $102,000 of each individual's annual wages for Social Security, 1.45% of each individual's total annual wages for Medicare, 0.8% on the first $7,000 of each individual's annual wages for FUTA, and 1.8% on the first $7,000 of each individual's annual wages for SUTA.

#### 8.2.9. Income Taxes

SGV and DRA both used an 8.84% state tax rate and 33.22% federal tax rate to calculate their respective income tax estimates. The $2,749,000 difference in income taxes resulted from applying state and federal tax rates to different operating revenues, operating expenses, and rate base estimates. The 8.84% state and 33.22% federal tax rates should be applied to the operating revenues, operating expenses, and rate base estimates being adopted in this proceeding.

### 8.3. Rate Base

The $1,269,000 difference in test year rate base resulted from differences in the treatment and allocation of a new Fontana Office Complex and an El Monte Office Building, as discussed in the subsequent General Division discussion. Test year allocated common rate base should be as set forth in that discussion.

### 8.4. Return on Rate Base

Even with a partial settlement agreement on revenue, expenses and rate base, the parties did not agree on the appropriate return on rate base for the test year. SGV contends that the rate of return should be 10.99% and DRA asks for 9.3%. Test year return on rate base should be 9.65% as set forth in our prior cost of capital discussion and applied to the adopted test year results of operations.

## 9. General Division

General Division provides services that are common to the LA and Fontana Divisions. Consistent with the RCP adopted by D.07-05-062, SGV included General Division expenses and rate base investments in this proceeding to be reflected in test year rates for both the LA and Fontana Divisions. The following tabulation summarizes differences in test year General Division common costs prior to allocation between the LA and Fontana Divisions.[68] The impact of LA Division test year issues upon which SGV and DRA could not agree is reflected in the following table and discussed in the remainder of this decision.

**(Dollars in Thousands)**[69]

| Category | SGV | DRA | Difference |
|---|---|---|---|
| Common Expenses | $6,600 | $6,278 | $322 |
| Rate Base | 12,315 | 9,868 | 2,447 |

### 9.1. Common Expenses

The $322,000 differences in General Division common expenses resulted from different forecasts in: (1) payroll, (2) Chairman of the Board's salary, (3) necessity of a current position, and (4) addition of new positions.

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[68] Total General Division common expense and rate base were derived by adding allocated expenses and rate base of General Division to LA Division on page 3 of 5 and to Fontana Division on page 4 of 5 of the partial settlement agreement.

[69] Amounts under $500 are rounded to the nearest thousand. For example, $500 is rounded up to $1,000. Minor differences occur due to rounding.

#### 9.1.1. Payroll

Differences in General Division payroll expenses paralleled those discussed and resolved regarding LA Division payroll, pension, and benefits. Test year General Division payroll forecasts should be as adopted for LA Division payroll, pensions, and benefits.

#### 9.1.2. Chairman of the Board's Salary

DRA recommended that only 54.45 % of the Chairman of the Board's (Chairman) salary charged directly to General Division be allowed in the test year allocated between the LA and Fontana Divisions. DRA argues that his time allocations do not make sense, appeared arbitrary and biased, and SGV failed to justify a need for the Chairman's position.[70] This issue is similar to an issue raised in Fontana Division's test year 2003 GRC by ORA, DRA's predecessor.[71] We once again address this issue.

The Chairman serves as Chairman of SGV and its affiliates. Based on daily time records, the Chairman spends approximately 82.00% of his time on SGV matters and 16.5% on AWC matters. An additional 1.5% of his time was spent on other affiliates including Utility Investment Company, Rosemead Properties, Inc., and United Resources, Inc.

DRA, unfamiliar with the functions the Chairman performs and unfamiliar with AWC operations, contends that the allocation of 82.0% of Chairman's time and salary on SGV matters in comparison to 16.5% on AWC matters defies common sense. DRA pointed out that both companies serve approximately the

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[70] Exhibit 29, pp. 42 and 44.

[71] D.04-07-034, pp. 30 through 34.

same number of customers, 86,089 versus 72,000, and both are Class A water utilities. DRA also questioned a need for SGV to have both a Chairman and a President position.[72] Based on these concerns, DRA recommended that the number of customers between SGV and AWC be used to allocate the Chairman's direct salary to SGV, resulting in allowing 54.45% of his salary.[73]

The Chairman is paid directly by SGV and directly by AWC for the time he devotes to those companies based on daily time records. Those records comply with the affiliated transaction rules adopted in D.93-09-036 and subsequently affirmed in D.04-07-034. We stated in that later decision that we will not disallow any portion of the Chairman's salary since SGV appears to be in compliance with D.93-09-036, and we find nothing else in the record that might support the recommended disallowance.[74] Nothing in this record warrants a reversal of our prior decisions on the Chairman's salary. There should be no adjustment to the Chairman's salary. This issue should not be readdressed in future proceedings unless new evidence is brought forward for our consideration.

#### 9.1.3. Current Position

SGV included a Junior Draftsman position it established and filled in July 2006 as a component of its General Division payroll. SGV added the position due to an increased workload. However, DRA excluded the position

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[72] Exhibit 29, pp. 43 and 44.

