Decision 08-08-030 August 21, 2008

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Investigation to Consider Policies to Achieve the Commission's Conservation Objectives for Class A Water Utilities.	Investigation 07-01-022 (Filed January 11, 2007)
In the Matter of the Application of Golden State Water Company (U 133 E) for Authority to Implement Changes in Ratesetting Mechanisms and Reallocation of Rates.	Application 06-09-006 (Filed September 6, 2006)
Application of California Water Service Company (U 60 W), a California Corporation, requesting an order from the California Public Utilities Commission Authorizing Applicant to Establish a Water Revenue Balancing Account, a Conservation Memorandum Account, and Implement Increasing Block Rates.	Application 06-10-026 (Filed October 23, 2006)
Application of Park Water Company (U 314 W) for Authority to Implement a Water Revenue Adjustment Mechanism, Increasing Block Rate Design and a Conservation Memorandum Account.	Application 06-11-009 (Filed November 20, 2006)
Application of Suburban Water Systems (U 339 W) for Authorization to Implement a Low Income Assistance Program, an Increasing Block Rate Design, and a Water Revenue Adjustment Mechanism.	Application 06-11-010 (Filed November 22, 2006)
Application of San Jose Water Company (U 168 W) for an Order Approving its Proposal to Implement the Objectives of the Water Action Plan.	Application 07-03-019 (Filed March 19, 2007)

DECISION RESOLVING PHASE 1B SETTLEMENT AGREEMENTS AND RETURN ON EQUITY ADJUSTMENT

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DECISION RESOLVING PHASE 1B SETTLEMENT AGREEMENTS AND RETURN ON EQUITY ADJUSTMENT

In today's decision, the second of two Phase 1 decisions, we adopt two settlement agreements for Golden State Water Company (GSWC) on conservation rates, a revenue adjustment mechanism and a modified cost balancing account, and customer education and outreach, and data collection and reporting. We also adopt a settlement expanding a conservation memorandum account for California Water Service Company (CalWater). We adopt two settlement agreements for San Jose Water Company (San Jose) on conservation rates and a pricing adjustment mechanism, customer education and outreach and data collection and reporting. Adoption of these settlements concludes our implementation of conservation rate objectives advanced in the Commission's Water Action Plan (WAP) for the five Class A water utilities whose conservation rate design applications were consolidated with this investigation.

We also reject the Division of Ratepayer Advocates' (DRA) proposal to adjust the return on equity (ROE) in association with the adoption of decoupling water revenue adjustment mechanisms (WRAM) and modified cost balancing accounts (MCBA) in trial conservation rate design programs.

1. Background and Summary

The Commission opened this investigation to address policies to achieve its conservation objectives for Class A water utilities and ordered the consolidation of four pending conservation rate design applications — Application (A.) 06-09-006 GSWC), A.06-10-026 (CalWater), A.06-11-009

(Park Water Company (Park)), and A.06-11-010 (Suburban Water Systems (Suburban)).[1] Those objectives included adoption of conservation rate designs and revenue adjustment mechanisms that decouple sales from revenues. A prehearing conference (PHC) was held on February 7, 2007. A second PHC was held on July 11, 2007. The first phase of this proceeding addressed rate-related conservation measures, including the parties' increasing block rate and WRAM proposals and ROE adjustment.

The Phase 1 scoping memo issued on March 8, 2007. The Scoping Memo defined Phase 1 to include rate-related conservation measures, WRAMs, and Suburban's proposed low-income assistance program. A May 29, 2007 ruling established Phases 1A and 1B, consolidated San Jose's conservation rate design application, and set hearings in Phase 1B on whether the consolidated applicants' ROE should be adjusted if a WRAM was adopted.[2] The ruling asked the parties to address ten issues in their testimony on the ROE adjustment.[3] The

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[1] A January 16, 2007 ruling affirmed consolidation of the applications with the OII.

[2] The parties' Phase 1A filed settlements on conservation rate designs, WRAMs and MCBAs did not resolve the return on equity adjustment issue. CalWater/DRA/TURN stated in the amended settlement that the impact of the trial program on ROE is not a part of the settlement and deferred to the Commission's decision on any impact on ROE. Park and DRA stated that they had failed to agree on the impact the WRAM and rate design would have on return on equity and could address that issue by submitting testimony in this proceeding.

[3] Specifically, the ruling asked 1) what measures of risk should be considered in setting a return on equity and in determining whether these risks have been altered when a WRAM is applied? 2) What impact(s) could adopting a return on equity adjustment have on the Commission's conservation objectives for Class A water utilities? 3) Should any return on equity adjustment be made if the adopted WRAM recovers all fixed costs affected by the proposed conservation rate design? 4) Should the adoption of a modified cost balancing account affect whether a return on equity adjustment is adopted? 5) Should company-specific factors be considered in weighing whether a

Footnote continued on next page

Commission held five days of hearings on the ROE adjustment issue and one day of hearings on CalWater's conservation memorandum account in November 2007. In hearings, the administrative law judge (ALJ) requested that DRA provide an implementation witness to address how its proposal would be implemented. DRA and TURN sponsored one witness. DRA presented one implementation witness. CalWater, California American Water (CalAm), Park, and California Water Association (CWA) sponsored six witnesses.[4] Opening and reply briefs were filed on January 16 and February 6, 2008, respectively.

In D.08-02-036, the Phase 1A decision, the Commission adopted eight settlement agreements affecting CalWater, Park and Suburban on conservation rates, revenue adjustment mechanisms, MCBA, ROE adjustment, a low-income assistance program, customer education and outreach, and data collection and reporting. In an April 25, 2008 ruling, submission of Phase 1B was set aside to consider the GSWC and Joint Consumer settlement and the proceeding was

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return on equity adjustment should be adopted? What methods (e.g., Discounted Cash Flow (DCF); Capital Asset Pricing Model (CAPM); Risk Premium; Multiple Regression; other) for estimating any potential impact of a WRAM on the required return on equity should be utilized *prior* to instituting the WRAM? 6) What methods (e.g., DCF; CAPM; Risk Premium; Multiple Regression; other) for estimating any potential impact of a WRAM on the required, and achieved, return on equity should be utilized *after* instituting the WRAM? 7) How much historical data (e.g., 1 year? 3 years? 5 years?) would be required for an accurate estimate of this potential impact? 8) Should publicly-traded companies with similar operating, financial, and business risks be utilized for these calculations? 9) Is the experience of non-water utilities germane? 10) Should any return on equity adjustment be interim subject to reconsideration in the separate cost of capital proceeding?

[4] Suburban also sponsored a witness to address its pending settlement on ROE; D.08-02-036 adopted that settlement. San Jose offered a witness and withdrew it after San Jose and DRA's settlement, including an agreement on the ROE adjustment, was filed.

resubmitted on May 2, 2008. GSWC and DRA filed a motion for an extension of time from April 30 to July 15, 2008 to file the Region I conservation rate design application referenced in the settlement agreement. In a June 20, 2008 ruling, the motion was granted. In that ruling, submission was set aside until June 30, 2008 to consider the San Jose and Joint Consumer settlement.

The joint motions and settlement agreements addressed in this decision were filed before and after the Phase 1B hearings as follows:[5]

- GSWC/ DRA on conservation rate design trial program on October 19, 2007 and amendment to settlement on March 21, 2008;
- GSWC/Joint Consumers[6] on data collection and reporting, customer outreach and education initiatives on March 21, 2008;
- San Jose/DRA on conservation rate design and pricing adjustment mechanism trial program on November 14, 2007;
- San Jose/Joint Consumers on customer education and outreach and data collection and reporting initiatives on June 12, 2008; and
- CalWater/DRA on conservation memorandum account on December 21, 2007.[7]

The Consumer Federation of California's (CFC) request for hearings on the GSWC/DRA and San Jose/DRA settlement agreements was denied by October 30, 2007 and March 7, 2008 rulings, respectively.

