STATE OF CALIFORNIA GRAY DAVIS, Go vernor

PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298

February 20, 2003

TO: ALL PARTIES OF RECORD IN APPLICATION 02-04-022

Decision 03-02-030 is being mailed without the Concurring Opinion of Commissioner Lynch. The Concurring Opinion will be mailed separately.

Very truly yours,

ANGELA K. MINKIN
ANGELA K. MINKIN, Chief
Administrative Law Judge

ANG:tcg

Attachment

ALJ/JCM/tcg **Mailed 2/20/2003**

Decision 03-02-030 February 13, 2003

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of the California-American Water Company (U210W) for an Order Authorizing it to Increase its Rates for Water Service in its Monterey Division to Increase Revenues by $5,725,300 or 22.47% in the Year 2003; $1,772,100 or 6.94% in the Year 2004; and $996,500 or 3.02% in the Year 2005.	Application 02-04-022 (Filed April 15, 2002)

Lenard G. Weiss, Attorney at Law, Lori Anne Dolqueist, Attorney at Law, and David P. Stephenson, for California-American Water Company, applicant.
Laura Tudisco, Attorney at Law, and Yoke Chan, for the Commission's Office of Ratepayer Advocates, protestant.
David A. McCormick, Attorney at Law, for United States Department of Defense and Federal Executive Agencies; David C. Laredo, Attorney at Law, for Monterey Peninsula Water Management District; Darryl D. Kenyon, for Del Monte Forest Property Owners Association, and Monterey Commercial Property Owners Association; interested parties.

OPINION RESOLVING GENERAL RATE CASE

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OPINION RESOLVING GENERAL RATE CASE

Summary

California-American Water Company (CalAm) is authorized a $2,642,100 (10.36%) general rate increase in its Monterey Division for test year 2003, $948,410 (3.37%) for test year 2004, and $714,320 (2.46%) for attrition year 2005. We continue Monterey Division's per-capita rate design where it now applies, establish a new four-block rate design to promote conservation in Hidden Hills and Ryan Ranch, and combine Ambler Park and Bishop rates into a single tariff. CalAm is authorized to establish two new conservation and rationing-related memorandum accounts, and to extend its Water Revenue Adjustment Mechanism (WRAM) balancing account and its State Water Resources Control Board (SWRCB) Order WR 95-10 memorandum account. There is insufficient information in the record to determine that the amounts in CalAm's WRAM balancing account, its SWRCB Order WR 95-10 memorandum account, its Endangered Species Act memorandum account, and its expense balancing account are reasonable and should be recovered from ratepayers.

Background

CalAm provides public utility water service to approximately 106,000 customers in various areas in San Diego, Los Angeles, Ventura and Monterey counties. In early-2002 CalAm acquired the water utility assets of Citizens Utilities Company of California, adding another 60,000 customers in four districts located in Sonoma, Santa Cruz, San Mateo, Sacramento and Placer Counties. This general rate case (GRC) involves only CalAm's Monterey Division. CalAm is a California corporation and a wholly owned subsidiary of American Water Works Company, Inc., which announced in September 2001 that it is being acquired by RWE Aktiengesellschaft, Thames Water Acqua

Holdings GmbH. The effects of that acquisition (Application (A.) 02-01-036) were not considered in this proceeding except as specifically noted below.

Monterey Division

CalAm's Monterey Division provides water service to approximately 38,200 customers on the Monterey Peninsula and vicinity, encompassing the cities of Carmel-by-the-Sea, Pacific Grove, Monterey, Sand City, Del Rey Oaks and part of Seaside, much of the Carmel Valley, the Highway 68 corridor, and several other nearby unincorporated areas. The last general rate increase for Monterey Division was authorized by Decision (D.) 00-03-053 as modified by D.01-10-014; there have been various other rate adjustments since that time.

Because the issues in Monterey Division's general rate cases are so intertwined with the area's longstanding critical water supply problems, we provided an overview of the Monterey Peninsula's water supply situation and CalAm's involvement in D.00-03-053. Rather than repeat that background, we give a brief summary and update here.

CalAm's Monterey Peninsula Water Supplies

CalAm supplies approximately 85% of the Monterey Peninsula's water. It develops its supply from Carmel River surface water and wells in the Carmel Valley, Seaside basin, and along the Highway 68 corridor. CalAm has two large storage facilities on the Carmel River, San Clemente Dam and Los Padres Dam. It has been apparent for some time that despite the best efforts of CalAm, the Monterey Peninsula Water Management District (MPWMD), the local community and others, during periods of drought there is simply not sufficient water to satisfy fully both environmental requirements and unrestrained municipal water demands, but various factors prevented construction of any new, major storage facilities in decades past. By 1976, the U.S. Army Corps of

Engineers had developed estimates for a proposed New San Clemente Dam, but local opposition left it unfulfilled. The drought of 1976-1977 brought water rationing, increased public concern, and state enactment of the Monterey Peninsula Water Management District Law, followed by local voters' creation of MPWMD in 1978.

MPWMD has taken an active role in each of CalAm's last three Monterey Division GRCs. MPWMD's mission is to "manage, augment, and protect water resources for the benefit of the community and the environment" of the greater Monterey Peninsula area. Its charges include managing and regulating water use, reuse, reclamation and conservation, and financing water public works projects. Almost all of CalAm's Monterey Division water system lies within MPWMD's 170 square mile jurisdiction.

In 1995 the State Water Resources Control Board added a major new legal constraint to the Monterey Peninsula's physical water supply limitations. SWRCB, following hearings begun in 1992, acted on complaints alleging that CalAm's Carmel River water use was without valid rights and adversely impacted environmental and public trust values. In Order WR 95-10, it directed CalAm to cut its Carmel River diversions to 14,106 acre-feet annually and implement conservation measures to bring that figure down by 20% more beginning with the 1997 water year.

In November 1995, voters turned down MPWMD's proposal to improve supplies by financing approximately $116.5 million to construct a 24,000 acre-foot New Los Padres Dam on the Carmel River. To further complicate matters, two Carmel River animal species were later listed as threatened, bringing the possibility of additional water production limits imposed under the federal Endangered Species Act.

CalAm characterizes the SWRCB in Order WR 95-10 as having, in essence, directed it to solve the water supply problem. According to CalAm, to correct the unauthorized diversion, SWRCB directed CalAm to either (1) obtain appropriative permits for water being unlawfully diverted from the Carmel River, (2) obtain water from other sources of supply, and/or (3) contract with another agency having appropriative rights to divert and use water from the Carmel River, i.e., the MPWMD per SWRCB Decision 1632.

In response, CalAm has proposed constructing a new facility, the Carmel River Dam and Reservoir Project, "physically identical to the New Los Padres Project previously proposed by MPWMD, except no water is dedicated for growth." CalAm currently has pending before the Commission A.97-03-052 for the certificate of public convenience and necessity it would need to proceed. In compliance with D.98-08-036 in Applications 98-05-008 through 98-05-011 and a ruling in A.97-03-052, CalAm is also now preparing a proposal for a long-term water supply solution for the Monterey Peninsula should the Carmel River Dam and Reservoir Project not go forward, the so-called "Plan B."

We previously expressed our strong preference that CalAm work cooperatively to develop mandatory conservation and rationing plans consistent with complementary measures to be developed by MPWMD. MPWMD subsequently enacted Ordinance 92 establishing an expanded water conservation and standby rationing plan, and we authorized CalAm to adopt Ordinance 92 as its conservation and standby rationing plan.

Many of CalAm's proposed expenditures considered in this GRC, and in particular a number of its Special Rate Requests, relate to these projects, its water supply constraints, and the company's efforts to address them.

CalAm's Application

CalAm filed the application on April 15, 2002, and the Commission in Resolution ALJ 176-3086 preliminarily determined this to be a ratesetting proceeding expected to go to hearing. Assigned Commissioner Michael Peevey's June 17, 2002 scoping ruling confirmed the category and need for hearing, defined the issues, established a schedule, and designated assigned Administrative Law Judge (ALJ) McVicar as the principal hearing officer and thus the presiding officer.

CalAm's application requests the overall rate increases shown in Table 1 to compensate it for increased expenses and capital investment costs in excess of increased revenues over time. In addition, it seeks Commission approval of twelve so-called Special Rate Requests described in the Discussion section below, some of the rate effects of which are not included in the Table 1 figures.

Table 1

Revenue Requirement Increases

	2003		2004		2005	
	$ (000)	%	$ (000)	%	$ (000)	%
CalAm						
Application Request	5,725.3	22.47	1,772.1	6.94	996.5	3.02
Revised Request	3,077.6	12.07	1,112.2	3.89	825.4	2.78
ORA						
Initial Recommendation	(2,465.4)	(9.63)	325.2	1.41	357.8	1.53
Revised Recommendation	(2,619.3)	(8.50)	474.9	2.03	578.3	2.98
Adopted	2,642.1	10.36	948.4	3.37	714.3	2.46

CalAm prepared its GRC request using an 11.00% return on common equity, which it estimates would produce 8.97% and 8.92% rates of return on rate base for test year (TY) 2003 and TY2004, and 8.87% in attrition year (AY) 2005.

The ALJ held a prehearing conference on June 3, 2002 and five days of evidentiary hearings from August 19 through August 23. The proceeding was submitted upon receipt of a late-filed reconciliation exhibit and concurrent briefs filed September 9.

Discussion

Summary of Earnings

The CalAm-proposed, ORA-proposed, and adopted summaries of earnings are shown in Appendix A. CalAm and ORA agree on many summary of earnings figures. We discuss their differences below.