[73] SGV pointed out that DRA's proposed allowance equated to only 47.3% because DRA applied its 54.45% allocation percentage to a salary paid by SGV that was already reduced by 13%, which was directly allocated to AWC. See Exhibit 33.

[74] D.04-07-034, p. 30 and Findings of Fact 22 and 23, p. 67.

because SGV never formally requested and has not justified the Junior Draftsman position.[75]

The Commission does not manage regulated water utilities. As such, it neither requires a utility to accurately forecast all of its staffing needs over a three-year GRC cycle nor requires a utility to seek Commission authority to add staff positions to meet customer needs. The Commission's sole test for a utility's ability to recover its expenses in future rates is whether the expenses are reasonable. In this instance, SGV added a position due to increased workload. There is no evidence that the budgeted salary was excessive or improper. The Junior Draftsman position should be included as a component of General Division test year payroll expenses.

#### 9.1.4. New Positions

SGV included as a component of General Division payroll expenses salary and benefits for three new General Division positions. These positions are a Regulatory Analyst, Conservation Coordinator, and a Regulatory Compliance Coordinator.

##### 9.1.4.1. Regulatory Analyst and Conservation Coordinator

The parties agree that the General Division should hire a new Regulatory Analysts and Conservation Coordinator. However, DRA excluded those salaries and related benefits from its forecasted General Division payroll on the basis that SGV has a history of not timely filling its authorized positions. DRA

[75] Exhibit 29, p. 11.

recommended that SGV should recover these salaries and related benefits through advice letters only after the positions are filled.

The Commission found in Fontana Division's 2002 GRC that SGV should seek recovery of costs associated with new positions through advice letters based on an observation that SGV has taken its time to fill authorized new positions.[76] However, SGV contended that this observation, which occurred in a 2002 GRC decided in 2004, was outdated and no longer applicable.

SGV testified that General Division's new positions would be filled by the beginning of the test year and that some of those positions would even be filled before the start of its 2008 test year.[77] There is no evidence to the contrary. General Division test year expenses should include the salaries and related benefits for a new Regulatory Analyst and Conservation Coordinator.

#### 9.1.4.2. Regulatory Compliance Coordinator

SGV requested authority to include a new Regulatory Compliance Coordinator position in General Division test year expenses. DRA opposed the inclusion of this position on the basis that several of the duties described for the new position duplicated duties of current employees, such as an existing Water Quality Superintendent responsible for drinking water quality and a Safety Coordinator responsible for workplace safety.

SGV explained that once the Regulatory Compliance Coordinator position is filled, these duplicative functions will no longer exist. SGV established this new position to transfer all non-core functions to a person who can be expert in

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[76] D.04-07-034, p. 33 and Ordering Paragraph 7, p. 72.

[77] Reporter's Transcript vol. 3, p. 204.

all non-core regulatory compliance issues and can identify, understand, and comply with increasingly complex and stringent regulations. Since its prior GRC, the LA Division has been required to comply with new and enhanced regulatory requirements for which it has not been staffed.[78] For example, in 2005 the district was required to undertake an infrastructure needs survey as part of its annual Drinking Water Program report. In 2006, the district's emergency stand-by generators were required to meet South Coast Air Quality Management District Tier 2 emission standards. At the start of 2008, it was required to increase water quality monitoring of emission standards.

SGV has substantiated that it is required to comply with new and enhanced regulatory requirements for which it has not been staffed. General Division test year expenses should include the salaries and related benefits for a new Regulatory Compliance Coordinator.

### 9.2. Rate Base

The $2,447,000 General Division test year rate base difference resulted from different capital treatment and allocation of (1) an El Monte office building, and (2) a new Fontana office building.

#### 9.2.1. El Monte Office Building

SGV's headquarters and operations offices have been at their current location in El Monte since the company's inception in 1937. Since that time, SGV acquired adjoining properties in 1948, 1952, 1965, 1980, and 1986. These acquisitions were used to accommodate additional office space, storage area, and parking. The latest building expansion occurred in 1965 when the main portion

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[78] Exhibit 20, pp. 6 through 8, and Attachment A.

of the existing building was completed. Now, more than 40 years later, the building infrastructure has become obsolete.[79] Office space has also become inadequate since 1965 because of a 46% increase in the number of employees, 146 from 100, who occupy the same square footage in the same building. To alleviate its infrastructure obsolescence and inadequate office space, SGV sought to recover through annual advice letters approximately $12,600,000 of forecasted capital costs for either refurbishing or replacing the El Monte building.

DRA provided testimony in opposition to SGV's proposal. In response, SGV reconsidered its advice letter recovery request for full recovery of its cost to renovate or replace the existing building.[80] SGV replaced its advice letter request with a request to include $164,000 in the General Division's test year rate base. Of that amount, $108,000 would be used to refurbish existing office space being vacated by 26 General Division employees relocating to a new Fontana building and $56,000 would pay for a more complete and comprehensive long-term space study.[81]

DRA also opposed SGV's revised request. DRA's opposition was on the basis that SGV violated the RCP, Section IV. F.[82] Although the RCP provides for water utilities to update their GRC requests, such request must be made within 45 days after the filing of their GRC application. The updated request exceeded the 45-day limit because it was made at a December 6, 2007 evidentiary hearing,

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[79] Exhibit 9, pp. 20 and 21.