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[5] The settlement agreements were e-filed with the Commission. The provisions of the settlements are summarized *infra*. The settlements can be obtained on the Commission's website under the index of currently opened proceedings.

[6] The Joint Consumers are The Utility Reform Network (TURN), the National Consumer Law Center (NCLC), Disability Rights Advocates (DisabRA), and Latino Issues Forum (LIF).

[7] Hearings were held on CalWater's conservation memorandum account proposal. The parties settled after hearings had concluded.

2. Standard for Reviewing Settlements

Our rules provide that:

> The Commission will not approve settlements, whether contested or uncontested, unless the settlement is reasonable in light of the whole record, consistent with law, and in the public interest. (Rule 12.1(d) of the Commission's Rules of Practice and Procedure.)

We will review the four settlements under this standard.

3. GSWC and San Jose Conservation Rate Design Proposals

The conservation rate design settlements are trial programs, which will be reviewed in the utilities' next general rate cases (GRC). The purpose of the trial programs is to initiate conservation rates; the rate design will change over time. We will examine the settlements' trial programs in light of our settlement objectives. CFC objects to various aspects of the settlements' rate designs and WRAMs.[8] The other parties do not oppose the settlement. We discuss CFC's objections below.

3.1. GSWC's Proposed Conservation Rate Design Settlement and Amendment to Settlement

The GSWC settlement and the amendment to the settlement incorporating the revenue requirement adopted in D.07-11-037 include conservation rate designs for two regions with recent rate designs and interim conservation rates for the remaining region pending completion of the company's GRC. No conservation rate designs are proposed for areas with unmetered service, low average consumption or Commission-imposed rate freezes in high-cost service

[8] CFC did not object to the amendment to the settlement.

areas.[9] One area with an existing three-tier tariff will not have additional changes in its rate design.

The settlement agreement as amended proposes conservation rate designs for six of the nine GSWC ratemaking areas.[10] The conservation rate design for residential customers in Regions II and III consists of a reduced service charge and increasing block rates. The two-tier increasing block rates are based on seasonal averages that are determined to be a proxy for indoor water consumption and will ensure that consumers with low and average use remain within Tier 1. Tier 2 rates will be approximately 15% greater than Tier 1 rates. Nonresidential customers will have reduced service charges and a uniform quantity charge that recovers a greater percentage of fixed costs than the current rate design. Service charges will be reduced by approximately 5-10% and the quantity charge will increase by no more than 10%.[11]

In Region I, the interim conservation rate design will be the same for both residential and non-residential customers. These customers will have a reduced service charge and a uniform quantity charge that recovers a greater percentage of fixed costs than existing rates. In only one of the four ratemaking areas in Region I are more than 70% of revenues recovered from the existing quantity charge. Within 90 days after the Region I GRC decision issues, GSWC will file an

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[9] The parties do not propose conservation rate designs for three ratemaking areas in Region I, Ojai, Arden Cordova, and Clearlake, and for two ratemaking areas in Region III, Wrightwood and Desert, including Apple Valley and Morongo.

[10] GSWC provides service to approximately 250,000 customers in three regions which are comprised of nine ratemaking areas.

[11] Rates will not change for other sales and services, other utilities for resale, flat-rate service connections and reclaimed/recycled customer classes.

application proposing revised conservation rates in a manner consistent with those proposed for Regions II and III in this settlement.

3.1.1. Comments on Conservation Rate Design

The Joint Consumers proposed that GSWC adopt aggressive notice and outreach measures to minimize customer confusion in the transition to conservation rates. Joint Consumers also propose data collection measures for monitoring purposes. The GSWC/Joint Consumers' settlement agreement on these issues is discussed *infra*.

CFC states there is no basis for the failure to propose increasing block rates for the four ratemaking areas in Region I pending the completion of the GRC for Region I. Instead, the settling parties have proposed decreasing the service charge and increasing the quantity charge for those ratemaking areas in Region I on an interim basis and no changes in three other ratemaking areas. We concur with CFC. In D.08-01-043, we adopted revised rates and a low-income assistance program for Region I. Since the proposed conservation rates for Region I do not conform to the recently adopted revenue requirement for Region I, we decline to adopt them here. GSWC and DRA agreed to modify the Region I rates within 90 days of resolution of the pending GRC, or April 30, 2008 and were granted two extensions of the settlement until July 15, 2008 and twenty days from the issuance of this decision for GSWC to file its application. That application shall govern the conservation rates adopted for Region I.

CFC states the settlement agreement fails to provide a cost allocation study underlying the creation of residential and non-residential customer classes. GSWC and DRA state no cost allocation study is necessary, because the settlement incorporates revenues currently recovered from residential customers and non-residential customers as separate groups and maintains the existing

allocation of costs between those classes of customers. The amendment to the settlement incorporates the revenue requirement recently adopted in D.07-11-037. In that decision, the cost allocation studies submitted by GSWC and DRA did not address deaveraging of rates into residential and nonresidential customer classes, because a single quantity rate was adopted in the GRC. In this proceeding, GSWC and DRA stated that they determined the revenue breakdown between residential and nonresidential customers by type of dwelling unit. Residential customers are all single residences with one dwelling unit and nonresidential customers are all other meter customers. Prior classification of residential customers fell into four categories, including single residences with one dwelling unit.[12]

The lack of an analysis of the deaveraging of rates between Regions II and III residential and nonresidential customers in GSWC's GRC does not assist us in assessing CFC's concerns here. However, we are not persuaded that a cost allocation study in this proceeding is the appropriate remedy. We have no requirement for cost allocation studies when rates change from a single quantity rate to rates specific for each customer class. In addition, cost allocation studies, if necessary, are best reviewed in GRCs.[13] Although GSWC and DRA state the proposed conservation rates recover the existing revenue requirement for

[12] The three other categories formerly included as residential were two three or four dwelling units served by one meter, five to twenty dwelling units served by one meter, and twenty-one or more dwelling units served by one meter. Exhibit 1, Exhibit (Attachment) 2.

[13] We make no determination whether a cost allocation study would have been preferable to developing rates based on the existing allocation between residential and nonresidential customers.

residential and nonresidential customers, the definition of residential customers has changed. Because customers with greater than one dwelling unit are now nonresidential customers, under the settlement a greater percentage of revenue requirement will be recovered from nonresidential customers.

CFC states that the conservation rates in Region III are not consistent with the California Urban Water Conservation Council's (CUWCC) best management practice (BMP) 11 requirement that 70% or more of revenues be recovered through the quantity charge. GSWC and DRA point out that CFC is discussing existing rates in Region III and not the proposed conservation rates. GSWC and DRA provide the breakdown of revenue requirement between the two classes. In the original settlement rates, the combined revenue recovery through the quantity charge when rounded equals 70%. However, the residential revenue requirement separately does not. In the amendment to settlement GSWC and DRA have adjusted the service charges for both Regions II and III to conform to the revenue requirement adopted in D.07-11-037 and state that the revenues recovered through the quantity charge now meet CUWCC's requirement.