Operating Revenues

ORA's operating revenue estimates are slightly higher than CalAm's for TY2003 and TY2004. The difference is due entirely to their differing estimates of usage per customer in the Bishop service area. Most of their other water sales and operating revenue estimates were based on two-year (2000 and 2001) and three-year (1999, 2000, and 2001) averages of historical consumption; but for Bishop CalAm made an exception and used as its test year estimates the 2001 recorded usage, while ORA used a 2000 and 2001 average. CalAm points out that the Bishop area is growing through the addition of smaller tract homes that use less water, a marked downward usage trend is evident in the historical data, and a single large tract now being developed should continue that downward trend. ORA agrees that Bishop's growth will continue through the addition of small tract homes, but argues that there was a sufficient number of customers (181 in 2000, and 255 in 2001) to validate its two-year estimating method. The recorded usage per customer figures CalAm presented in its exhibit show a very strong downward trend for 1999 through 2001 and lead us to accept CalAm's lower estimates for the test years.

Operation Expenses

Pumping

After having initially differed in both test years' estimates due to the use of different escalation factors, CalAm and ORA now agree on the TY2003 and TY2004 base pumping expense estimates before adjustment. ORA has adjusted its TY2003 figure downward by $40,000 to reflect the savings it expects CalAm to realize by completing Investment Project 00-084 Phase III. It did not make the same adjustment in TY2004. ORA has recommended capital funding in 2002 and TY2003 to complete the project, and it became apparent on cross examination that ORA's witness had mistakenly made the $40,000 adjustment in TY2003 rather than in TY2004 when the project would be complete. We accept ORA's adjustment but shift it from TY2003 to TY2004.

Transmission and Distribution – Meters

CalAm and ORA disagree over the proper historical time period to be used to calculate these expenses. CalAm used an escalated five-year average (1997 through 2001). ORA used an escalated two-year average (2000 and 2001) as being more typical because CalAm incurred extraordinarily high expenses in 1998 to replace thousands of one particular type of defective meter. CalAm responds that most of those were meters that would have had to be replaced in 2000 and 2001 in the normal course, so that 2000 and 2001 were extraordinarily low expense years. Simple inspection of CalAm's recorded figures going back to 1996[1] bears out its contention: meter replacement expenses in 2000 and 2001 were far lower than in any other year. We adopt CalAm's TY2003 and TY2004 figures.

Transmission and Distribution – Miscellaneous

The remaining difference between CalAm and ORA for this account is in their estimates for post-September 11 enhanced security expenses, as described in Special Rate Request (SRR) #12 below. We have accepted ORA's estimates for both test years.

[1] Exhibit CA-1, Tab B, Table 6-3.

Maintenance Expenses

Pumping Equipment

ORA's TY2003 estimate for this account is $135,572 based on the most recent three-year inflation-adjusted average of recorded expenditures. CalAm used the same method, but a five-year average to arrive at its initial TY2003 estimate of $146,100, and then on rebuttal increased its estimate to $161,619 without explaining why. CalAm charges ORA with choosing a three-year average because 2000 and 2001 were dryer and more mild than earlier years, producing lower expense amounts. CalAm says it chose a five-year average to capture the effects of earlier, wetter years with more inclement weather and higher pump repair expenses. The TY2004 amounts and methods paralleled those for TY2003.

Looking at the expense history in the record, it appears that each side chose its averaging period to optimize the result in its favor: of the five years at issue, 1997 and 1998 show the highest expenses and 1999, 2000, and 2001 the lowest. We will use CalAm's initial TY2003 and TY2004 estimates (without its later increases) as being a middle ground between the parties' most recent estimates. We also believe that longer periods are in general more likely to average out the extremes.

Transmission and Distribution Mains

The differences between CalAm's and ORA's TY2003 and TY2004 estimates for this account parallel those for Pumping Equipment, above. The 1998 and 1999 recorded expense figures are far higher than those for 2000 or 2001. ORA used the past two years' data, producing the lowest possible averages, and CalAm used the last four years, producing the highest possible averages. Again, CalAm cites recent mild weather compared to earlier, wetter years, and again it increased its initial estimates without explanation.[2] And again we will use CalAm's initial TY2003 and TY2004 estimates as being a middle ground

Transmission and Distribution – Meters

The 1996 through 2001 recorded figures in the record for this account show a strongly declining trend, from a peak of $13,800 in 1997 to $1,900 in 2001. ORA notes the trend to justify using the last recorded (2001) figure as its TY2003 and TY2004 estimates. CalAm on rebuttal claims those figures, taken from its application, are in error and have been corrected. CalAm has not provided the revised figures for the record, and ORA is silent on whether corrections were indeed needed. With such a sparse record to rely on, we will split the difference for this relatively small account and use $4,000 for each test year.

Administrative and General Expenses

Office Supplies and Other Expenses

Both parties used inflation-adjusted four-year averages for estimating the components of this account. ORA, however, dropped 1999 from one of its component averages, "because of wide variations in the dollar figures." This leads CalAm to charge that ORA has intentionally chosen years which produce its desired lower result. While we might consider it reasonable to make such an adjustment once the reason for a seemingly inconsistent recorded figure

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[2] On brief, ORA also cites increased SCADA (Supervisory Control and Data Accumulation) equipment in the system since CalAm's last GRC as a reason for favoring the more recent recorded data, but nowhere does the record reflect how that would lead to lower costs in this account.

has been evaluated and explained, there is no indication ORA has done that here. We accept CalAm's figures for each test year.

Employees' Pensions and Benefits

The differences in this account are due to ORA's lower payroll expense estimates and lower escalation factors. As explained in the Payroll Expense section below, we will use ORA's payroll expense estimates. CalAm escalated health care premiums by 10% annually into the test years, based on historical trends and direction from its parent, while ORA used a 4.5% inflation factor provided in the Energy Cost of Service Branch's June 2002 Memorandum and derived from the monthly DRI-WEFA "U.S. Economic Outlook." CalAm has accepted the DRI factors for most other accounts, and on rebuttal even increased its estimates to reflect them. It does not accept them for this account. We adopt ORA's estimates.

Regulatory Commission Expenses

CalAm's application estimated regulatory expenses at $96,000 spread over three years, or $32,000 for each test year, and on rebuttal it increased those estimates to $171,368, or $57,100 annually. CalAm explains, "since 1989, a majority of all issues and all of CalAm's general rate cases were either stipulated or settled." Because this case was not settled, CalAm hired outside consultants to testify, used more counsel time, and brought in parent company employees to participate in the evidentiary hearings. ORA reduced components of the company's request related to public meetings, working hours, hotel costs and miscellaneous expenses to arrive at $14,500 annually for three years.

ORA objects to CalAm's untimely, significant increase in its estimate, an increase that it learned of only on the Thursday before hearings began the following Monday. While we understand CalAm's position, we agree that ORA was disadvantaged in that regard. More importantly, however, ORA points out that a major part of the increased rate case expense CalAm is claiming is for two out-of-state expert witnesses brought in to present rebuttal testimony. In the first case, the witness' firm is retained by CalAm's parent as its auditor, he has done and continues to do work for the parent, and those paid relationships are expected to continue. That witness charges CalAm $650 per hour. In the second case, the witness is a principal in a consulting firm which has done and is currently doing work for CalAm's parent, hopes and expects to continue to receive its business in the future, and charges $500 per hour. In addition to pointing out these witnesses' obvious conflicts and high costs, ORA maintains, and we agree, that neither witness' testimony was of significant help in developing the record.

It is understandable that CalAm's costs in 2002 to pursue this case would be higher than in years past. Given the long history of GRC settlements, however, we decline to assume that the costs of this GRC will be typical of all GRCs in the future. We adopt a regulatory expense level of $120,000 over the next three years, or $40,000 annually in the test years. That is far higher than ORA advocates, somewhat higher than CalAm estimates as typical based on its past GRCs, but less than its late-presented estimate in this GRC.

Outside Services

The recorded expenses for this account have varied widely over the years with no perceptible trend, from a high of $285,000 in 1996 to a low of $95,600 in 2001. CalAm's $136,600 figure for TY2003 is a five-year average escalated using ORA's factors. ORA believes CalAm was not sufficiently responsive in providing a detailed list of legal services in this account, so ORA used the abbreviated list for 2000 and 2001 it did receive, adjusted that list, and arrived at an estimate of $44,400 for TY2003. CalAm's figure appears to fall reasonably within the range of recorded expenses for this account since 1996; ORA's is far below even the lowest recorded figure. We accept CalAm's TY2003 and TY2004 estimates.

Miscellaneous General Expenses

The largest single component of this account is CalAm's Special Rate Request #8 for $450,000 (TY2003) to promote conservation under MPWMD's Ordinance 92. We have reduced that amount to $330,000 for each test year as explained under SRR#8 below. ORA's estimates for the remaining components of the account differ from CalAm's application estimates by much smaller amounts, but CalAm subsequently increased its estimate on rebuttal and we are unable to evaluate its revised non-conservation related total from the information in the record. Considering the relatively small net difference between ORA and CalAm for the non-conservation related components and ORA's lack of coherent support for its estimates, we will accept CalAm's application estimates for both test years, but with $330,000 in annual conservation expenses. The resulting figures are $845,500 (TY2003) and $852,200 (TY2004).

Payroll Expense

For estimating purposes, the parties separated out payroll from the expense accounts and show them separately in the summary of earnings. ORA's payroll expense figures were slightly lower than CalAm's. CalAm's estimates of union and non-union salaries were based on 4% annual increases. ORA's later estimates adjusted union salaries to reflect the 3% annual salary increase provided for in CalAm's union contract. For non-union payroll, ORA used the most recent DRI labor escalation factors, 1.8% for TY2003 and 2.9% for TY2004.

On brief, CalAm acknowledges the later 3% union increase and says it would stipulate to using 3% for both union and non-union salaries for Monterey Division employees. For union salaries, we will use the actual 3% escalation in the contract. For non-union salaries, CalAm states on brief, "CalAm has provided actual annual salary increases of well over 4% for the past four years and expects this level of increase to continue." Recorded payroll figures provided by the company, however, show recorded total expensed payroll growing at a 2.50% compound annual rate from 1996 through 2001.[3] This gives us confidence that the DRI-derived estimates ORA has used for non-union labor expenses are reasonable for our purposes. We will adopt ORA's estimates for both union and non-union payroll expense for both test years.