[80] Reporter's Transcript vol. 3, p. 208.

[81] *Id.*, pp. 211, 214, and 215.

[82] See D.07-05-062.

approximately 150 days after the filing of SGV's July 2, 2007 GRC application. DRA further opposed the revised request on the basis that the RCP precludes acceptance within that 45-day period of new or additional items or forecasted costs, as proposed by SGV.

Although SGV failed to satisfy the RCP's 45-day period, that test is not applicable since the revised request relates to the renovation portion of the original request. By its application, SGV requested recovery of its forecasted costs to *either* refurbish or replace the El Monte building.[83] Accompanying testimony further substantiated that SGV engaged a design building firm to perform a space study that recommended either refurbishment (renovation) or replacement of the building to satisfy the company's needs.[84] The revised renovation request cannot be considered a new or additional item, disfavored by the RCP.

We decline to treat the revised renovation amount as a forecast update as set forth in the RCP. SGV had substantiated, as part of its initial filing, the need to correct El Monte building infrastructure obsolescence and inadequate office space, leaving the issue of how much should be authorized to correct these conditions. The reason for a substantial reduction of requested capital costs, $108,000 from $12,600,000, to mitigate the inadequacy of its El Monte building is consistent with our goal to encourage prudent investment in water utility infrastructure. General Division's test year rate base should be increased by $108,000 to cover the costs of El Monte building renovations.

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[83] Application, p. 9.

[84] Exhibit 9, p. 21.

However, the request to undertake a more complete and comprehensive long-term space study does violate the RCP 45-day update rule. The request is a new item not requested as part of the application and was not made known until well beyond the 45-day limit. SGV's request to increase General Division's test year rate base by $56,000 to cover a long-term space study is denied.

#### 9.2.2. New Fontana Building

SGV included $2.9 million, or 30%, of its $9.6 million forecasted cost for a new Fontana office building expected to be completed in December 2008.[85] That $2.9 million was allocated to General Division because the new building will house 27 General Division employees, a new Rate Analysts position being approved by this decision and 26 employees located at the El Monte headquarters building. The remaining $6.7 million, or 70%, of building costs along with an additional $3.3 million of related building complex costs would be allocated to Fontana Division since the division will directly use the space.[86]

DRA excluded all General Division allocation of a new Fontana office building on the basis that it was premature, unsupported, and should be considered in Fontana Division's July 2008 GRC. DRA took this position because Fontana Division was previously authorized to include only $4.9 million of a forecasted $6.0 million cost for a new Fontana office building. That authorization was granted by the Commission in Fontana Division's prior GRC and conditioned upon a subsequent justification of whether the entire new building

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[85] The 30% represents the space General Division employees are expected to occupy based on a new building floor plan.

[86] The total projected building and project cost was $12.9 million, of which $9.6 million directly pertains to a new Fontana building.

would be used and useful as part of Fontana Division's July 2008 GRC.[87] The Commission took this position because total building cost was not known at the time and the proposed size of the building was questionable. For example, SGV had forecasted that Fontana employees occupying 4,719 square feet of space at that time would be occupying approximately 11,548 square feet, a 144% increase, of office space in the new Fontana building.

DRA also had a space allocation issue in this proceeding given that the employees to be transferred would occupy approximately 79% more space than they occupy in the El Monte headquarters building, from 4,479 square feet to 8,048 square feet. DRA contends that if the transferred General Division employees occupy the same space they currently occupy in El Monte they would need only 17%, not 30%, of a new 26,827 square foot building.[88]

Consistent with DRA's assertion and SGV's acknowledgment in its opening brief that the final costs of a new Fontana building complex would be reviewed in Fontana Division's 2008 GRC,[89] we conclude that this is not the appropriate proceeding to resolve any allocation of new building costs or space. However, SGV proposed, in its opening brief, to include a portion of the new Fontana building's estimated costs in General Division's rate base subject to refund, pending a review of building costs in the upcoming Fontana Division

[87] D.07-04-046 *mimeo.*, p. 48.

[88] Exhibit 29, p. 61.

[89] SGV Opening Brief, p. 67.

GRC. DRA concurred with this proposal only if a subsequent allocation of part of that building to the General Division is authorized in this proceeding.[90]

SGV substantiated the existence of an overcrowded space situation at the El Monte headquarters building, as addressed in our prior El Monte Office Building discussion. Therefore, it is reasonable to expect that 27 General Division employees would relocate to the new Fontana Building. Although we authorize an allocation of new building space for those employees, we cannot specify the square footage or costs at this time. That allocation must be decided in Fontana Division's next GRC as acknowledged by SGV and DRA.