CFC questions the residential conservation rate design proposed for Regions II and III. CFC criticizes how the settling parties determined winter usage and proposed rates, which may be adjusted to recover within 1% of revenues recovered under a single quantity rate. GSWC and DRA point out that CFC's concerns about the development of average winter usage are based on incorrect data. The data CFC references refer to the amended application, not the settlement agreement. DRA and GSWC state that achieving revenue neutrality by adjusting rates to recover the target revenue requirement, plus or minus 1%, is a common rate design approach. We concur that CFC's concerns

about the development of average winter usage and revenue neutrality of the proposed conservation rates are misplaced.

CFC also criticizes the impact of conservation rates on overall consumption in these regions and the establishment of a 15% difference between Tier 1 and Tier 2 rates. GSWC and DRA state that the 15% difference between tiers provides an incentive to reduce consumption while recognizing that conservation measures can require long-term investments, so a greater increase between tiers might result in a greater burden on customers in the short term. CFC disagrees because many conservation measures are not costly, for example, low-flow showerheads and leak detection and repair. GSWC and DRA counter that detection and repair of water leaks typically is very costly and time consuming.

We have not set a required minimum or maximum differential between tiers. Instead, we have examined parties' proposals on a case-by-case basis. The GSWC and DRA proposed differential between tiers is not inherently unreasonable for a trial program. Although CFC points out municipalities have differentials between tiers that are higher than proposed here, we have not required that utilities follow those rate structures. Since the trial programs will be assessed to determine whether they achieve targeted reductions in overall consumption, the differentials between tiers will be adjusted in future GRCs.

GSWC and DRA note that the number of residential customers in Regions II and III are 71% and 89% of all customers even though, as CFC discusses, overall sales for those customers are 40% and 58%, respectively. Conservation price signals through increasing block rates will affect more customers in both of those regions even though they are not customers with the highest consumption. Applying increasing block rates to a larger percentage of customers, even if sales

attributable to those customers are lower on a per customer basis, is not inherently unreasonable.

CFC claims nonresidential customers will not experience appropriate conservation signals since rate increases are limited to 10%. GSWC and DRA explain that non-residential customers have significantly higher consumption as reflected in sales data and, as a result, a 10% increase will be significant in dollar amounts. CFC also states that nonresidential customers will see rate decreases, not rate increases. GSWC and DRA point out that the proposed single quantity rate is an increase over the existing rate. Although some customers will realize rate decreases since there are decreases in service charges and increases in the quantity charge, increased usage will result in rate increases. A higher rate for greater usage is an appropriate conservation price signal.

CFC proposes that we adopt a budget-based rate approach for GSWC's non-residential customers where base indices of water use are determined from historical usage and the monthly bill is calculated by comparing actual usage with the base index.[14] We have permitted conservation rates for nonresidential customers to be based on CUWCC's requirement that 70% or more of revenues be collected through the quantity charge. GSWC has more than 37,000 nonresidential customers in Regions II and III.[15] GSWC and DRA state the

[14] CFC also is concerned that there is insufficient data to determine the impact of the proposed nonresidential conservation rates and recommends that additional data be collected. The proposed data collection and reporting settlement, discussed *infra*, includes usage information for nonresidential customers and should, at least in part, satisfy CFC's concerns.

[15] CFC applauds the settlement's categorization of multi-family households as nonresidential, since CFC recommended that approach in Phase 1A. In its testimony in

Footnote continued on next page

budget-based approach proposed by CFC is both time-consuming and costly. We will not require such an approach here. We will require GSWC to propose increasing block rates for its nonresidential customers in its next GRC.

CFC opposes the settlement's exclusion of the Wrightwood and Desert service areas from the conservation rate design included in the settlement. Wrightwood and Desert, including Apple Valley and Morongo Valley, are excluded because the Commission ordered that rates in these high cost areas remain frozen until rates in the other Region III service areas reach a similar level. Although the Region I and II GRCs recently were concluded, Region III was not. The rates in the Wrightwood and Desert service areas remain higher than other rates in Region III. Under D.00-06-075, GSWC is precluded from seeking any increase, or change in rate design that would increase, those rates. It is reasonable to exclude the Wrightwood and Desert service areas from the proposed conservation rate design.

CFC states the proposed rates are not seasonal rates. GSWC and DRA note that the proposed rates incorporate seasonality of water usage by using seasonal averages to establish breakpoints between Tier 1 and Tier 2. Seasonality of water usage results in rate increases for higher summer average usage. Usage at summer averages will result in customers' receiving bill increases. It is not necessary to adopt seasonal rates in order to capture seasonality. The proposed rate design is a reasonable means to address higher summer usage.

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this proceeding, CFC recommended that two GSWC categories of multi-family dwelling units be categorized as nonresidential. Exhibit 8, p. 4.

3.2. WRAM and MCBA

GSWC and DRA propose separate WRAMs for each ratemaking area, which will ensure recovery of the portion of GSWC's fixed costs that are recovered through the quantity charge and all variable costs not included in the MCBA.[16] The WRAM will track the difference between adopted and actual revenue.[17]

CFC recommends that we reject the proposed WRAM because it is unlikely that the proposed conservation rate design will result in any revenue loss to GSWC.[18] GSWC and DRA state that without a WRAM a rate design that is intended to promote conservation could substantially reduce GSWC's earnings. The WAP supported the adoption of decoupling mechanisms due to existing financial disincentives to conserve water. GSWC proposed reducing monthly service charges, because it was concurrently proposing a WRAM. With a WRAM, GSWC's earnings and revenue requirement would not be subject to the fluctuation of sales resulting from reducing service charges and recovering the costs captured in that portion of the service charges in quantity rates. (*See generally* Exhibit 1, pp. 13-14, 17.) Increasing block rates also increase volatility in sales, sales forecasts, and earnings. The proposed WRAM eliminates that volatility. (*Id.* at 14-15.)

[16] The variable costs included in the WRAM are variable costs other than purchased power, purchased water, and pump tax.

[17] Fire service, unmetered service and other non-general metered service revenues are not included.

[18] CFC's concerns about reduction in business risk and the impact on return on equity will be discussed in the return on equity adjustment section.

GSWC notes that for Region III's six water programs, GSWC's 2005 water conservation budget would save about 753 acre feet of normal annual consumption. That level of savings would result in a revenue loss of $567,000. (Exhibit 4, p. 6.) Adoption of a WRAM removes the risk of that revenue loss. Adoption of a WRAM also removes weather and economic risk associated with sales volatility from both GSWC and its customers. (*Id.* at 14.) A WRAM will not affect GSWC's incentive to reduce costs, since it only adjusts actual revenues or sales. (*Id.* at 17.) We conclude the record sufficiently demonstrates GSWC is at risk for any revenue losses associated with adoption of the conservation rate design. Although the proposed conservation rate design was modeled to be revenue neutral, there is no guarantee it will achieve that result.

The MCBAs will capture the cost savings and cost increases associated with purchased water, purchased power, and pump taxes by tracking the difference between actual and adopted variable costs. The MCBAs will replace the existing supply cost balancing account, which only tracks cost changes attributable to changes in unit price. GSWC stipulates that it will exercise due diligence in ensuring the least-cost mix of its water sources and will track significant changes in water purchases.[19]

Annually the over- or under-collection traced in the WRAMs and the difference between adopted and actual costs tracked in the MCBAs will be reported to the Commission's Water Division. If the combined over- or under-collection exceeds 2.5% of GSWC's prior year revenue requirement, the

[19] Significant changes occur when the annual volume of purchased water in a region is greater than 10% of the purchased water adopted in the most recently adopted test year for that region.

combined balance of the accounts will be amortized. Combined under-collections will be passed through as surcharges on volumetric charges; combined over-collections will be passed through as surcredits on volumetric charges.[20]

3.2.1. Adoption of Conservation Rate Design and WRAM/MCBA Settlement Agreement as Amended

We have reviewed the conservation rate design and WRAM/MCBA settlement as amended and CFC's objections to the specific rate design and decoupling WRAM. We find GSWC's trial conservation rate design will advance our conservation objectives; it incorporates increasing block rates for residential customers and moves its nonresidential customer class to CUWCC's requirement to recover over 70% of revenues through the quantity charge. We will review this rate design to determine whether it meets targeted reductions in consumption. If it does not meet these goals or is unlikely to meet future goals, GSWC will propose rate designs that will accomplish these goals.