Plant in Service

ORA reviewed each of the more than 60 plant construction projects CalAm proposed in its application. By the time briefs were filed, the parties had narrowed their differences to the projects listed in this section.

Security Improvements

CalAm proposed $521,500 for capitalized security items in 2002, and smaller amounts in TY2003 and TY2004. ORA examined a detailed list of those items and determined that $320,000 of the 2002 amount was appropriate, and that the remainder for 2002 was either duplicated in other capital categories or unneeded. CalAm does not agree, but its response has been limited to general

[3] Exhibit CA-1, Tab B, Table 6-1.

statements and it has not explained the specific amounts ORA deleted. ORA agrees with CalAm's TY2003 and TY2004 amounts. We accept ORA's estimate for 2002 and the parties' agreed-upon TY2003 and TY2004 amounts.

Carmel Valley Filter Plant Clearwell

CalAm's CWIP (Construction Work In Progress) at the end of 2001 included $5,000,600 associated with its Carmel Valley filter plant clearwell project. ORA proposes to delete $213,000 in combined design, construction administration, and inspection costs as being in excess of the industry standard for such projects. CalAm on rebuttal explained that the higher amounts were due to, among other causes, significant challenges it faced in addressing concerns raised by the local homeowners association. This explanation came too late for ORA's witness to evaluate it and respond.

ORA apparently does not dispute that the funds were expended, only whether the expenditures were prudent. ORA's reliance on an industry standard percentage that gives no consideration to the complexity of a particular project does not provide sufficient justification to make a disallowance in this instance. Since this project was essentially complete by the time of ORA's investigation, the actual figures from the company's plant or construction records should have been available. If ORA intends to press disallowances such as these in the future, we suggest it support them with at least rudimentary audits of the underlying accounts. We accept CalAm's 2001 end-of-year CWIP estimate for the project.

Water Treatment Improvements

CalAm's application proposed $398,700, $250,000, and $250,000 in 2002, TY2003 and TY2004 for water treatment improvements. ORA reviewed a detailed cost estimate provided by CalAm which showed a cost of

$250,000 in 2002 for filter media work at the Carmel Valley filter plant and nothing in TY2003 and TY2004. CalAm did not describe any further work needed under this heading for TY2003 and TY2004, so ORA adjusted its estimates accordingly. On rebuttal, CalAm's witness acknowledged the $250,000 expenditures for TY2003 and TY2004 had been postponed, but also presented for the first time a replacement estimate of approximately $75,000 each year for ongoing work at various, unspecified locations. CalAm has provided little support for those fill-in estimates. We accept ORA's position.

Ambler Park Improvements

CalAm proposed construction work of $60,000, $209,000, and $290,800 in 2002, TY2003 and TY2004 for improvements to its Ambler Park water system. ORA reviewed a budget report provided by CalAm and concluded that the majority of the work on the project had already been completed and booked to plant. That conclusion appears to have been wrong. CalAm provided evidence[4] showing a schedule of expenditures by year through TY2004, and an engineering cost estimate for the entire $1,000,000 project. CalAm's evidence did show a different figure, $226,000 rather than $290,800, for additions in TY2004. We accept CalAm's estimates for the Ambler Park project, but with $226,000 for additions in TY2004.

Small Main Replacements

For small main replacements, CalAm proposed $281,000 in 2002 expenditures and $300,000 annually for TY2003 and TY2004. ORA reviewed the narrative description supporting the project and found that all of

[4] Exhibit ORA-15, a portion of CalAm's response to Master Data Request #6

the seven mains listed would fit into the budget and schedule for completion in 2002. At the beginning of the proceeding and again in May 2002, ORA had made data requests that should have led CalAm to include more detail about its small main replacement program, but CalAm did not do so. ORA accepted CalAm's $281,000 figure for 2002, and, since CalAm had not identified any other mains for replacement in TY2003 and TY2004, ORA recommended no funding for those years.

In rebuttal testimony served just days before hearings began, CalAm provided a list of potential main replacements for TY2003 and TY2004. CalAm went on to explain that specific mains to be replaced are not known until a district field staff review each fall identifies them for the following year's budget. CalAm may have discussed this main-identification process with ORA during a field visit earlier in the investigation, but it apparently neglected to describe it in response to ORA's data requests until shortly before hearings began. From CalAm's explanation, it appears that CalAm may not yet have a reliable list for TY2003 and TY2004, and that the mains identified in hearings were more illustrative than actual.

To choose reasonable TY2003 and TY2004 figures for the small main replacement program, we will focus on three things: ORA's recommendation of zero allowance; the CalAm witness' statements that this is an ongoing program and "the work proposed for 2002 is fairly consistent with... what we expect to have done in 2003 and 2004"; and prior years' expenditures. The witness' statements taken together imply a measure of year-to-year consistency in CalAm's expenditures for small main replacements. The pre-TY2003 data in the record show actual 2001 expenditures of $18,890 (plus another $16,307 carried over in CWIP at the end of 2001),[5] and CalAm's estimate of $281,000 for 2002. Given these figures, we will allow $150,000 for each test year, mid-way between CalAm's and ORA's recommendations, and roughly in the center of the 2001-2002 expenditure range.

Middle Canyon Road and Carmel Way Mains

These are two undersized mains that CalAm proposes to replace during TY2003 and TY2004. ORA says that they show no evidence of leaks, and the projects' purposes are "to improve fire flow, etc." ORA sees no urgency and therefore recommends their replacement be deferred to the next GRC cycle. CalAm views both as "necessary and critical for maintaining the integrity of the distribution system," and implies (but does not state) that, in addition to increasing fire flow, replacing them will improve distribution system pressures and hydraulics.[6] We agree with CalAm: there may be justifications for replacing mains other than reducing leakage; improving fire flow is one of them. We allow the amounts CalAm requests: For Middle Canyon Road, $150,000 in TY2003; for Carmel Way, $50,000 in TY2003 and $300,000 in TY2004.

Carmel Valley System Improvements

CalAm proposes $671,000, $800,000, and $1,725,000 in 2002, TY2003, and TY2004 for a new well, raw water transmission main, and treatment plant modifications. As it did for another project described above, ORA proposes to delete $355,000 in combined design, construction administration, and inspection costs as being in excess of the industry standard percentage for

[5] Exhibit ORA-1, Table 8-1, repeated in Table 8-2.

[6] Exhibit CA-21, Q&A 17.

such projects. CalAm responds that this project is a series of interrelated components, each requiring a separate design approach, a separate construction timetable, and corresponding inspection. In this case, the project was just getting underway in mid-2002 when ORA's investigation was done, so we are dealing with rough estimates that could not be audited rather than actual costs. That the project is not yet well defined can be seen from CalAm's statement on rebuttal: "CalAm will be working with National Marine Fisheries Service over a long period of time to develop and ultimately install specific improvements in this endeavor." CalAm's estimate of the various overheads is a considerably higher percentage of the project cost than for the other project ORA advocated reducing, and CalAm has not provided ORA or this record with a good breakdown of its estimate. We accept ORA's estimates for the project.

Endangered Species Act Expenditures

As discussed in the SRR#10 section below, we adopt ORA's figures for CalAm's capitalized Endangered Species Act-related expenditures: $550,000, $500,000, and $300,000 in TY2003, TY2004 and AY2005. These amounts will be used as estimates of CWIP in rate base for ratesetting in this GRC cycle; CalAm's actual expenditures will be booked into CWIP as they are incurred, and eventually into plant in service when the associated capital projects are completed.

San Clemente Dam Retrofit, and Carmel River Dam Project

As discussed in the SRR#2 section below, we adopt the following capitalized expenditure amounts and require they be classified as CWIP and included in rate base. For pre-1/1/02 expenditures: San Clemente dam retrofit, $4,406,700; and Carmel River dam project, $2,852,900. For 2002, TY2003 and TY2004 expenditures: San Clemente dam retrofit, $666,300,

$1,000,000, and $1,000,000. For Carmel River dam project, $750,000, $750,000, and $750,000.

Other Projects

ORA recommends not including in this GRC the estimated costs of several of CalAm's proposed capital projects. Instead, ORA would have CalAm submit advice letters seeking Commission approval for rate base offsets when the projects are completed and the costs accurately known. We accept ORA's recommendation for the following projects:

a. Sludge drying beds at Begonia plant (project #2). Estimated to be complete in TY2004 at a maximum cost of $750,000.

b. New well and arsenic treatment at Hidden Hills (project 02-083). Estimated to be complete in AY2005 at a maximum cost of $1,750,000.

c. Arsenic treatment at Ambler Park and Luzen wells (project 02-085). Estimated to be complete in AY2005 at a maximum cost of $4,100,000.

d. Carmel Valley Road 24" main (project #14). Estimated to be complete in AY2005 at a maximum cost of $5,000,000.

Depreciation Expense and Reserve, and Rate Base

The only differences in depreciation expense and reserve relate to the differences in CalAm's and ORA's estimates of plant in service, discussed above. CalAm used a straight-line remaining life composite depreciation rate of 3.02% based on a study it commissioned in early-2002.

At the close of evidentiary hearings, ORA disagreed with CalAm's operational working cash calculations, a component of rate base. On brief, ORA reported that further discussions with CalAm had led it to support

CalAm's working cash results. The only other differences in rate base relate to plant differences discussed above.

Taxes

CalAm and ORA agree on the tax rates and methods used to determine payroll taxes, ad valorem taxes and income taxes. The remaining differences in their figures result from differing estimates in other areas.

General Office

CalAm's general office expenses are typically presented for Commission examination every three years with its Monterey Division GRC. After determining the allowable general office expenses and investments, the results are then spread to all of the affected operating districts as expense amounts. CalAm and ORA agree on many general office figures; their remaining differences are explained here.

Salaries

CalAm and ORA differ on three issues that affect general office salaries: escalation factors; a new director of governmental affairs position; and a management incentive program.