Consistent with D.07-04-046 and both SGV's and DRA's comments in this proceeding, we will include $2.9 million of the new Fontana building's current estimated costs in General Division's rate base. The $2.9 million should be allocated $1.5 million to LA Division and $1.4 million to Fontana Division, based on the adopted four-factor rate. LA Division's share should be made subject to refund, pending a review of building costs in the upcoming Fontana Division GRC. Consistent with D.07-04-046, Fontana Division's $1.4 million allocated amount should not be included in rates until the building costs have been reviewed for prudence and the facility's size evaluated to determine whether the entire facility is used and useful. Also, consistent with that decision, should the final amount of the new facility placed into Fontana Division rates by D.07-04-046 exceed the amount for which construction work in progress (CWIP) was allowed, the balance plus an allowance for funds used during construction should be placed into Fontana Division's rate base.

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[90] DRA Reply Brief, p. 8.

### 9.3. Four-Factor Allocation Method

There was no dispute on how common General Division costs and rate base investments should be allocated between the LA and Fontana Divisions. SGV and DRA concurred that these common costs and investments should be allocated 52.8% to the LA Division and 47.17% to the Fontana Division, based on a four-factor allocation method.[91] Test year common General Division costs being adopted in this proceeding should be allocated between the LA and Fontana Divisions based on agreed upon four-factor rates.

### 9.4. Recovery of General Department's Common Costs

Although SGV seeks to recover LA Division's share of General Division costs in test year rates, it seeks to recover Fontana Division's share through a surcharge. This is because SGV forecasted that Fontana Division's share of General Division costs would require only a 1.5% incremental revenue requirement above authorized rates adopted by D.07-04-046. We concur with this approach. Fontana Division's share of increased or decreased General Division costs should be recovered via a surcharge or surcredit.

## 10. One-Way Conservation Balancing Account

DRA concurred with SGV that test year conservation expense should be forecasted at $652,000, $650,000 of which would be applicable to LA Division's enhanced conservation programs. DRA also concurred with SGV that $652,000 should also be forecasted for the 2009 and 2010 years for the same purposes. However, DRA is concerned that the LA Division may incur

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[91] The four-factor method allocates General Division costs and investments to the LA Division and Fontana Division based on a weighted average of each division's active service connections, direct payroll, direct operating expenses, and gross utility plant.

implementation problems that would prevent the full expenditures of forecasted costs in the test year. To ensure that the LA Division does not earn an inappropriate windfall by retaining unspent forecasted conservation costs, DRA recommended a one-way balancing account to be cleared at the end of each year with any balance to be refunded to ratepayers.

SGV opposed the one-way balancing account because: (1) it conflicts with an ALJ ruling that memorandum accounts would not be addressed in this proceeding; (2) it conflicts with the WAP and RCP; and (3) the conservation programs are well defined.

We first address SGV's opposition to a one-way balancing account. A one-way balancing account does not conflict with an ALJ ruling on a memorandum account. A memorandum account enables a utility to track costs with an opportunity to recover its costs in the future while a balancing account records actual costs to be recovered or distributed in a future date.

Contrary to SGV's assertion, a one-way balancing account does not conflict with the WAP or RCP because these documents do not address one-way balancing accounts. Also, it could be argued that a one-way balancing account simplifies the ratemaking process by authorizing unused funds to be refunded to ratepayers without future consideration of alternative distribution.[92] The final argument that costs of the conservation programs were well defined has no bearing on whether or how any unused funds should be distributed.

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[92] We observe that SGV took a strict interpretation of the RCP. However, it contended in discussion of prior allowance for water sales losses due to enhanced conservation programs that the RCP should be used only as a general guideline. See Reporter's Transcript vol. 2, p. 109.

Although there is no merit to SGV's opposition of a one-way conservation balancing account, we recognize that GRC forecasts are based on a multitude of activities, including maintenance and general office expenses such as postage, none of which are required to be the subject of a one-way balancing account. The Commission has not and does not intend to micro manage water utilities. There is no assurance that the LA Division will spend all of its forecasted conservation costs for conservation programs. There is also the possibility that it would spend more than its forecasted costs. The same hold true for each of LA Division's other activities, many of which DRA concurred with without seeking one-way balancing accounts.

SGV has identified enhanced conservation programs it intends to partner with its CBMWD and SGVMWD neighbors. These districts expect the LA Division to participate in the conservation programs and we have no knowledge to the contrary. The one-way conservation balancing account proposed by DRA should not be adopted. At the same time we realize that the approximate $650,000 yearly conservation budget is a substantial commitment on the part of SGV. Hence, SGV shall track its actual conservation expenditures associated with its yearly conservation budget being approved by this decision. SGV shall also report the results of its conservation tracking as part of its next Los Angels Division GRC application.

## 11. Irrigation Service

The LA Division offers limited irrigation service under Tariff Schedule No. LA-3L. This schedule is restricted to those irrigation customers acquired by SGV many years ago from Vallecito Water Company. By terms of the schedule, new customers are not eligible for this service.

SGV seeks authority to cancel the limited irrigation service because there are no customers receiving service under the schedule. There was no opposition to this request. Schedule No. LA-3L should be cancelled.