GSWC's WRAM and MCBA will balance utility and ratepayer interests and will ensure neither is harmed nor benefits from the adoption of conservation rates. The WRAM and MCBA implement the WAP's objective of decoupling sales from revenues to encourage successful conservation programs. The GSWC/DRA settlement agreement is reasonable in light of the record, consistent with the law, and in the public interest and will be adopted.

[20] Remaining balances will be addressed in GRCs.

3.2.2. GSWC Data Collection and Reporting and Customer Education and Outreach Initiatives

GSWC and the Joint Consumers agree that GSWC will implement customer initiatives prior to conservation rates going into effect. GSWC will provide customers with conservation rate notices as a bill insert and will explain the impact of conservation rates on customers' bills.[21] The notice will provide key information in large type and in Spanish and how to get a large print or Spanish version of the entire notice.[22] GSWC will provide information on customer bills referring to the insert in both English and Spanish.[23] GSWC's website will include notices in both English and Spanish regarding the new conservation rates. GSWC will distribute notices to community based organizations and will make best efforts to partner with them to develop additional educational material.[24] GSWC will continue outreach efforts by making large type notices available to the visually impaired, making its website accessible to the visually impaired and establishing TTY accessibility.

GSWC will provide an annual report on conservation rates and WRAM that will provide data concerning the number of customers in each customer class, with residential and non-residential customers broken out, and bi-monthly customer usage in billing units, by ratemaking area and by customer class. This

[21] GSWC shall submit the proposed notice to the Commission's Public Advisor's office for review.

[22] GSWC also will distribute flyers in Spanish if the Commission approves tracking of costs for preparation and distribution of the flyers.

[23] This commitment is subject to space limitations on the bill.

[24] Notices will be submitted to the Public Advisor and will be distributed 30-60 days before conservation rates go into effect.

information will be provided for low-income ratepayer assistance (LIRA) customers. The report also will include bi-monthly usage for the current month of the current year versus prior year, using average customer profiles.[25]

The GSWC and Joint Consumer settlement was not opposed. The settlement provides a comprehensive customer education program, which advises customers of the benefits of conservation and the impacts of conservation rates. It requires comprehensive data collection and reporting that will assist in monitoring the impact of the trial program. The settlement is reasonable in light of the whole record, consistent with the law, and in the public interest. Thus, we shall adopt the settlement.

3.3. San Jose and DRA's Proposed Conservation Rate Design Settlement

The San Jose and DRA proposed settlement would implement a trial program consisting of two-tiered increasing block rates for residential customers and a pricing adjustment mechanism that is similar to the balancing account (also known as a WRAM) adopted for CalAm's Monterey District.[26] The parties agree that an adjustment to San Jose's ROE is not a contested issue. San Jose agrees to work with DRA and other consumer organizations to develop

[25] GSWC will provide additional information on a quarterly basis including separately compiled information on the number of residential and LIRA accounts, the number of accounts over 30 days past due and the dollar value of those accounts; the number of disconnection notices, the number of customers who have had service discontinued for non-payment and the number who have had service restored after discontinuance for non-payment.

[26] San Jose provides water service in one ratemaking area that consists of approximately 199,000 residential and about 16,000 nonresidential customers. All of San Jose's customers are metered, bills are provided on a bi-monthly basis, and San Jose has a Water Rate Assistance Program for low-income customers.

customer education and outreach and data collection and monitoring programs. San Jose agrees to withdraw its request to implement a Water Quality Expense Memorandum Account without a cap and the parties agree San Jose should be authorized to track no more than $150,000 of additional conservation expenses in a memorandum account.

3.3.1. Conservation Rate Design

San Jose and DRA propose modifying the current single quantity rate for all residential customer classes by establishing two quantity rates and a breakpoint between those rates. The upper level of the first consumption block is set at the mid-point between the average monthly consumption over an entire year and the average monthly consumption during the winter months. There are two proposed schedules for residential customers. One schedule is for customers with meters ranging from 5/8 to ¾ to 1-inch in diameter, and the other schedule is for customers with meters ranging from 1 to 2 inches in diameter. The Tier I quantity rate is approximately a 3.23% discount from the current rate, and the Tier II rate is approximately 10% above the Tier I rate.

CFC objects to the lack of a cost allocation study for the change from a single quantity rate for all customers to a tiered rate design for residential customers. San Jose and DRA state that the settlement maintains the existing allocation of costs among San Jose's customer classes adopted in D.06-11-015. CFC points out that the Commission adopted a settlement agreement in D.06-11-015 and in the GRC prior to the last one. CFC also states that residential customers with larger meters use more water than customers with smaller meters so rates should separately recover costs from each group.

Neither San Jose in its consolidated application proposing to deaverage rates nor the settling parties explain how rates were deaveraged into residential

and nonresidential customer classes.[27] The settling parties state that customers were classified by individual customer group (rate code) and that customers in the residential rate codes were separately analyzed. San Jose does not track multi-unit residential buildings; however, these buildings tend to have larger meters.

CFC disputes the methodology the settling parties used to set the breakpoints and states that breakpoints were not set at the mid-point between annual average monthly consumption and average monthly winter use. The settling parties explain the breakpoint for the group of residential customers with smaller meter sizes was based on ¾" meters because 86.7% of the customers had that type of meter. The breakpoint for residential customers with larger meters was based on data for 1½" meters because more than 80% of customers with larger meters have 1½" meters. We have not required conservation rates for each meter size. However, rates for each meter size more specifically target consumption in that group. We also do not know whether customers with smaller meter sizes share any common characteristics, for example whether they are more likely to be single residences. Similarly, it is unclear whether customers with larger meter sizes more likely to be multi-family dwelling units. San Jose believes many of its low-income customers reside in multi-family dwelling units served by larger meter sizes.

CFC states the proposed conservation rates will not encourage conservation. San Jose and DRA state the conservation rate design was set to prevent rate shock and to be consistent with the take-or-pay provisions in San

[27] Nonresidential customers include business, industrial, public authority, resale, private fire, and reclaimed/recycled.

Jose's contract with the Santa Clara Valley Water District (SCVWD).[28] San Jose must pay for at least 90% of the water scheduled over the three-year period of the contract under the take-or-pay provision and must contract for a minimum of 95% of the highest amount of water contracted for in any one year of those three years. This provision requires a gradual reduction in consumption in order to ensure San Jose does not pay for scheduled water its customers did not use. A gradual reduction in consumption is consistent with our targeted reduction in consumption.

CFC states a third rate tier should be created to encourage conservation. The third tier should be set at a level of use that exceeds 70 or 80% of other residential customers with the same meter size. CFC proposes an alternate rate design that establishes a third tier with a breakpoint at the amount of water used by 80% of San Jose's customers with residential meters. San Jose and DRA state that the alternate rate design is not revenue neutral and would recover more than the Commission-adopted revenue requirement in D.06-11-015. We have not required trial programs to include a third tier or established parameters that would require a third tier. We decline to require a third tier for San Jose.