To estimate general office salaries, CalAm used a constant annual escalation factor of 4%. CalAm states that it "has provided actual annual salary increases of well over four percent over the past four years and expects this level of increase to continue." It views that increase level as being necessary to retain associates in a highly competitive market. ORA used the most recent DRI labor escalation factors, 1.8% for TY2003 and 2.9% for TY2004. We adopt the lower DRI escalation factors ORA has used.

CalAm supports its request for added funding for a director of governmental affairs with this statement:

> Increased legislation in the areas of water quality standards and environmental rules is resulting in an ever-increasing impact on the Company and our ratepayers. It is in the interest of our ratepayers and the Company to have a knowledgeable employee responsible to keep current on new legislation and the legislative process in order to advocate lawmaking based on good science in the area of water quality and reasonable, feasible implementation of environmental policies consistent with the need to provide our customers a reliable water supply.

On cross-examination, however, it became clear that the company has not well thought out just what this new position would do, or it if has, the description is not consistent through its presentation here. The president of American Water Works Service Company, to whom this new position would likely directly or indirectly report, was the first to testify: "There is no new position for director of government affairs. There is an existing position for director of government affairs who has been with the company for a number of years.... It is not a new position for the company." CalAm's sponsoring witness, testifying later, was unsure whether this is indeed a new position or a realignment of existing positions: "I can't recall if we have had this position within our company before, but certainly it is a renewed effort to have this position." She thereafter shifted to describing it as a new position. Under ORA cross-examination, the witness resisted characterizing it as a lobbying position, but the job description, later introduced as Exhibit ORA-17, shows that, if this is not a lobbyist position in the legal sense, lobbying is certainly one of the major functions it would serve on the company's behalf. These were the first five of nine "principal responsibilities" of this position:

> Monitors and provides input to positively influence proposed legislation and emerging issues that could affect the company.
>
> Assists in determining action or positions regarding government matters.
>
> Develops and maintains effective working relationships with federal, state and local legislators, officials and members of regulatory authorities.
>
> Assists the President in communicating with governmental officials at all levels regarding company positions on federal/state legislation and regulations.
>
> Coordinates communications and personal contacts by company management with elected and appointed officers.

Three of the remaining four principal responsibilities were directed at promoting the company's media and public relations. Not one principal responsibility specifically mentioned water quality standards, water reliability, implementing environmental rules, or indeed, promoting any interest of CalAm's ratepayers whatsoever.

With already high rates and a greater than 30% increase request pending for this GRC cycle, we would be hard-pressed to explain to ratepayers on the Monterey Peninsula why their rates should be further increased to fund this position.

CalAm's application described its management incentive plan:

> [T]here is an additional $389,198 per year included in total salaries that is not subject to payroll taxes. This addition is a deferred long-term performance-based incentive plan implemented by the Company

> in 1994, effective as of January 1, 1993. Under the plan, designated executives and other key employees are eligible to receive awards if performance goals based on earnings-per-share growth and total return to company stockholders, in comparison to a designated peer group of water companies, is met. We have included in rates the historical percentage of the expected payout. The incentive plan in lieu of salary increases relates to merit once an employee reaches the average expected wage level for that position. This program was accepted in full by staff in the prior two CalAm GRC proceedings.[7]

CalAm's witness later clarified several points on rebuttal. First, any incentive payout is based not only on American Water Works Service Company's financial performance goals, but on achieving certain customer satisfaction goals as well. Second, the plan's customer satisfaction goals include, among other criteria, "no public or customer notification of a violation of any state or federal drinking water regulation or monitoring/reporting failure...." Third, CalAm paid out in 1999 only 62% of the incentive plan budget; in 2000 only 50%; and in 2001, 113%. Higher ranking employees are eligible for higher percentage payouts, and awards are determined by the compensation committee of the company's board of directors.

As ORA points out, the fact that management incentive plan funding was accepted in rates for CalAm's previous rate cases is not relevant to this proceeding. Commission decisions in those earlier proceedings each adopted settlements that represented compromises of strongly held positions by the settling parties, and those prior settlements convey no precedential value for

[7] Exhibit CA-1, Tab C, page 3-1

this proceeding. And, as ORA also notes, CalAm in 2002 did have violations of state or federal drinking water regulations: eight "boil orders" in the Monterey Division and a compliance order issued against it by the California Department of Health Services. ORA sees this as an indication that the Commission would be funding incentive pay that CalAm could not flow through to its officers and other eligible personnel under its own customer service performance criteria. The amounts CalAm would have us include in rates during the test years are (by necessity) only estimates of what it might award. Any funds not awarded would not be reduced from rates, but rather could be flowed directly through to stockholders as higher before-tax earnings. In two of the three years CalAm has cited for us, actual payouts have in fact been considerably lower than the incentive plan budgets.

CalAm has not shown that adding nearly $400,000 additional in expenses each year for the next three years as management incentives would be a cost-effective proposition for its Monterey Division customers.[8] Certainly, given the increase in customer complaints to our Consumer Affairs Branch (CAB) and the health violations we discuss in the Service Quality section below, any management incentive funding we authorized in past rate case settlements has not had the desired effect.[9]

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[8] Monterey Division is allocated 14.74% of the service company's expenses. The remainder is allocated to CalAm's other districts.

[9] That is not to say that management incentives were not productive from CalAm's and American Water Works Service Company's perspective, however. According to the application, "The average return on ratemaking equity during the past five years has been 12.69%. Authorized return on ratemaking equity during the same period of time was between 10.17% and 10.49%. The authorized return on average ratemaking equity was 10.36%. The company's earnings were above the authorized levels due in largest part to very favorable weather conditions and the timing of Commission authorization of revenue recoveries for prior

Footnote continued on next page

We accept ORA's position for salaries in both test years.

Legal Services

CalAm based its general office legal service expense estimates on its average recorded expenses for 1998 through 2001. Those recorded expenses were $26,770, $50,068, $190,633, and $519,738, respectively. ORA also used the same four years, but only after adjusting the 2000 and 2001 totals by removing specific items. CalAm does not object to some of ORA's adjustments: management and reorganization issues, late contribution issues, and stock acquisition issues. It does object to removing expenses related to financing, insurance claims, audit issues, review of regulatory rules and agenda, and miscellaneous and general administrative legal expenses. The major issue in this account, however, is ORA's deletion before averaging of $427,820 in 2001 related to a single lawsuit, which ORA describes as a wrongful termination suit by a company officer. CalAm acknowledges that this single incident represents "a dramatic increase in associate and employment-related litigation," but, "With increased demands and expectations placed on employees, and an increasingly litigious society, particularly in California, it is not unreasonable to expect future employee litigation, despite efforts to mitigate." ORA sees this as an extraordinary and nonrecurring expense that should be removed before any averaging is done, because there is no reason to believe similar expenses are likely to reoccur. "If, however, the company seriously expects to face similar lawsuits by its own executives in the test years, it should be taking proactive

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balancing account shortfalls, drought losses, and water conservation related expenditures." (Exhibit CA-1, Tab E, page 2-1).

measures to deal with the causes of such actions, not raising its customers' rates."

There is at least some merit in both parties' arguments. We seek a middle ground that neither ignores the possibility of occasional high litigation years nor establishes rates based on an expectation they will recur about every four years. We have examined the other deletions ORA made for 2000 and 2001 and agree that CalAm makes a case for restoring those to which it objected. We will also restore one-half of the $427,820 in 2001. Recalculating then produces a four-year average of approximately $115,000 per year, which is coincidentally about the midpoint of the parties' estimates. We will use that figure as a reasonable general office legal services expense level for both test years.

Auditing & Other Services

To estimate the two components of this account, CalAm used its current audit contract increased 25% for the addition of the former Citizens properties, and removed numerous non-recoverable amounts from other services before deriving a two year inflation-adjusted average. CalAm then used the sum as its TY2003 and TY2004 estimates. All of the adjustments and calculations in the workpapers placed in evidence[10] appear to be appropriate. ORA disallowed all amounts for other services, including expenses related to offsite storage and security of CalAm's computer records. From the ORA witness' testimony, it appears that he did not understand what was in the account, the workpapers he was provided, or the methods CalAm used to arrive at its estimate. We accept CalAm's figures for both test years.

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[10] Exhibits CA-41 and CA-42.

Customer Service & Information Expense

This account includes charges for customer bill insert notifications. The recorded expenses for 1998 through 2001 were: $11,361, $9,953, $19,769, and $58,096.[11] Both CalAm and ORA claim to have used a four-year average,[12] but because it considered the 2001 figure unusually high and unlikely to recur, ORA appears to have substituted for 2001 the recorded 2000 figure increased by 20%, and then taken the average.[13] CalAm claims to have used a four-year average of the unadjusted data, but clearly could not have done so and produced the figures it did. More likely, it used the high 2001 recorded figure and escalated it to TY2003 and TY2004.

Neither party has correctly explained what it did, and neither result seems a reasonable projection into the test years. To arrive at an adopted amount, we begin by reciting the more relevant points that do appear in the record. This account includes bill inserts required by various government agencies, such as the water quality confidence report, and other inserts through which the company communicates information to its customers about, e.g., "immune deficiency, power blackouts, and general conservation efforts."[14] Beginning in about 2001, "the company has experienced a dramatic increase in this expense due to governmental, regulatory and conservation requirements."[15] Those increased requirements are not further explained. ORA reasoned that

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[11] Application (Exhibit CA-1) Tab C, page 3-5.

[12] Exhibit ORA-2A, paragraph 2.16, and CalAm brief.

[13] Both CalAm and ORA misstate their own methods on brief.

[14] Exhibit CA-18, page 8; and Exhibit CA-43, a CalAm data response.

[15] Application (Exhibit CA-1) Tab C, page 3-2.

CalAm's higher than normal bill insert expenses were due in part to California's energy crisis. Apart from any increased requirements, CalAm also expects higher expenses due to its acquisition of the former Citizens properties. The three-year average pre-2001 recorded amount was $13,700. We will allow $36,000 in each test year, an amount midway between that average and the recorded 2001 figure. This result recognizes that there may be some increase due to additional (unspecified) governmental requirements, that some of these notices are not government-mandated, that 2001 included notices related to California's energy crisis that will not likely recur every year, and that there will be some (again unspecified) increase due to having added the Citizens properties.