### 12. Water Quality Litigation Memorandum Account

SGV requested authority to amortize the recorded balance in the LA Division's defense-related component of its Water Quality Litigation Memorandum Account (WQLMA). Pursuant to a partial settlement agreement, SGV and DRA agreed that LA Division would seek recovery of further costs recorded in this balancing account by advice letter.[93] However, the agreement was silent on how the current costs recorded in the defense-related component of the WQLMA should be treated.

Consistent with an agreed intent by SGV and DRA to allow SGV to recover costs recorded in the WQLMA, SGV should file an advice letter with the Water Division for authority to amortize the remaining balance in its defense-related component within its WQLMA. Further costs recorded in the WQLMA should be recovered through the advice letter process as agreed to by SGV and DRA.

### 13. Water Action Plan

On December 15, 2005, the Commission adopted a WAP that identified policy objectives to guide it in regulating investor-owned water utilities and highlighted actions to implement the policy objectives. Those policy objectives were four fold: (1) high quality and safe water, (2) highly reliable water supplies, (3) efficient use of water, and (4) reasonable rates and viable utilities.

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[93] Settlement Agreement Section II. (E.), 1.

SGV provided a report on implementation of the Commission's WAP for its LA Division that assessed the many separate elements of its water production, storage, distribution, and treatment facilities and operations. It also provided a road map for future utility plant additions for production, storage, distribution and water treatment. With no party raising any issue with regard to the accuracy or sufficiency of its implementation of the WAP, we find SGV's response to be satisfactory.

SGV and DRA provided testimony on the LA Division's compliance with the WAP. The testimony included copies of its 2004, 2005, and 2006 water quality reports to the California Department of Health Services (DHS).[94] Those reports indicated that SGV complied with all DHS water quality standards and regulations since its prior GRC, D.04-07-044. DRA affirmed those results and testified that there were no formal complaints against SGV during that time period. We conclude that SGV is in compliance with all applicable state and federal safe drinking water quality standards and regulations.

## 14. Summary of Earnings

Our adopted Summary of Earnings is shown in Appendix B. It reflects the operating revenues that would be provided at present rates and those that will be required to produce the 10.50% ROE we are authorizing for the test year. The rate of return which we are authorizing SGV will produce additional revenues of $3,885,500 in the test year, an increase of 8.1% over the revenues produced by existing rates.

[94] Exhibit 13.

## 15. Rate Design

Finally, turning to rate design, SGV and DRA agreed that metered rates would continue to provide recovery of approximately 50% of SGV's fixed costs through the service charge component and the remaining costs recoverable through a single commodity rate. The resulting rates are set forth in the Tariff Schedules for the various classes of service in Appendix B.

## 16. Comments on the Proposed Decision of the ALJ

The proposed decision of the assigned ALJ was mailed to the parties in accordance with Section 311 of the Public Utilities Code and Rule 14.3. Comments were filed on May 5, 2008 and reply comments were filed on May 12, 2008. To the extent changes were necessary as a result of the filed comments, they were addressed in the body of this decision.

## 17. Categorization and Need for Hearing

SGV requested that this matter be categorized as ratesetting. By Resolution ALJ 176-3196, dated July 26, 2007, the Commission preliminarily determined that this was a ratesetting proceeding and that hearings might be necessary. There was no objection to the ratesetting categorization.

A PHC was held on August 23, 2007 to establish issues and a hearing schedule. Following this PHC, on September 6, 2007, Commissioner Simon issued a Scoping Memo and Ruling confirming that this was a ratesetting proceeding and set a schedule that included an evidentiary hearing.

## 18. Assignment of Proceeding

Timothy Alan Simon is the assigned Commissioner and Michael J. Galvin is the assigned ALJ in this proceeding.

## Findings of Fact

1. On January 25, 2008, SGV and DRA filed a partial settlement agreement, Appendix A to this decision.

2. The burden of proof in GRC applications, such as this proceeding, rests upon SGV to demonstrate the reasonableness of its request.

3. A Valencia GRC decision (D.07-06-024) found that in the absence of evidence that a utility is manipulating its capital structure in order to achieve an artificially high rate of return, basing a rate of return calculation on its actual capital structure is consistent with a goal of ratemaking to approximate the economic returns that a regulated company would achieve in a competitive environment.

4. SGV seeks adoption of its projected actual capital structure for the test and escalation years.

5. Test year long-term debt ratio and costs of that debt were based on year end 2007 and year end 2008 data.

6. The March 2007 Global Insight 5.27% interest rate forecast used by SGV for calculating its long-term debt cost dropped 36 basis points to 4.91% in the September 2007 forecast.

7. An equity return is set at a level of return commensurate with market rates on investments having corresponding risks, and adequate to enable a utility to attract investors to finance the replacement and expansion of a utility's facilities to fulfill its public utility obligation.

8. Rate design is not in dispute.

9. SGV and DRA used DCF and RPM financial models to support their respective equity return recommendations.

10. SGV and DRA used a same proxy group of six Class A water utilities, two of which were California water utilities.

11. Quantitative financial models are commonly used as a starting point to estimate a fair equity return.

12. An important component of the *Hope* and *Bluefield* decisions is that a utility has the ability to attract capital to raise money for the proper discharge of its public utility duties.