CFC criticizes the settlement for failing to include any change to nonresidential rates. San Jose and DRA state the existing nonresidential rate design recovers approximately 80.93% of nonresidential revenues through volumetric rates. This recovery exceeds CUWCC's requirement of 70% or greater revenue recovery through the quantity charge. San Jose and DRA also state that it is more difficult to set fair quantity limits for commercial and

[28] San Jose's water supply mix adopted in D.06-00-015 includes 46% or more of its supply from SCVWD.

industrial customers. Based on the high percentage of revenue recovered from nonresidential customers under the quantity charge, lowering the service charge to recover additional revenues through the quantity charge is not necessary.[29] If no adjustment is made to the service charge, the quantity charge cannot be raised and still comply with the Commission's authorized revenue requirement. We have encouraged Class A water utilities to adopt block rates for residential customers, but have not required them to do so for nonresidential customers in this proceeding. We will require San Jose to propose increasing block rates for nonresidential customers in the GRC following implementation of its residential conservation rate design trial program for at least one year.

3.3.2. Pricing Adjustment Mechanism

San Jose and DRA propose a pricing adjustment mechanism similar to the Monterey-style WRAM. The pricing adjustment mechanism will track the difference between revenue San Jose receives for actual metered sales through the tiered volumetric rate and the revenue San Jose would have received through the uniform, single quantity rates if they had been in effect.[30] San Jose will provide an annual report showing the revenue over- or under-collection for the prior calendar year. If the over- or under-collection exceeds 2% of San Jose's adopted revenue requirement for the present year for amounts recovered through the quantity rates of residential customers, San Jose will file an advice

[29] San Jose's service charge was modified in 2006 in its last GRC decision, D.06-11-015.

[30] The balancing account will track the actual water amount sold in a month and apply the single quantity rate to result in an adjusted revenue amount for that month. The difference between the adjusted revenue and the actual revenue will be reflected in the balancing account. The account will not track revenues recovered through the service charge.

letter within 30 days that amortizes the balance in the account. If the cumulative 2% threshold is not met, the balance in the account will be amortized in the next GRC.[31]

The settling parties agree this mechanism complements San Jose's limited water supply and adequately ensures the recovery of sufficient revenue. CFC opposes adoption of the pricing adjustment mechanism because the rates are not true conservation rates. The proposed pricing mechanism ensures that San Jose's revenues do not decline as the result of adopting conservation rates. Although we find the pricing adjustment mechanism reasonable, we will not adopt it until the settling parties further clarify the conservation rate design.

3.3.3. Conservation Memorandum Account

San Jose and DRA agree that San Jose should be authorized to track additional conservation expenses in a memorandum account, not to exceed $150,000 a year, in addition to the amount authorized in D.06-11-015.[32] Recovery of these expenses is subject to a reasonableness review. In order to implement the Commission's water conservation goals, the Class A water utilities are incurring additional costs. It is reasonable to permit San Jose to track additional conservation expenses in a memorandum account.

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[31] Recovery of under-collections and refunds of over-collections will be passed on to ratepayers through volumetric surcharges and surcredits.

[32] DRA and San Jose state the amount authorizes for conservation expenses was $236,000 for 2007, as noted in Attachment E at p. 1. Attachment E to D.06-11-015 states conservation expenses were $61,600 for 2007.

3.3.4. Adoption of Conservation Rate Design and Pricing Adjustment Mechanism Settlement Agreement

We have reviewed the conservation rate design and pricing adjustment settlement and CFC's objections to the specific rate design and pricing adjustment mechanism. We find San Jose's trial conservation rate design will advance our conservation objectives; it incorporates increasing block rates for residential customers and nonresidential customers'rates, although unchanged, exceed CUWCC's requirements. We will review this rate design to determine whether it meets targeted reductions in consumption. If it does not meet these goals or is unlikely to meet future goals, San Jose will propose rate designs that will accomplish these goals.[33]

3.3.5. Customer Education and Outreach, Data Collection and Reporting

San Jose and the Joint Consumers agree that San Jose will implement customer outreach prior to conservation rates going into effect. San Jose will provide customers with conservation rate notices as a bill insert and will explain the impact of conservation rates on customers' bills in English, Spanish, and Vietnamese.[34] The notice will provide key information in large type. San Jose will provide information on customer bills referring to the insert in English, Spanish, and Vietnamese. San Jose's website will post notices regarding the new

[33] San Jose notes that its proposed conservation rates should be updated to reflect San Jose's rate changes subsequent to its adopted 2006 revenue requirement. The mechanism adopted in D.08-02-036, a Tier I compliance advice letter with prior DRA review and subject to Water Division review and disposition, should be used to update the settlement's proposed rates.

conservation rates in a clear and conspicuous manner, which will be accessible to screen readers. San Jose will provide TTY information on its bill. San Jose will take out newspaper ads and provide in-language flyers to targeted communities. San Jose will provide information on conservation rates and the low-income water ratepayer assistance program (WRAP) to community based organizations and will provide information about these organizations on its website.[35]

San Jose will provide an annual report on conservation rates and its price-based revenue adjustment mechanism that will provide data concerning the number of customers in each customer class, with residential and non-residential customers broken out, and monthly customer usage in billing units and by customer class. The report also will include monthly usage for the current month of the current year versus prior year, using average customer profiles. The report also will include monthly reconnections, disconnections, and 48-hour shut-off notices.[36] This information also will be provided for WRAP customers in an annual report. The WRAP report will include an estimated annual penetration rate, change in participation after notices, the total number of customer accounts over 30 days past due and the total dollar value of the past due accounts.

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[34] San Jose shall submit the proposed notice to the Commission's Public Advisor's office for review.

[35] Notices will be distributed 30-60 days before conservation rates go into effect.

[36] In its next GRC, San Jose will seek modification of its systems to provide additional information monthly on the number of residential and WRAP accounts over 30 days past due and the dollar value of those accounts; the number of disconnection notices, and the number of customers who have had service disconnected for non-payment. In addition, weather-normalized monthly usage data will be made available in San Jose's GRC at parties' request.

The San Jose and Joint Consumer settlement was not opposed. The settlement provides a comprehensive customer education program, which advises customers of the benefits of conservation and the impacts of conservation rates. It requires comprehensive data collection and reporting that will assist in monitoring the impact of the trial program. The settlement is reasonable in light of the whole record, consistent with the law, and in the public interest. Thus, we shall adopt the settlement. Implementation of the settlement is conditioned on adoption of the conservation rate design settlement.

4. CalWater Conservation Memorandum Account

CalWater and DRA agree that CalWater should have the flexibility to expand conservation programs for the for the Antelope Valley, Bear Gulch, Dominguez-South Bay, Hermosa-Redondo, Kern River Valley, Marysville, Palos Verdes, and Redwood districts. CalWater should be authorized to set up a conservation memorandum account in each of these districts, because the revised rate case plan delays the GRC for the Antelope Valley, Bear Gulch, Dominguez-South Bay, Hermosa-Redondo, Kern River Valley, Marysville, Palos Verdes, and Redwood districts by a year and a half.[37] The latest GRC decision for these districts, D.06-08-011, authorized a total conservation budget of $538,933 a year, to be booked into a one-way balancing account by district. As of July 1, 2007, CalWater had spent $182,340 of its authorized annual conservation budget. CalWater and DRA agree that the additional conservation funding from July 1, 2009 through December 31, 2010 should be $766,600 for all ten districts and sub-

[37] The conservation memorandum account for each district will be in effect from July 1, 2009 until December 31, 2010.

districts.[38] The settling parties propose that CalWater provide DRA a report of its planned conservation programs, program design and program evaluation for the 18-month period. CalWater agrees to focus on water conservation programs for low income customers in addition to other cost-effective programs. CalWater and DRA agree that the conservation memorandum account will be reviewed in 2011 through a Tier III advice letter filing. If there is a zero balance in the memorandum account and a balance in the one-way balancing account, the amount in the one-way balancing account will be returned to ratepayers as required by D.06-08-011.