Office Rental

CalAm moved its offices to a new location in 2002. Staff views both the move and the new, lower rental cost as prudent, but advocates disallowing any of the leasehold improvement costs CalAm incurred to make the new space usable. Since these expenditures were made in 2002 when CalAm was moving into the building, ORA considers them no longer recoverable under the retroactive ratemaking ban. CalAm points out that it is normal accounting treatment not to expense leasehold improvements, but rather to amortize them over the life of the lease, seven years in this case. The cost of the improvements is not at issue, and CalAm does not seek a return on the unrecovered portion. We accept CalAm's estimates for both test years.

Dues & Memberships

ORA made several major adjustments to CalAm's dues and membership expenses. It initially deleted all fees for CalAm's board of directors and all trustee fees for its secured bond trustee. Both were later restored as necessary costs of doing business. ORA also effectively removed all bank facility fees and loan syndication costs. CalAm described these as "bank fees and legal costs associated with establishing [American Water Capital Corporation's] syndicated credit facility and represent about 85% of these costs. This credit facility is required as backup liquidity for any company accessing the commercial paper market." It then went on to describe the other 15% of the costs in this line item.[16] We agree these fees should be restored as necessary and effective costs of doing business. ORA also made two minor adjustments, the first reducing CalAm's miscellaneous professional memberships to the lowest level recorded since 1996, and the second reducing CalAm's annual payment to the California Urban Water Conservation Council (CUWCC) to the 2001 level. We restore the miscellaneous professional memberships fees to the level CalAm requested, because the request is consistent with the historical data. CalAm paid CUWCC nothing in 1999, $2,442 in 2000, $2,789 in 2001,[17] and yet requested $9,000 in each test year. We will retain the approximate $6,000 disallowance ORA recommends for that line item. We adopt CalAm's estimates less $6,000 for each year: $158,100 for TY2003 and $161,600 for TY2004.

Group Insurance & Pensions

The only remaining issue in this account is the yearly increase in premium costs for health insurance. CalAm used a 10% yearly escalation factor and ORA used the DRI-recommended escalation rates. We accept ORA's results here as we did in the Employee Pensions and Benefits subsection for Monterey Division above.

[16] Exhibit CA-22, page 17.

[17] Exhibit CA-22, Tab F.

Employee Welfare

This line item includes company matching costs for the employee stock ownership plan and 401(k) accounts, and other expenses.[18] ORA reduced this item to reflect its recommended denial of the new director of governmental affairs position and the resulting lower payroll levels. CalAm responds that these are allocated costs provided by the parent company and cannot be arbitrarily reduced as a result of employee reductions. We agree that there needs to be some correspondence between employee levels during the test years and the amounts of these costs charged to CalAm's ratepayers. We accept ORA's estimates for TY2003 and TY2004.

Depreciation Expense and Interest Expense

The difference in each of these accounts is due to differences between CalAm and ORA in general office plant estimates, principally for the ORCOM project discussed below.

Payroll Taxes

The difference between CalAm and ORA here is due to ORA's recommendation to deny the new director of governmental affairs position discussed earlier.

Data Processing

Data processing costs are the sum of postage and billing costs, bank charges, leased lines, and the one-time costs of having started up the Shared Services Center and Customer Call Center. CalAm and ORA differ on the allowance for postage costs and the treatment of one-time startup costs.

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[18] Application (Exhibit CA-1) Tab C, page 3-3.

For TY2003 postage, CalAm reflected a 9.55% overall increase based on the Postal Service's increase effective June 30, 2002; CalAm included a very brief worksheet in its rebuttal testimony.[19] ORA states that it "uses an overall increase of 8.7% prepared by the United State Postal Service and included in CalAm's workpaper 000461."[20] That workpaper is not in the record and there was no cross-examination regarding its content. We accept CalAm's postage estimate for TY2003. ORA did not increase its postage estimate for TY2004 because it saw no indication that there would be a postage increase. CalAm inflated postage a further 2.1% in TY2004, using the DRI 2004 non-labor inflation factor. There is no reliable way to predict whether there will or will not be postage rate increases in TY2004, but, given the recent history of such increases,[21] CalAm's assumption is the more reasonable. We adopt CalAm's postage estimates for TY2003 ($453,052) and TY2004 ($462,567).

CalAm seeks to recover over four years $2,855,034 incurred by American Water Works Service Company during 2000, 2001 and 2002 as one-time startup costs for its Shared Services Center and Customer Call Center. ORA is opposed.

CalAm describes these two projects in an April 20, 2001 letter to Water Division:

> [T]he Shared Services Project involves the establishment of a consolidated, centralized organization to provide a variety of administrative

[19] Exhibit CA-44, page 2; and Exhibit CA-18, Attachment 5.

[20] Exhibit ORA-2, paragraph 2.38.

[21] See Exhibit CA-44, "History of First-Class Stamp Rates."

> and management support services to the operating subsidiaries.... The operating companies have historically obtained these services locally through their own employees or through regional offices of Service Company. The objectives of this project include cost efficiencies and reductions, sharing of employee knowledge, experience, skills and resources across the American System, higher levels of skill and training, improved and more consistent service levels and response times and development of new career paths and growth options for employees.
>
> [T]he second project... relates to the establishment of a new, centralized customer service center that will serve the entire American System... operating in 23 states and serving more than 10 million people. The centralized customer service center will enable all of the AWWA operating subsidiaries, including CalAm, to, in the overall, reduce customer service costs, to access new technologies designed to provide high quality, efficient, cost-effective service, to streamline and standardize processes to achieve a consistent level of service, and to provide improved customer services through a staff of highly trained employees with excellent opportunities for job growth.
>
> In order to implement both projects, Service Company will incur substantial, one-time start up expenses of approximately $34 million that cannot be capitalized.[22]

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[22] Exhibit CA-19, Attachment B.

CalAm's letter went on to request Commission authorization for memorandum account treatment.[23]

Water Division responded on May 14, 2001, citing four criteria for an item to qualify for memorandum account treatment, the first of which was, "The item is caused by an event of an exceptional nature that is not under the utility's control." Water Division concluded,

> Corporate reorganizations occur regularly and frequently. However, most organizational changes are initiated by the corporations and are under the corporations' control. We believe, therefore, the present case has failed the Commission's first requirement. In addition, it is premature to determine if your requested changes will benefit the ratepayer. In fact, if such changes are beneficial to the ratepayer, the start-up expenditures should be offset by the savings [resulting] from the changes.
>
> We believe the company should follow the generally accepted accounting principles in the recording and accounting for the expenditures [resulting] from its reorganization.[24]

As ORA points out, these are amounts which American Water Works Service Company has long since expended (and in fact, they were costs that in CalAm's words, "cannot be capitalized"). American Water Works Service Company and its affiliate CalAm are now attempting to pass down to its California ratepayers $2,855,034 of those historic expenses through its general office expenses for TY2003 and beyond.

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[23] CalAm sought to book the costs as a deferred debit to be amortized over four years.

[24] Exhibit CA-19, Attachment A.

ORA argues at great length that allowing CalAm to recover these costs now is prohibited under Public Utilities Code Section 728 as retroactive ratemaking.[25] Since these past expenditures were neither associated with a capital investment project nor Commission-preauthorized for memorandum account treatment, that conclusion is clear and need not be further pursued here.

We also disagree with each basis on which CalAm argues for recovery, Section 728 notwithstanding. The essence of CalAm's case is its argument that "sound regulatory policy dictates that the company be allowed to recover the costs associated with creating the efficiencies and savings cause[d] by the investment." CalAm is, in fact, today recovering those costs in its Monterey Division and other districts, has been recovering them for some time, and will continue to recover them until it has had GRCs in every district. Its customers in every district are today paying rates established to include the older, higher level of expenses that exceed its new, lower costs. Not until it comes to the Commission to revise those customers' rates will the Commission recognize the lower costs these two projects bring.

CalAm also argues that Commission precedent allows recovery of these costs already incurred. It cites our D.90-10-036 (1990) 38 CPUC 2d at 27, in which it received a rate increase to recover the costs of studies relating to a proposed long-term water supply project. That case can be

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[25] The California Supreme Court has repeatedly affirmed the prohibition against retroactive ratemaking. See, e.g., Pacific Tel. & Tel. Co. v. Public Utilities Commission (1965) 62 Cal. 2d 634, 655; and City of Los Angeles v. Public Utilities Commission (1972) 7 Cal. 3d 331, 357. In fact, the Commission in D. 02-07-011 recently denied A.02-03-019, a similar CalAm request seeking recovery for expenditures not reflected in rates for "security measures needed to address potential terrorist attacks."

distinguished from this, however, in that the study for which CalAm was reimbursed was performed in response to Commission directives, and in connection with a potential capital project (an off-stream storage reservoir). There the Commission observed, "It would be unjust for the Commission to direct the undertaking of studies, and not allow the utility to be compensated for that undertaking. This is so regardless of whether the studies lead to the ultimate construction by the company of the studied project." Neither of those conditions obtain in this proceeding.

We deny CalAm's request to recover one-time startup costs previously incurred by American Water Works Service Company for the Shared Services Center and Customer Call Center.

Rate Base

The effects of general office rate base are reflected as general office depreciation, interest and income tax effects. ORA and CalAm differ here in two items: ORCOM, and CWIP.

The only description in the record of American Water Works Service Company's ORCOM is that it is a capitalized software project that pertains to customer billing. CalAm expects the project to be completed during 2002 and fully in service during TY2003 and TY2004. According to ORA, CalAm originally estimated the cost at $1,200,000 in 1999, increased the estimate to $2,111,000 in 2001, and to $2,511,000 today. In an attempt to evaluate the company's estimate, ORA requested additional supporting data on the total implementation cost, and failing to receive more than a generalized response, prepared its own estimate of $2,230,000. When CalAm had not responded with a cost breakdown by the time of the evidentiary hearings, ORA stayed with that estimate. CalAm criticizes ORA's estimating method, which was based on increasing the project's cost in proportion to the increase in CalAm customers as a result of the Citizens acquisition, and a lower contingency amount. CalAm objects that ORA's estimating method is too general and not appropriate to reflect the increased work involved.