13. Financial models are dependent on subjective inputs.

14. SGV and DRA used different time periods in their respective financial models' forecasts.

15. Financial risk is tied to a utility's capital structure.

16. Business risk pertains to uncertainties resulting from competition and the economy.

17. Regulatory risk pertains to new risks that investors may face from future regulatory actions that we, and other regulatory agencies, might take.

18. SGV used March 2007 ECSB inflation rates for its July 2007 application and updated October 2007 ECSB inflation rates for its November 2007 rebuttal testimony.

19. DRA used June 2007 ECSB inflation rates.

20. SGV and DRA concurred that they would not object to the use of the latest ECBS inflation rates used by SGV or DRA, or a more current version.

21. October 2007 ECSB inflation factors are the most recent inflation factors in this record.

22. SGV forecasted water sales losses due to enhanced conservation programs by multiplying a stated amount of water savings for individual water efficient plumbing fixtures and appliances times the number of plumbing fixtures and

appliances to be installed in the test and escalation years. The per unit water savings were based on the California Urban Water Conservation Council's computation formula.

23. SGV forecasted payroll, pension, and benefits based on April 2007 actual salary levels for all existing position in the LA, Fontana, and General Divisions plus step increases with all new positions assumed to be filled at the beginning of the test year.

24. DRA forecasted payroll separate from pension and benefits. DRA used 2006 recorded payroll data for individual employees of the LA Division and excluded vacant positions, step increases, a currently filled position, and new positions that it opposed being filled.

25. SGV has filled several of its vacant positions since the filing of its GRC but has had six new terminations during that same time period.

26. SGV provided justification for its prior hiring and filling of two Water Treatment Operator positions as part of its response to DRA's Master Data request.

27. SGV requested approval of adding a Customer Serviceman/Conservation Specialist position and a Water Treatment Operator III position in the LA Division.

28. The new Customer Serviceman/Conservation Specialists will be responsible for making approximately 40 customer contacts and 3 actual residential survey and audits per workday.

29. The new Water Treatment Operator III position will be responsible for additional monitoring and maintenance due to the approval of two new wells, three new booster stations, four new reservoirs, and six emergency generators in the GRC proceeding.

30. SGV negotiated a single umbrella insurance policy covering SGV and its affiliates with each entity being billed separately for their actual share of insurance.

31. SGV used a 10% overhead rate to forecast its test year recovery of overhead costs associated with the services SGV provides to its affiliates.

32. SGV did not explain how the 10% overhead rate applied to services it provides to its affiliates was developed.

33. SGV included General Division expenses and rate base investments in this proceeding to be reflected in test year rates for both the LA Division and Fontana Division, pursuant to D.07-05-062.

34. The Chairman of the Board of Directors is paid directly by SGV and directly by AWC for the time he devotes to those companies based on daily time records in conformance with the affiliated transaction rules (D.04-07-034 and D.93-09-036) adopted by the Commission.

35. SGV added and filled a Junior Draftsman position in the General Division due to increased workload.

36. SGV testified that the new Regulatory Analyst and Conservation Coordinator positions would be filled by the beginning of the test year.

37. The General Division established a Regulatory Compliance Coordinator position to transfer all non-core functions to a position where the incumbent can be expert in all non-core regulatory compliance issues and can identify, understand, and comply with increasingly complex and stringent regulations.

38. The latest El Monte office building expansion occurred in 1965.

39. The number of employees located at the El Monte office building has increased by 46 to 146 from 100 since 1965.

40. SGV initially requested authority to recover approximately $12.6 million of capital costs for either refurbishing or replacing the El Monte building.

41. SGV revised its El Monte building capital improvement request with a request to include $164,000 in General Division's rate base, of which $108,000 would be used to refurbish the El Monte building and $56,000 to undertake a space study at that building site.

42. SGV included $2.9 million, or 30%, of its $9.6 million forecasted cost for a new Fontana office building expected to be completed in December 2008.

43. SGV's Fontana Division was previously authorized to include only $4.9 million of a forecasted $6.0 million cost for a new Fontana office building subject to justification of whether the entire new building would be used and useful.

44. Common General Division costs and rate base investments are allocated between the LA and Fontana Divisions via a four-factor method.

45. LA Division does not have any customers receiving irrigation service under its Tariff Schedule No. LA-3l.

46. SGV provided a plan for satisfying the Commission's WAP for its LA Division that assessed the many separate elements of its water production, storage, distribution, and treatment facilities and operations. The plan also provided a road map for future utility plant additions to production, storage, distribution and water treatment facilities.

47. SGV did not comply with Rule 13.1 which requires water utilities to give notice of a hearing, not less than five nor more than 30 days before the date of a hearing, to entities or persons who may be affected thereby, by posting notice in public places and by publishing notice in a newspaper or newspapers of general circulation in the area or areas concerned, of the time, date, and place of hearing.