No party opposed the settlement agreement. The settlement provides additional conservation funding to be booked into a memorandum account as a result of the delay in the GRC for these ten districts and sub-districts. Since we are encouraging Class A water utilities to increase their conservation efforts, it is reasonable to permit CalWater to book additional conservation expenses in the one-way balancing account for these districts for the 18-month period. Since the expenses booked to the account cannot be reviewed in these districts' GRC, review through the Tier III advice letter process is reasonable.

5. Return on Equity Adjustment

The scope of the proceeding was designed to resolve whether or not an adjustment to the ROE of a water utility is required as a result of the adoption of a WRAM.

While evidence was introduced at length on the general subject of risk mitigation, the record in this proceeding does not provide a reasonable basis to

[38] The proposed conservation budget limits for the 18-month period by district are attached as Attachment 1.

establish whether to make such an adjustment or provide sufficient precision to determine a range within which such an adjustment could be made to an ROE based on a change in a single risk factor in isolation. No party presented statistical analysis that would support a unique basis point adjustment. However, providing clarity on the ROE issue is beneficial for those companies that have adopted decoupling WRAM's and for those companies considering the adoption of a WRAM.

In summary, the arguments explaining why the adoption of the WRAM should be considered outside of a generic cost of capital proceedings are not persuasive. As stated by Dr. Vilbert, "The adoption of a RAM, if it is well designed, would simply offset the additional risk created by pursuit of the conservation policy.[39]" Therefore, we do not adopt DRA's proposals on an ROE adjustment.

5.1. Impact of WRAMs

The Commission's WAP concluded that water utilities had a financial disincentive to conserve water. Therefore, to advance the goals of conservation, the Commission would need to remove that disincentive. To begin the effort of changing the usage patterns and valuation of water, the first steps must address the linkage between utility profitability and the growth of water sales. At a minimum, the adoption of decoupling mechanisms for the water utilities was necessary. The question then becomes, has adoption of that one mechanism, in isolation, caused a change in risk that is sufficiently clear and precise so as to warrant an adjustment to the cost of capital.

[39] See Direct Testimony of Dr. Michael J. Vilbert on Behalf of CalAm, Oct. 19, 2007, Exhibit 33, p. 3, lines 20-21.

Dr. Vilbert's testimony raised the most persuasive arguments to address this question. He argues that a well-designed revenue adjustment mechanism should merely remove the increased risk that resulted from the adoption of policies that promote conservation. He cited the Commission's previous actions with regard to ERAM's and DRAM's to substantiate this conclusion. To further buttress his position he also raises a series of questions and concerns regarding the adoption of an adjustment to the ROE. He posits that the resultant risk change is not one that warrants a change in the cost of capital. Moreover, even if it could be determined that the WRAM affected the systematic risks of a utility, it is simply not possible to estimate the isolated changes to the cost of capital with sufficient precision to justify a change in an established ROE.

Furthermore, the effort to do so invites an even larger debate on how one would characterize the differences in regulatory environment, and business and financial risk. Is the isolation of one policy provision and its effects reasonable? Could there be the unintended consequence of diluting the meaningfulness of generic cost of capital proceedings that more holistically review a company's risks? Could other policies from the past that hadn't been given this same isolated review become suspect? As a result, would the regulatory environment be negatively affected? And are we further skewing the regulatory environment in California with regard to a water company's ability to earn its allowed rate of return at a time when we want to see more investment and more efficient use of resources?

Testimony from Susan Abbott also raises arguments against making an adjustment. In discussing the process of rating agencies' evaluation, she notes that any uncertainty of the regulatory environment at a time when attracting capital investment is critical, is viewed as a negative by investors. She argues

that "any diminution of California's water utilities' allowed returns on equity as a result of implementing WRAM's would be incompatible with equal treatment within the regulated monopoly segment of the economy of the State of California.[40]" In her testimony, she informs us that neither the financial community nor the rating agencies have specifically addressed the issue of diminution in business risk resulting from implementing a WRAM. She argues that while WRAM's are innocuous, ROE adjustments are not. She concludes that "The financial damage that arbitrary reductions in authorized returns would cause has the potential to seriously impede the water utilities in their efforts to maintain their financial integrity through the extremely challenging period of capital-raising and expenditures they currently face."[41] She concludes her testimony with a cautionary note about the need to recognize the extraordinary challenges[42] facing the water utilities and the resultant effect of reducing even further a water utility's ability to generate cash flow to cover its fixed obligations.

While DRA argues that the WRAMs eliminate almost all variations in earnings due to sales fluctuations,[43] there are other risks[44] to consider before

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[40] Direct Testimony of Susan D. Abbott for CWA, Exhibit 43, p. 11.

[41] *Id.,* p. 12.

[42] Those challenges include financial integrity, high levels of capital expenditures, a crucial need to promote conservation, the fragmented nature of the industry, contamination risks, security and transportation risks, unexpected condemnations, and the high levels of awareness about product quality which relate to the unique health and welfare risks of the water supply business.

[43] Testimony of Terry Murray, Exhibit 40, pp. 7-8.)

[44] Those risks include financial risk, operating/business risk, weather, variations in water supply, local and general economic conditions, systematic risk as measured by beta, unsystematic risk, implementation of the water action plan, etc.

assessing an ROE adjustment. They are best reviewed comprehensively in a cost of capital proceeding.

The utilities argue that the desired outcome and purpose of the WRAMs and MCBAs is to ensure that the utility and ratepayers are proportionally affected when conservation rates are implemented.[45]

The Commission has previously found that balancing accounts that relieve a company of additional variability in its revenues and/or expenses do so by shifting that risk to ratepayers, but it doesn't necessarily result in an adjustment to the ROE in the authorizing decision.[46]

We conclude that the adoption of WRAMs cannot be used, in isolation, to adjust a previously authorized ROE. Rather, we conclude that the WRAM mechanism, as designed, will stabilize revenues.

5.2. DRA's Proposed ROE Adjustment

DRA's methodology looks at changes in earnings volatility as the key indicator of how adoption of a WRAM affects water utility risk and the required ROE. (Exhibit 39.) DRA asserts increasing the percentage of fixed cost recovery guaranteed through a WRAM increases justification for an ROE adjustment. DRA recommends relying on the change in earnings volatility, as applied in the context of the Capital Asset Pricing Model (CAPM) to determine the magnitude of the appropriate ROE adjustment before the adoption of a WRAM as well as

[45] The proportional impact is defined as resulting in neither harm nor benefit to the utility or ratepayers from changes in consumption over the forecast level in the context of the settlement agreement.

[46] "Consequently, we expect that in future proceedings all of these existing and adopted protections against erosion of future earnings will be given their proper weight in the determination of risk and consequently return on equity." (D.05-07-022, Section VII.G.)

after. Because it is not possible to observe the change in earnings volatility before adoption of the WRAM, DRA recommends the Commission use its informed judgment to determine the expected change in earnings volatility.

The Class A water utilities state DRA's recommendation is without foundation. The utilities assert adoption of a WRAM will have no impact on a utility's nondiversifiable risk. Instead, they assert that the only impact will be on diversifiable risk.