ORA charges that CalAm has not provided the information necessary to evaluate ORCOM's increased costs. CalAm apparently does not dispute that charge. The record before us lacks sufficient information to understand what this project is, what benefits it will provide CalAm's customers, and, beyond the cost data summarized above, what it should cost. Absent our inference that ORA understands ORCOM and agrees that it is worthwhile, we would simply disallow it. Instead, we accept ORA's recommendation and reduce CalAm's ORCOM estimate by $281,000.

CalAm proposed a 2002 beginning CWIP balance of $1,027,000, plus $2,511,000 for ORCOM. ORA requested verification for the $1,027,000 figure and did not receive it, so it averaged the 1996 through 1998 recorded figures to arrive at its $400,000 estimate of CWIP other than ORCOM. ORA chose 1996 through 1998 for averaging because ORCOM began in 1999 and was reflected in the later CWIP figures. CalAm has still not explained its figures. We accept ORA's 2002 beginning-of-year and end-of-year CWIP estimates.

Special Rate Requests

CalAm seeks approval of twelve Special Rate Requests, each of which involves ratemaking treatment of some aspect of its operations. We deal with each here, and the results are reflected in other areas of this decision where appropriate.

Special Rate Request #1

In D.00-03-053, the Commission authorized CalAm to continue an earlier-established balancing account to track variations in revenue caused by differences between the decision's special conservation-promoting rate design (termed the per-capita rate design) and that called for under the Commission's standard rate design policy. This is the WRAM (Water Revenue Adjustment Mechanism)[26] balancing account. CalAm would have the Commission authorize it to (a) continue the WRAM account for as long as per-capita rate design is in effect; and (b) recover the current WRAM balance as a surcharge on customers' quantity rates.

ORA opposes both requests. ORA observes that the Commission initially authorized WRAM because the effect on revenues of Monterey Division's new, conservation-promoting rate design was difficult to predict. With several years' experience with the new rate design, ORA believes the initial justification no longer applies and WRAM should be discontinued. CalAm rightly points out that WRAM may protect both the company and its ratepayers, although as of December 31, 2001, the account was undercollected by $1,088,829. This is clearly an account with considerable variability; experience notwithstanding, revenues under the per-capita rate design have been difficult to predict. We will extend WRAM, but only through this GRC cycle, not indefinitely as CalAm requests. In its next GRC for Monterey, CalAm may renew its request and we will decide whether WRAM should be further extended.

[26] Also referred to as the Water Rate Adjustment Mechanism. See, e.g., Special Request #8 in D.00-03-053.

ORA also opposes allowing CalAm to recover the WRAM balance at this time. The Commission has opened a proceeding to evaluate its balancing account procedures, and ORA recommends that amortization of the balance in this balancing account and others be handled as prescribed by the order we issue in that proceeding.[27] In rebuttal, CalAm argues that "staff has repeatedly deferred recognition of the Company's request to recover previously authorized memorandum and balancing account balance[s] based on their inaccurate interpretation of R.01-12-009 and W-4294."[28] CalAm's central argument is that R.01-12-009 does not pertain to balancing or memorandum accounts other than those related to purchased power, purchased water and pump tax, and then only to non-general rate case recovery of those amounts. As CalAm correctly notes, ORA neither conducted nor presented here a reasonableness review of the WRAM balancing account entries. In CalAm's view, that leaves CalAm's evidence uncontroverted and requires we award it the relief it seeks. In making its arguments, CalAm refers to the Draft Decision of Commissioner Brown in R.01-12-009, mailed August 29, 2002. Accordingly, we take official notice of that document.

We will not at this time authorize CalAm the balancing account recovery it seeks. First, the Draft Decision in R.01-12-009 to which CalAm refers does propose to establish rules for other than purchased power, purchased water

[27] Rulemaking (R.) 01-12-009 Order Instituting Rulemaking on the Commission's Own Motion to Evaluate Existing Practices and Policies for Processing Offset Rate Increases and Balancing accounts in the Water Industry to Decide Whether New Processes are Needed.

[28] Resolution W-4294 preceded R.01-12-009 and related to the same subject.

and pump tax expense balancing accounts.[29] Appendix B, Procedure for Class A Water and Sewer Utilities to Dispose of Balancing Account Balances Accrued Before November 29, 2001, to the Draft Decision makes the following statement at footnote 17: "While R.01-12-009 suspended only purchased power, purchased water and pump tax balancing accounts, this procedure will apply to all outstanding balancing accounts." Although it has not been suspended, CalAm's WRAM balance has been accumulating since well before November, 2001, and would be covered by the proposed rules. Even if WRAM were outside the scope of the proposed new rules, we would not be inclined to grant a rate increase for the WRAM balance, because neither ORA nor any other party has evaluated it to determine that recovery through rates would be reasonable.

Special Rate Request #2

SRR#2 is CalAm's proposed ratemaking treatment of its past and ongoing expenditures on its San Clemente Dam retrofit project, and its Carmel River Dam. It has divided those expenditures into two categories, pre-1/1/02 and post-1/1/02, for ratemaking purposes.

Pre-1/1/02 Expenditures

CalAm's application proposed all pre-1/1/02 costs be transferred to plant in service and rate base. ORA countered with a proposal to expense and recover them over three years through a surcharge, without interest on the unrecovered balance. MPWMD concurred with ORA's recommendation.

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[29] See, e.g., Section V.B.3.(a)(1), which discusses establishing guidelines for other account types and would be applicable in all scenarios. That discussion is carried forward as Conclusion of Law #3, and into the proposed rules at Appendix B, Section 2.a.

CalAm and ORA agree on CalAm's total costs incurred before 1/1/02: San Clemente Dam, $4,406,700, and Carmel River Dam $2,852,900, for a total of $7,259,600. CalAm now agrees with ORA's proposed three-year surcharge recovery, except CalAm would require that interest accrue at its authorized rate of return on the unrecovered balance. ORA explains why it recommends expensing the pre-1/1/02 expenditures:

> In general, both the San Clemente Dam and the Carmel River Dam face a number of legal and environmental hurdles before the projects can proceed, and actual construction on the projects may not be under way for years. In the meantime, ratepayers have not benefited from the costs incurred in these two projects as neither has contributed to the source of supply. These costs, therefore, should be considered as special expenses, not as plant costs.[30]

Post-1/1/02 Expenditures

CalAm's application proposed to account for all post-1/1/02 costs as CWIP and place them in rate base. To the extent CalAm's actual costs might vary from the adopted estimates, it proposed to accrue AFUDC (Allowance for Funds Used During Construction) on the excess, but it was silent on how to treat any underruns. ORA proposed that all post-1/1/02 charges not be allowed in rate base, but instead accrue AFUDC at the 90-day commercial paper rate. As support for applying AFUDC, ORA cites the Commission's

[30] ORA brief, page 39.

similar treatment of these projects in CalAm's last general rate case.[31] MPWMD favors expensing rather than capitalizing post-1/1/02 expenditures.

CalAm and ORA were initially far apart but now agree on the 2002, TY2003 and TY2004 amounts CalAm will spend. For the San Clemente dam retrofit, they agree to use CalAm's estimates: $666,300, $1,000,000, and $1,000,000. For the Carmel River dam, they would use ORA's estimates: $750,000, $750,000, and $750,000.[32]

In rebuttal testimony, CalAm agreed to support ORA's proposed post-1/1/02 AFUDC treatment, but CalAm advocates using its authorized rate of return rather than the 90-day commercial paper rate as its AFUDC rate.

Special Rate Request #2 Discussion

As CalAm has correctly stated, "[Carmel River dam and San Clemente dam retrofit] are both capital projects and as such should be accounted for properly. Capital outlays are not a proper charge to operating expenses."[33] The parties noted in the evidentiary hearings that our ratemaking policy for water utilities has long been to place CWIP in rate base rather than apply AFUDC.[34] The fact that we accepted a different ratemaking treatment for setting

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[31] D.00-03-053, Special Request #6.

[32] On brief, CalAm cites the agreed-upon total as $5.1 million, whereas these amounts sum to $4,916,300. The difference is unexplained, but we accept the individual amounts for ratemaking purposes.

[33] Exhibit CA-22, page 41.

[34] See, e.g., Exhibit ORA-20 May 11, 1982 Memorandum to the Commission re: Policy for Including CWIP in Rate Base for Water Utilities; and D.94-08-031, Order Denying Rehearing of D.94-02-045.

rates for the 2000-2002 GRC cycle now ending when we approved the parties' settlement in D.00-03-053 carries no precedential value for our decision in this GRC. ORA notes that both projects face hurdles before any construction could begin, and it is far from assured that either will ever be completed. CalAm explains many of those hurdles at length in various parts of its application. For both projects, we will adopt the pre- and post-1/1/02 figures CalAm and ORA have agreed to for estimating purposes, and require they be accounted for as CWIP in rate base. Allowing CWIP in rate base is fair to both CalAm and its ratepayers. CalAm will earn a return on its expenditures for these major capital projects until they are either put into service or abandoned, at which time the Commission may evaluate whether and how much of those expenditures should be allowed into rates permanently. Ratepayers, for their part, will not be asked to bear the full costs of repaying CalAm's very considerable pre-1/1/02 expenditures through a rate surcharge during the next three years, and will retain the opportunity to challenge the projects' costs when they are finally completed or abandoned.

One more aspect bears mentioning. In D.00-03-053, we authorized accruing AFUDC on these projects' costs. The record does not reflect what portion, if any, of the figures ORA and CalAm have agreed on constitute AFUDC, so we consider it to be subsumed within our adopted estimates for ratemaking purposes in this GRC. However, to the extent D.00-03-053 may have authorized AFUDC to accrue on CalAm's actual expenditures through the end of 2002, CalAm may include that AFUDC in its CWIP accounts for future ratemaking.