## Conclusions of Law

1. The partial settlement agreement submitted by the parties is reasonable in light of the whole record, consistent with the law, and in the public interest.

2. The adoption of the partial settlement agreement does not constitute approval of, or create precedent regarding, any principle or issue in this proceeding or in any further proceeding.

3. SGV's method of forecasting its test year long-term debt component of its capital structure was inconsistent with its test year time period and its test year forecasts of the common equity component of its capital structure and rate base.

4. Our review of the Valencia capital structure decision (D.07-06-024) found more dissimilarities than similarities between Valencia and GRC.

5. The Valencia capital structure decision was applicable only to Valencia and based on the facts presented in that proceeding, as such it cannot be considered precedent-setting for SGV.

6. There should be no reliance placed on a 1975 academic study used by SGV to support its projected actual capital structure because the study pertains only to unregulated entities.

7. A strengthening of shareholders' equity stake does not necessarily result in a strengthening of ratepayers interests.

8. Official notice is taken of Global Insight's September 2007 interest rate forecasts.

9. SGV has a duty to substantiate that its capital structure balances the interest of both shareholders and ratepayers.

10. A 37.0% long-term debt and 63.0% common equity capital structure, which is approximately midway between the average equity ratio of the comparable

water utilities used by the parties in this proceeding and SGV's projected actual capital structure, should be adopted.

11. A 7.70% long-term debt cost for the test year is appropriate due to a decline in forecasted interest rates and lack of justification for use of a 246 basis point premium above long-term Treasury rates.

12. A subjective equity return range deemed fair and reasonable for the test and escalation years is 10.5% to 11.0%.

13. Additional financial, business, and regulatory risks justify the adoption of an equity return toward the upper end of the equity range found reasonable in this proceeding. We find a 10.5% equity return fair and reasonable for the test and escalation years.

14. October 2007 ECSB inflation rates of 3.2% for labor and 3.0% for non-labor should be used for forecasting test year costs.

15. SGV provided no evidence on whether customers participating in the enhanced conservation programs would result in water sales losses to SGV.

16. Appropriate methods to forecast water sales losses are a policy issue that should be resolved on an industrywide basis.

17. SGV should seek appropriate recovery for loss of water sales due to its enhanced conservation programs in the conservation investigation (I.07-01-022) along with the other Class A water utilities.

18. DRA's water sales forecast should be adopted.

19. SGV's base payroll forecast of April 2007 actual salary levels, annualized and adjusted to reflect adopted ECSB inflation factors for the escalation years, should be adopted.

20. The 12 vacant positions included in SGV's base payroll calculation should be removed from the payroll forecast.

21. Although SGV identified specific employees eligible for step increases, it failed to include offsetting adjustments for the possible effects of departures and retirements of higher paid senior employees. Step increases should be excluded from the payroll forecast.

22. The two Water Treatment Operator positions previously filled should be included in the payroll forecast.

23. A new Customer Serviceman/Conservation Specialist position and a Water Treatment Operator III position should be included in the payroll forecast.

24. SGV's forecasted umbrella insurance costs should be adopted.

25. SGV's 10% overhead rate which is applied to direct services being provided by SGV for its affiliated companies should be adopted for this proceeding only.

26. SGV should be required to prepare and complete a study prior to its next General Division GRC that justifies an overhead rate to be applied for recovery of its overhead costs associated with its direct services being provided to its affiliated companies.

27. There should be no adjustment to the Chairman's salary because his time is based on daily time records in conformance with the Commission's affiliated transaction rules.

28. General Division's Junior Draftsman position added and filled by SGV should be included in its test year payroll, pension, and benefits.

29. General Division test year expenses should include the payroll, pensions, and benefits for a new Regulatory Analysts, Conservation Coordinator, and Regulatory Compliance Coordinator.

30. SGV's revised El Monte building request should not be considered a new or additional item, as set forth in the RCP, because SGV identified in its application a request to either refurbish or replace its El Monte building.

31. General Division test year rate base should be increased by $108,000 to cover the costs of El Monte building renovations.

32. SGV's $56,000 request to undertake a space study at its El Monte building is denied because it violates the RCP 45-day update rule.

33. The appropriate proceeding to resolve any allocation of a new El Monte building costs or space would be in the Fontana Division's next GRC.

34. SGV has substantiated the existence of an overcrowded space situation at the El Monte building.

35. General Division rate base should include $2.9 million for construction of a new Fontana building. That amount should be allocated $1.5 million to the LA Division and $1.4 million to Fontana Division, based on the adopted four-factor rate.

36. The LA Division's $1.5 million share of the new Fontana building should be made subject to refund, pending a review of building costs in the upcoming Fontana Division GRC.

37. Fontana Division's $1.4 million share of the new Fontana Division building should not be included in rates until the building costs have been reviewed for use and usefulness. Should the final amount of the new facility placed into Fontana Division rates by D.07-04-046 exceed the amount for which CWIP was allowed, the balance plus an allowance for funds used during construction should be placed into Fontana Division's rate base.

38. Test year common General Division costs being adopted in this proceeding should be allocated between LA Division and Fontana Division based the agreed upon four-factor rates.