Therefore, the parties disagree on whether the WRAMs and MCBAs impact nondiversifiable risk and should result in a lower cost of capital. The utilities assert most differences between actual and forecasted sales are due to weather conditions. Since weather is a diversifiable risk, there should be no impact on the cost of capital. (Testimony of Dr. Michael Vilbert, Exhibit 33, p. 26; *see also* Testimony of Dr. Thomas Zepp, Exhibit 26, pp. 4-5.) DRA states weather is not entirely diversifiable and is not the only factor that results in a difference between actual and forecasted sales. CalWater testified that weather, economics and demographics all influence actual sales. (Testimony of Dave Morse, Exhibit 4, p. 14.) CalAm notes other components affecting sales—unexpected changes in demand, unanticipated conservation from another source, and unanticipated changes in recreation habits. (Exhibit 35, Answer 2.) DRA states the impact of climate change on weather is not a diversifiable risk and notes that CalAm's witness Dr. Vilbert is in accord. (DRA's reply brief, p. 13.) DRA states the Commission can determine that the WRAMs and MCBAs affect both diversifiable and nondiversifiable risk.

We have not previously concluded that decoupling mechanisms exclusively impact diversifiable risk. In setting ROE for energy utilities, we have not quantified the impact of decoupling mechanisms but have noted those

mechanisms reduce risk. (D.93887, 7 CPUC2d 349, 357; D.82-12-055, 10 CPUC2d 155, 162.)

The utilities find no support for the methodology used by DRA in the articles relied on by DRA. They fault DRA's methodology for assuming that the WRAM reduces all risks by the same factor, whether they are diversifiable or nondiversifiable. In rebuttal, witness Vilbert points out that the underlying paper[47] upon which DRA witness Murray relies, uses three accounting variables to forecast the systematic risk: earnings variability, payout ratio, and average asset growth. An appropriate implementation of this theory, he argues, would involve forecasting the effect of the WRAM on all accounting variables used in the prediction, not just one.

Utilities note that analysts rely on stock returns to estimate nondiversifiable risk and not on accounting variables. (Exhibit 34, p. 7.) DRA states the articles provide sufficient support for its conclusion that there is a correlation between accounting earnings volatility and nondiversifiable risk. Dr. Vilbert challenges the notion of a "correlation" relationship as a substitute for a causal relationship. In summary, the utilities' witnesses offered testimony that supports their conclusion that accounting variables are not the best measure of the change in risks due to the WRAM.

CalWater and GSWC's witness analyzed market reaction to recently approved decoupling mechanisms for eleven gas utilities. He found no significant change in share price at one, seven, or 90 days from the date of

[47] Beaver, Wiliam, Kettler, Paul, and Scholes, Myron, "The Association Between Market Determined and Accounting Determined Risk Measures," The Accounting Review, October 1970.

approval of the decoupling mechanism. (Testimony of Walter S. Hulse III, Exhibit 45, p. 6.) He also focused on two gas utilities that operate exclusively in the same state from the public announcements of requests for decoupling mechanisms and found no sustained increase in share price. (Exhibit 45, p. 10.) Regardless of whether or not the gas industry experiences are representative of the water industry in this regard, CWA's witness examined credit rating agencies' perceptions of adoption of electric revenue adjustment mechanisms for California energy utilities and found the agencies did not heavily weight these mechanisms in their rating deliberations. (Testimony of Susan Abbott, Exhibit 43, p. 2.) This raises the point of whether or not it is rational to make an adjustment when financial market participants wouldn't.

Witness Abbott stresses greater concern with the regulatory action to arbitrarily reduce the ROE. Negatively impacting cash flow at a time when the water industry is facing environmental requirements, aging infrastructure and the challenges of being a capital intensive industry speaks to the soundness of overall regulatory policy. Such an adjustment, on an industry that is already a net negative cash flow business, has the potential to impede their ability to raise capital. Park also raises the cash flow issue. The transition to conservation rates and a WRAM can result in under-collection and lost cash flow until the WRAM is amortized. The impact on small companies, such as Park, is greater than on large ones. On an industry that is already hugely fragmented, we cannot ignore the additional burdens on companies that are smaller. As Abbott points out, large electric utilities, with large debt offerings, have the ability to attract CalPERS dollars whereas, NO California water utilities have successfully done so (even with more attractive returns than other CalPERS investments).

We have only one methodology before us to examine the reduction of risk on the utilities' ROE following the removal of sales related risk by the WRAM, DRA's proposal to measure earnings volatility. DRA asks us to do that in the absence of relevant financial models.[48] Buried within DRA's methodology of estimating volatility and multiplying it by the difference between authorized ROE and the value of a government bond, is the recommendation for the Commission to exercise considerable judgment without sufficient supporting analysis in estimating a reduction in earnings volatility and possible impact on required ROE. It has been shown, through cross-examination and rebuttal testimony, to be a unique methodology. The DRA proposal is loosely based upon the precedent from a previous drought OII when the Conservation Memorandum Accounts were adopted. At that time, there was no requirement for water companies to file a GRC every three years, unless the Commission opened an OII requiring such a filing. Given the lack of any filing requirement and the short-term nature of the drought, it would have made sense for the Commission to reason that consideration of the ROE impact could not be deferred to the next normally scheduled ROE determination because there would be no certainty as to when that might occur. While we commend DRA for its creativity and attempt to quantify an isolated change in ROE due to the adoption of a WRAM, we will not adopt this methodology.

[48] DRA witness Murray uses the Risk Premium model (and indirectly, CAPM), by referring to the risk-free rate plus the difference between the ROE and the Risk Free rate. She uses accounting variables for earning volatility correlated with systematic risk. The witness did not use, or at least did not mention using, the DCF model.

5.3. Future Determination of Impact on Risk

To obtain a more accurate estimate of the impact of a WRAM on the required ROE, we would need more data, collected subsequent to implementation of the ROE adjustment. Ideally these data would include ROE estimates at a minimum using Discounted Cash Flow (DCF), Risk Premium (RP), and CAPM models. These ROE models should be applied to the company in question (if publically-traded) and other (publically-traded) companies of comparable business, financial, and regulatory risk, and other relevant risk factors. Preferably, there would be an analysis of regulated utilities with comparable risk factors, and which have been authorized a revenue adjustment mechanism similar to the WRAM we are considering, but we realize this will be a very limited sample. Ideally, we would also prefer that there be at least 30 months of data with the RAM in effect, either for comparable companies or for the water utilities authorized in this proceeding to implement a WRAM.

The Commission's determination of the required ROE would benefit from a multiple regression analysis which has the required ROE (estimated by the ROE models identified above) as a dependent variable impacted by various independent variables, including but not limited to: business risk, financial risk, regulatory risk, WRAM, other adjustment mechanisms, balancing accounts, customer income, GNP, taxes and fees paid by the utility, population, inflation, unemployment rate, time-of-year, weather, water rates, variability in water supply, and risk of inadequate water quality .

In summary, the Cost of Capital proceeding is the most appropriate venue to explore these relationships. In this context, one can adequately consider the interconnectedness of all policies and risks, the cumulative effect of risks from all new and ongoing policies, and the resultant impact of the cumulative effects of

policies. In the water arena, where the conflicting policy goals of low rates and reliable water supply are becoming harder and harder to balance, it is imperative to refrain from isolated decision making with regard to the financial earnings of a diversely-challenged industry based upon one policy.