Special Rate Requests #3 and #8

In D.00-03-053, CalAm's last GRC, the Commission authorized CalAm to adopt MPWMD Ordinance 92 as its conservation and standby rationing plan. By SRR#8 in this proceeding, CalAm requests authority to continue using Ordinance 92, and a $450,000 allowance in TY2003 ($455,800 in TY2004) for related conservation-promoting activities. Those figures do not include any activities associated with rationing; in SRR#3, CalAm would have the Commission authorize a memorandum account to track the expenses it would incur if mandatory rationing were triggered under the plan.

Our D.00-03-053 authorization to adopt Ordinance 92 was not a temporary measure, so no reauthorization is required in this proceeding.

In response to SRR#3, ORA recommends a rationing memorandum account be established at the time rationing is declared,[35] and that actual charges be subject to review by ORA. CalAm, and we, interpret this to mean that ORA concurs with CalAm's request. We will authorize CalAm to establish the memorandum account to accumulate what CalAm describes as "unbudgeted... activities mandated for rationing." As CalAm proposes in SRR#3, once it is known that rationing is to be declared, it is to submit to the Commission staff 30 days before the effective rationing date an estimate of the costs it expects to book in the memorandum account. Authorization to establish and make entries into the account is not intended to assure that any or all costs booked in it are recoverable in rates; the Commission will make that determination, and the method for any such recovery, only after it has received CalAm's request and reviewed its justification.

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[35] CalAm defines rationing as implementation of phases 4, 5, 6, or 7 of its Ordinance 92 plan.

ORA proposed to allow $294,000 to promote water conservation in TY2003 and $300,174 in TY2004, but the analysis underlying its estimates was unhelpful. CalAm provided one breakdown of its $450,000 TY2003 estimated conservation expenses in the application and another in its rebuttal testimony:

Table 2

Conservation Expenses

	CalAm Estimate		
	Application[36]	Rebuttal[37]	Adopted
Outside Water Auditor	$ 40,000	$ 30,000	$ 30,000
Customer Notices	60,000	60,000	60,000
Advertising	150,000	50,000	50,000
Miscellaneous Programs	50,000	40,000	40,000
Water Saving Device Rebates	150,000	250,000	150,000
Contingency	—	20,000	0
Total	$ 450,000	$ 450,000	$ 330,000

As the last column of Table 2 shows, we will include $330,000 in rates for this activity in TY2003 (and the same in TY2004), less than CalAm requests but more than ORA recommends. In A.02-04-022, CalAm is proposing to increase Monterey customers' rates by more than 30% during this three-year GRC cycle. The application[38] shows administrative and general expenses, of which these special conservation expenses will become a part, of $1.609 million in 1996, increasing to $1.631 million in 2001, and $2.936 million in TY2003.[39]

[36] Exhibit CA-1, Tab B.

[37] Exhibit CA-23, page 5.

[38] A.02-04-022, Tab B, Table 6-5.

[39] CalAm on rebuttal increased some estimates and decreased others; its updated administrative and general expense request for TY2003 is now $2.492 million.

Promoting conservation is not a new and unfamiliar activity for CalAm and its customers; we authorized a special conservation rate design in its TY1997 GRC, and strengthened it in the form of the current per capita rate design in the test year 2000 GRC. As CalAm notes, "[R]egardless of what type of weather year it is, consumers on the Monterey Peninsula lead the nation in conservation, at about 7.5 units/month consumed for the average CalAm customer." While we understand the supply constraints CalAm is under, given the magnitude of the increase it seeks in this GRC, we are not convinced that granting it $450,000 under SRR#8 will be a cost-effective use of its customers' dollars. This is particularly so considering that they currently face exceptional incentives built into their rate design and already lead the nation in conservation.

Special Rate Request #4

In currently pending A.97-03-052, CalAm is seeking Commission authority to construct the Carmel River Dam and Reservoir Project. By D.98-08-036,[40] CalAm is required to prepare a long-term contingency plan ("Plan B") describing the program or combination of programs that the company would pursue if, for any reason, the project does not go forward. Assembly Bill 1182[41] requires the Commission, in consultation with CalAm, the Department of Water Resources, and other affected interests, to prepare the long term contingency plan described in D.98-08-036, and to set forth the criteria that it uses to decide on the program or combination of programs to include in the plan.

CalAm has been and will continue to be required to fund Plan B studies. By SRR#4, CalAm seeks to establish an interest-bearing memorandum

[40] Applications 98-05-008, -009, -010 and -011.

[41] Chapter 797, Statutes of 1998.

account to accumulate for later distribution to either ongoing expenses or capital all funds the Company is required to expend on Plan B. ORA and MPWMD oppose SRR#4. CalAm states in rebuttal testimony, "This request must be allowed in compliance with resolutions of the Commission." On brief, CalAm reiterates, "[T]hese Plan B expenses are mandated by the Legislature and by this Commission itself." Indeed, the Commission has twice required CalAm to provide funding for those Plan B expenditures the Commission and the Legislature have required of it. By Resolution W-4131, the Commission required CalAm to reimburse it for the costs of Plan B consulting services and environmental assessments, estimated to be $750,000, and authorized opening an interest-bearing memorandum account to track the payments for later recovery through rates. Again in Resolution W-4237, the Commission ordered up to an additional $500,000 in payments and authorized an interest-bearing balancing account for recovery through rates. Each time the Commission has required the funding CalAm anticipates in SRR#4, the Commission has authorized memorandum or balancing account treatment at the same time. If and when additional funding is ordered, we will consider the appropriate tracking treatment as we have in the past. CalAm's SRR#4 is unnecessary and will be denied.

Special Rate Request #5

As authorized by the Commission,[42] CalAm has adopted MPWMD Ordinance 92 as its conservation and standby rationing plan. Under Ordinance 92, MPWMD bills CalAm for MPWMD's actual costs under the plan, whether for conservation or rationing, and CalAm requests those billings be afforded

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[42] See discussion in SRR#3 of this decision.

balancing account treatment. In the Commission-approved settlement in CalAm's last GRC, CalAm was authorized to establish a memorandum account to record actual MPWMD charges up to a limit of $100,000 annually.[43] ORA advocates allowing CalAm to establish a memorandum, not balancing, account in this proceeding, and does not state an annual limit. MPWMD makes supportive comments about CalAm's plan, but does not state a clear position on establishing a balancing or memorandum account. On brief, CalAm accepted ORA's memorandum account recommendation. We adopt ORA's recommendation.

Special Rate Request #6

In the Commission-approved settlement in CalAm's last GRC, CalAm was authorized to book in a conservation memorandum account up to $550,000 annually of its costs to comply with State Water Resources Control Board Order WR 95-10.[44] CalAm now seeks recognition of its 2000 and 2001 actual and 2002 forecasted expenses, and a surcharge to recover those amounts over a three-year period. CalAm previously filed Advice Letter (AL) 556 seeking recovery of these expenses for year 2000. The Commission's Water Advisory Branch rejected AL556, saying "Since the establishment of the memorandum account does not guarantee full recovery of the expenses booked to that account, CalAm is required to justify the reasonableness of all expenses associated with the memorandum account," and, "[T]he staff will review the reasonableness of the conservation expenses during your next general rate

[43] D.00-03-053, Special Request #11.

[44] D.00-03-053, Special Request #2.

case."[45] Despite CalAm's SRR#6, our staff did not conduct that review in this GRC; instead, ORA recommended SRR#6 be handled according to the procedures to be adopted in R.01-12-009, similar to its recommendation discussed in SRR#1 above. According to ORA's witness, ORA was concerned lest it make a recommendation in this GRC proceeding that might conflict with the eventual outcome in R.01-12-009, and particularly with the type of earnings test that should be applied.[46]

We note that the amounts CalAm has asked to recover, $587,162 for 2000, $683,474 for 2001, and an estimated $550,000 for 2002, in two of the three years exceed the cap established in D.00-03-053. There is no support in the record for the nature or level of these figures other than CalAm's statement that they are amounts accumulated in the conservation memorandum account, and no other party has evaluated them. Lacking any evidence in the record that these are properly accounted for and reasonably incurred amounts, we arrive at the same conclusion for SRR#6 as for SRR#1: CalAm should await and follow the procedures that are established in R.01-12-009 to seek recovery.

Special Rate Request #7

In D.98-08-036, Ordering Paragraph #1, we ordered:

> 1. [CalAm] is authorized to establish a memorandum account that shall be used exclusively to record fines, if any, incurred for the water years ending September 30, 1998, or September 30, 1999, due to failure by Cal-Am to meet the requirements of Order WR 95-10 of the State

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[45] See Exhibits CA-30 for AL 556, and Exhibit CA-31 for Water Advisory Branch's rejection letter.

[46] RT 488.

> Water Resources Control Board (SWRCB) relating to the annual limit on Cal-Am's diversions from the Carmel River. Recovery of any such fines may be allowed, subject to "just and reasonable" review of Cal-Am's management and operations. Whether to continue this memorandum account beyond the water year ending September 30, 1999, is an issue to be determined in Cal-Am's Test Year 2000 General Rate Case (GRC) for its Monterey Division.

CalAm characterizes this ordering paragraph as having authorized the Company to recover from its Monterey customers any fines imposed upon it for exceeding SWRCB Order WR 95-10. We approved a settlement including a similar outcome in D.00-03-053 in CalAm's last GRC:

> 12.10 Special Request #10 – State Water Resources Control Board Fines. CalAm and RRB [Revenue Requirements Branch] have agreed that CalAm should be allowed to recover any fines imposed by the SWRCB due to overpumping of the Carmel River Water Resources System, but only if the actions taken by CalAm that resulted in the fines were reasonable in light of CalAm's obligation to serve its customers. CalAm will be allowed to file for the memorandum account upon receipt of notice from the SWRCB of an impending fine.