39. The LA Division's adopted test year costs should include $652,000 for enhanced conservation programs. That amount should also be included in each of the LA Division's escalation years.

40. A one-way conservation balancing account for enhanced conservation programs should not be adopted.

41. The LA Division's Irrigation Schedule No. LA-3L should be cancelled.

42. SGV should file an advice letter with the Water Division for authority to amortize the remaining balance in its defense-related component within its WQLMA. Further costs recorded in the WQLMA should be recovered through the advice letter process as agreed to by SGV and DRA.

43. SGV has complied with all DHS water quality standards and regulations since its prior GRC.

44. Fontana Division's share of increased or decreased General Division costs should be recovered via a surcharge or surcredit.

45. SGV should be subject to the monetary penalties set forth in Section 2107 of the Public Utilities Code for its violation of Rule 13.1.

46. The criteria set forth in D.98-12-075 for assessing a fine to the facts in this application indicates that SGV should be assessed a fine totaling $1,000.

## O R D E R

**IT IS ORDERED** that:

1. The San Gabriel Valley Water Company (SGV) and the Division of Ratepayer Advocates partial settlement agreement attached to this decision as Appendix A is adopted.

2. The rate tables and tariff sheets in Appendix B are adopted.

3. SGV is authorized to file in accordance with General Order (GO) 96-B, and to make effective on filing, tariffs containing the 2008/2009 test year increase for its Los Angeles County Division (LA Division) as provided in Appendix B. The revised rates shall apply to service rendered on and after June 30, 2008 or the tariff's effective date, whichever occurs later.

4. On or after May 1, 2009, SGV is authorized to file in accordance with GO 96-B, a Tier 1 advice letter, with appropriate supporting workpapers, requesting an escalation adjustment for its LA Division to be calculated in conformance with the Rate Case Plan (RCP) and Appendix B. The advice letter shall be reviewed by the Commission's Water Division for conformity with this decision, including the applicable provisions of the settlement, and shall go into effect upon five days notice, not earlier than July 1, 2009. The tariffs shall be applicable to service rendered on or after the effective date.

5. On or after May 1, 2010, SGV is authorized to file in accordance with GO 96-B, a Tier 1 advice letter, with appropriate supporting workpapers, requesting an escalation adjustment for its LA Division to be calculated in conformance with the RCP and Appendix B. The advice letter shall be reviewed by the Commission's Water Division for conformity with this decision including the applicable provisions of the settlement and shall go into effect upon five days notice, not earlier than July 1, 2010. The tariffs shall be applicable to service rendered on or after the effective date.

6. SGV shall prepare and complete a study for inclusion in its next LA and General Division general rate case (GRC) that justifies an overhead rate to be applied for recovery of its overhead costs associated with its direct services being provided to its affiliated companies.

7. The LA Division's $1.5 million share of General Division's costs associated with a new Fontana Building that is included in test year rates shall be subject to refund pending a determination of use and usefulness in the upcoming Fontana Water Company Division (Fontana Division) GRC.

8. Fontana Division's $1.4 million share of General Division's costs associated with a new Fontana Building shall not be included in rates until the building costs have been reviewed for use and usefulness in Fontana Division's next GRC. Consistent with Decision (D.) 07-04-046, if the final amount of the new Fontana building placed into rates by D.07-04-046 exceeds the amount for which construction work in progress was allowed, the balance plus an allowance for funds used during construction shall be placed into Fontana Division's rate base.

9. SGV is authorized to file in accordance with GO 96-B, and to make effective on filing tariffs containing the 2008/2009 test year increase for its Fontana Division surcredit applicable to reduced General Division costs as provided in Appendix B. The revised rates shall apply to service rendered on and after June 30, 2008 or the tariff's effective date, whichever occurs later.

10. SGV shall cancel its LA Division Tariff Schedule No. LA-3L.

11. SGV shall file in accordance with GO 96-B, a Tier 1 advice letter, with appropriate supporting workpapers, for authority to amortize the remaining balance in its defense-related component within its Water Quality Litigation Memorandum Account (WQLMA). Future costs recorded in the WQLMA shall be recovered through the advice letter process.

12. SGV shall track its actual conservation expenditures associated with its yearly conservation budget approved by this decision and shall report the results as part of its next Los Angeles Division general rate application.

13. SGV shall file a conservation rate design application, including a Water Revenue Adjustment Mechanism, modified cost balancing account and conservation memorandum account proposals, for its LA and Fontana Divisions with 90 days of issuance of this decision. That application shall be coordinated with its Fontana Division's July 2008 GRC application and may be consolidated with Investigation 07-01-022.

14. SGV shall pay a $1,000 fine for violating Rule 13.1 of the Commission's Rules of Practice and Procedure within 20 days from the effective date of this order. SGV shall tender to the Fiscal Office of the California Public Utilities Commission a check in the amount of $1,000 made payable to the State of California General Fund. SGV shall also file, as a compliance filing in this proceeding, proof of payment with the Commission's Docket Office within 10 days of payment.

15. Application 07-07-003 is closed.

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