6. Comments on Alternate Proposed Decision

The alternate proposed decision of Commissioner John A. Bohn in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities code and comments were allowed under rule 14.3 of the Commission's rules of Practice and Procedure. Comments were filed on July 29, 2008[49] and reply comments were filed on August 4, 2008.

7. Assignment of Proceeding

John A. Bohn is the assigned Commissioner and Janice Grau is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. The joint motions to adopt settlement agreements and settlement agreements were filed as follows:

- GSWC/DRA on conservation rate design trial program on October 19, 2007 and amendment to settlement on March 21, 2008;
- San Jose/DRA on conservation rate design and pricing adjustment mechanism trial program on November 14, 2007;
- CalWater/DRA on conservation memorandum account on December 21, 2007;

[49] San Jose requested and received an extension until July 31, 2008 to file its comments.

- GSWC/Joint Consumers on data collection and reporting, customer outreach and education initiatives on March 21, 2008; and
- San Jose/Joint Consumers on customer education and outreach and data collection and reporting initiatives on June 12, 2008.

2. The motions to adopt settlement agreements, comments, and testimony provide a comprehensive record for consideration of the settlements.

3. GSWC's proposed residential conservation rate design for Regions II and III consists of two-tier increasing block rates based on seasonal averages that are determined to be a proxy for indoor water consumption and will ensure that consumers with low and average use remain within Tier 1. There is a 15% difference between Tier 1 and Tier 2 rates. GSWC's proposed nonresidential rate design reduces service charges and includes a uniform quantity charge that covers a greater percentage of fixed costs than the current rate design. Rate increases are limited to 10%. The amendment incorporates the revenue requirement adopted in D.07-11-037.

4. The interim proposed rate design for Region I customers reduces service charges and increases the quantity charge, because the Region I GRC was pending when the settlement was filed. Conservation rate designs will be proposed for Region I on or before twenty days after the issuance of this decision.

5. D.00-06-075 precluded GSWC from seeking a rate increase in the Wrightwood and Desert service areas until other Region III service areas reach a similar level of rates.

6. The WAP supported the adoption of decoupling mechanisms due to existing financial disincentives to conserve water.

7. GSWC proposes separate WRAMs for each ratemaking area, which will track the difference between actual and adopted revenue and amortize over- or under-collections if they exceed 2.5% of GSWC's prior year revenue requirement.

8. GSWC's Region III water programs would save about 753 acre feet of normal annual consumption for a revenue loss of $567,000.

9. San Jose's proposed residential conservation rate design consists of two-tiered increasing block rates by setting the upper level of the first consumption block at the mid-point between the average monthly consumption over an entire year and the average monthly consumption during the winter months. The Tier 1 rate is approximately a 3.23% discount from the current rate, and the Tier II rate is approximately 10% above the Tier 1 rate. There are two proposed schedules, one for customers with smaller meter sizes and the other for customers with larger meter sizes.

10. San Jose's proposed conservation rate design is consistent with the take-or-pay provisions in San Jose's contract with the Santa Clara Valley Water District. (SCVWD). San Jose must pay for at least 90% of the water scheduled over the three-year period of the contract under the take-or-pay provision and must contract for a minimum of 95% of the highest amount of water contracted for in any one year of those three years.

11. San Jose's nonresidential rate design will not change. The existing nonresidential rate design recovers approximately 80.93% of nonresidential revenues through volumetric rates.

12. San Jose's proposed pricing adjustment mechanism tracks the difference between revenue San Jose receives for actual meter sales and the revenue San Jose would have received through the uniform, single quantity rates if they had been in effect. If the over- or under-collection exceeds 2% of San Jose's adopted

revenue requirement for the present year for amounts recovered through the quantity rates of residential customers, San Jose will file an advice letter to amortize the balance in the account.

13. The Commission has found that balancing accounts relieve a company of additional variability in its revenues and/or expenses and that future proceedings would weigh that impact in determining risk and adopting a return on equity.

14. WRAMs that decouple sales from revenues eliminate almost all variations in earnings due to sales fluctuations. MCBAs ensure predictable cost recovery.

15. The effect of WRAMs and MCBAs adopted in Phase 1 of this proceeding will not be reflected in market data of California utilities contained in financial models examined in cost of capital reviews.

16. Implementation of the WRAMs will greatly reduce utilities' earnings volatility compared to the situation that would prevail in their absence. Whether they reduce earnings volatility below that which would remain in the absence of other conservation-inducing policies is not clear.

17. DRA recommends a 50 to 100 basis point reduction in authorized ROE since it reflects a 10 to 20% reduction in earnings volatility.

18. The Commission reviews information that reflects' investors' perceptions of risk and uses its own judgment in assessing risks.

19. The Commission generally has found that decoupling mechanisms reduce risk, all other things being equal.

20. CalWater and GSWC's witness found no significant change in share price at one, seven or 90 days after the approval of decoupling mechanisms for gas utilities.

21. CWA's witness found credit rating agencies did not heavily weight electric revenue adjustment mechanisms in their rating deliberations.

Conclusions of Law

1. The proposed settlements generally are reasonable in light of the whole record, consistent with the law and in the public interest.

2. The conservation rate designs will advance the WAP's conservation objectives and will be reviewed to determine whether they meet targeted reductions in consumption. The GSWC WRAMs and MCBAs implement the WAP's objective of decoupling sales and revenues to encourage successful conservation programs. The San Jose pricing adjustment mechanism meets San Jose's unique circumstances.

3. Implementation of WRAMS and MCBAs may result in a diminution of shareholder risk relative to ratepayers, other things being equal.

4. It is reasonable to delay quantification of an ROE adjustment until it can be reviewed comprehensively with other risk changes in a cost of capital proceeding.

5. In order to promptly implement conservation rates, WRAM/pricing adjustment mechanism, MCBAs, customer education and outreach, data collection and reporting, and conservation memorandum accounts and changes to those accounts, this decision should be effective immediately.

O R D E R

IT IS ORDERED that:

1. The following settlement agreements are approved and adopted:
   - Golden State Water Company (GSWC)/Division of Ratepayer Advocates (DRA) on conservation rate design trial program and

amendment to settlement except the interim rate design for Region I;

- San Jose Water Company (San Jose)/DRA on conservation rate design and pricing adjustment mechanism trial program;
- California Water Service Company (CalWater)/DRA on conservation memorandum account;
- San Jose, TURN, NCLC, DisabRA, and LIF on customer education and outreach and data collection and reporting initiatives on June 12, 2008; and
- San Jose, TURN, NCLC, DisabRA, and LIF on customer education and outreach and data collection and reporting initiatives on June 12, 2008.

2. GSWC and San Jose shall provide the following information in their next general rate cases: monthly or bimonthly (depending on the billing cycle) per customer or service connection changes in consumption by district, separated by meter size and customer class, following the implementation of the conservation rate design trial program; surcredits or surcharges by district and customer class implemented in amortizing water revenue adjustment mechanisms (WRAM) and modified cost balancing accounts (MCBA) for GSWC and pricing adjustment mechanism for San Jose; increase or decrease in disconnecting low-income program participants for nonpayment by district after adoption of conservation rate designs; increase or decrease in low-income program participation by district after adoption of conservation rate designs; increase or decrease in residential disconnections for nonpayment by district after adoption of conservation rate designs; identification of any weather or supply interruption that might contribute to consumption changes in districts; and any other district-specific factor that might contribute to consumption changes.

3. Class A water utilities whose residential conservation rate design trial programs have been implemented for at least one year shall propose increasing block rates for nonresidential customer classes in the next general rate case.

This order is effective today.

Dated August 21, 2008, at San Francisco, California.

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