In SRR#7, CalAm seeks a further extension to last until a permanent water supply solution is placed into service. ORA concurs. MPWMD "supports equitable treatment of any fine that may be imposed...."

All three parties agree in principle as to what relief should be ordered here. Our D.98-08-036 was carefully crafted, and we will once again authorize what we did there, but update it to apply to SWRCB fines incurred through the effective date of our order in CalAm's next GRC.

Special Rate Request #9

D.00-03-053 also approved the following settlement provision:

> 12.03 Special Request #3 - Memorandum Account for Endangered Species Act. Cal-Am and RRB agree that Cal-Am should be authorized to establish a memorandum account to track expenses incurred to comply with the Endangered Species Act. The memorandum account would become effective on the effective date of this Decision. Estimated expenses for Test Year 2000 are $125,000, and amounts in excess of $125,000 will be included Test Year 2001. Annual expenses could equal $25,000.

By SRR#9, CalAm seeks to recover through a balancing account surcharge over the next three years $292,214 in costs booked to this Endangered Species Act (ESA) memorandum account during 2000 and 2001, and another $100,000 estimated for 2002.

The efforts CalAm describes in SRR#9 are the same as, or a subset of, those further described in SRR#10 below. They involve activities to meet requirements imposed by the U.S. Fish and Wildlife Service, the National Marine Fisheries Service, and perhaps the California Department of Fish and Game. CalAm's preparation of a Habitat Conservation Plan is among those activities covered in both SRR's.

As in SRR#1 and SRR#6 above, ORA did not analyze CalAm's SRR#9 request because it recommended that it be handled according to the procedures to be adopted in R.01-12-009. And, as in SRR#6, the amounts CalAm has asked to recover may exceed the amounts anticipated in D.00-03-053. CalAm has provided effectively no support in the record for the nature or level of those amounts other than its statement that they were accumulated in the ESA memorandum account, and, because no other party has evaluated them, we lack any evidence in the record that they were properly accounted for and reasonably incurred. We once again conclude that CalAm should await and follow the procedures that are established in R.01-12-009 to seek recovery.

Because we grant CalAm's SRR#10 request to include its TY2003 and beyond ESA expenditures in CWIP, there should be no further entries in the ESA memorandum account for expenditures made after the beginning of TY2003.

Special Rate Request #10

CalAm estimates that it will spend $600,000 annually during TY2003, TY2004 and AY2005 in connection with its federal ESA efforts. In SRR#10, CalAm proposes to include those amounts in CWIP, and thus rate base, for each year.[47] ORA's corresponding figures for the three years are $550,000, $500,000, and $300,000. MPWMD took the position that CalAm's estimated ESA-related attorneys' fees were excessive and should be examined, and that any ESA expenditures that the Commission accepts for ratesetting should be expensed rather than capitalized.

ORA opposes including CalAm's ongoing ESA expenditures in CWIP. Citing the Commission's treatment of San Clemente dam retrofit and Carmel River dam project amounts in CalAm's last general rate case,[48] ORA would have CalAm apply AFUDC and carry them forward outside of rate base until the associated capital projects are completed and placed in service.

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[47] Joint Reconciliation Exhibit CA-46 shows ESA CWIP of $600,000 at the beginning of TY2003, $1,200,000 at the beginning of TY2004, and $1,800,000 at the end of TY2004. Those figures appear to be inconsistent with CalAm's stated position.

[48] D.00-03-053, Special Request #6.

CalAm's ESA estimates are associated with three primary activities, and those activities are in turn associated with various capital projects including, most notably, the San Clemente dam retrofit and Carmel River dam. Some portion may also be associated with CalAm's operations separate from any capital project; if so, those activities have not been specifically identified or split out from the totals. For purposes of this GRC, we will treat the ESA expenditures in SRR#10 as being entirely capital-related. The three primary activities for which CalAm has estimated ESA costs are: a habitat conservation plan for the Carmel River; a habitat conservation plan for its entire system; and ESA-related attorneys' fees.

There is considerable material in the record introduced by CalAm to establish the amounts and timing of its ESA expenditures, while ORA's evidence was limited to analyzing CalAm's presentation. We will not detail here the methods either used because we did not find CalAm's estimates of its ESA amounts or their timing particularly reliable. CalAm's application estimate appears to have come through an impromptu response to an e-mail seeking quick input.[49] CalAm used the top of the range of each initial estimate and the most favorable interpretation of the timing. ORA's initial estimate used the middle or bottom of CalAm's ranges and its timing reflected later information. In the end, each made minor revisions to its figures and they moved closer together. On rebuttal, CalAm acknowledged that the first major activity for SRR#10, which had been dormant since summer, 2001, had still not begun by August 2002, "due to other more pressing ESA issues."

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[49] Exhibit CA-1, Tab B, e-mail following page 15-10. We also discount Exhibit CA-14A, a consultant's estimate of certain ESA costs, because it was presented too late to be analyzed.

Regardless of our discomfort with CalAm's projections, the company clearly faces some very significant ESA-related costs in TY2003 and beyond. We will adopt ORA's figures for ratesetting because they are the more conservative. These are capital expenditures, so the accounting process will eventually reflect CalAm's actual ESA-related costs in the company's plant accounts for the next GRC cycle and beyond rather than our adopted estimates.

As we noted in our discussion of SRR#2 above, allowing CWIP in rate base rather than AFUDC has long been our policy for the regulated water utilities. The fact that we accepted a different treatment for the GRC cycle now ending when we approved the parties' settlement in D.00-03-053 need have no precedential value for our decision in this GRC. We grant CalAm's request to account for its ESA-related capital expenditures for TY2003 and beyond as CWIP, and set rates for the test years accordingly.

Special Rate Request #11

CalAm asks to recover the accumulated balance in its expense balancing account over a three-year period through a surcharge on all units of water sold. The total balance as of December 31, 2001 was $809,260, and was expected to grow through 2002. To allow Commission staff an opportunity to review the accumulated balance, CalAm requests that the recovery begin as of July 1, 2003, and be spread over a 30-month period.

As with the other balancing and memorandum account recovery requests, ORA deferred to R.01-12-009. CalAm provided no further description, breakdown or justification, and no other party examined the account. CalAm must await and follow the procedures that are established in R.01-12-009 to seek recovery.

Special Rate Request #12

In SRR#12, CalAm sought $518,532 over a three-year period for increased security between September 11, 2001 and December 31, 2002, plus an additional $231,800 annual allowance for increasing security during TY2003 and TY2004.

Earlier this year, CalAm filed A.02-03-019 seeking authorization to establish a company-wide security cost memorandum account to track for possible later recovery what it estimated at that time to be $821,000 in expenses and $1.247 million in capital expenditures for 2001 and 2002. By D.02-07-011, the Commission denied the application, citing the prohibition against retroactive ratemaking for amounts already expended and suggesting that to the extent CalAm wished to pursue recovery of additional security costs, the issue should be addressed in its future GRCs. CalAm subsequently determined not to pursue in this GRC the 2001 and 2002 retroactive amounts, but it still seeks $231,800 annually for TY2003 and TY2004. ORA has evaluated CalAm's line item budget for enhanced security and recommends eliminating the expense of a single private security guard at $183,800 annually, and two much smaller amounts for water sampling labor and miscellaneous labor and equipment, leaving a recommended allowance of $13,000 in each test year. All of the amounts at issue for security are said to be over and above what CalAm would normally spend absent post-September 11 concerns.

Contrary to CalAm's characterization of these as mandatory ongoing security costs, they are not mandated measures under any of the supporting documentation CalAm cited in its rebuttal testimony. When asked what was meant by "mandatory" in this context, CalAm's witness responded, "Our own company's internal policies in securing our water systems, as well as how we interpret some of the actions that... were taken and are being taken to secure water systems by others." CalAm's supporting statement that, "The company was implored to take special extra precautions..." indicated only that it was responding to, e.g., a series of national advisories directed at community water systems in general throughout the country in the post-September 11 time frame, and the federal Public Health Security and Bioterrorism Preparedness and Response Act (HR 3448), enacted in June 2002.

Under HR 3448, community water systems are required to conduct vulnerability assessments and submit them to the Environmental Protection Agency between March 31, 2003 and June 30, 2004, the date depending on system size. HR 3448 also calls for EPA to provide financial assistance through fiscal year 2005 to water systems to perform these vulnerability assessments and to prepare emergency response plans, and for the costs of security enhancements (but not including personnel costs). Funding levels and specific criteria to qualify are not yet available.

Among ORA's primary concerns is whether the specific measures CalAm proposes are the most effective at the least cost. When asked on cross examination whether the company had done any sort of evaluation of what would the be most cost effective way of providing security, CalAm's witness responded, "The only analysis I could say is that we solicited the costs from security firms as to what they would charge us to provide a security [guard]...."

We accept only ORA's recommended allowance of $13,000 in each test year. As ORA points out, if ratepayers are to be charged additional costs for security enhancements, then the Commission should be assured that the methods chosen are at least effective. We anticipate that in the course of preparing its vulnerability assessment due to EPA next year, CalAm will prepare a thorough evaluation of its requirements and costs and will know more about what HR 3448 reimbursements it may qualify for. In the meantime, CalAm's showing does not persuade us to add the full additional amounts that it requests into rates. That is not to say that we have determined that CalAm should or should not take additional security steps; rather, that CalAm must determine the most cost-effective means of meeting any needs it identifies and then give them whatever priority they are due among all of its other funding priorities. In denying CalAm's A.02-03-019 request for a security costs memorandum account, we pointed out, "There is no requirement of the utility to spend exactly, or only, the projected amount on each rate base or expenditure component used to set rates.... We leave fine-tuning of a utility's operation to the discretion of its management. Management discretion is exercised in allocating total dollars for capital and expense items to those areas where the capital and expense is most necessary, as dictated by constantly evolving priorities."

During the course of the proceeding, the ALJ agreed that certain materials relating to security of the company's water facilities are confidential and should be kept under seal: exhibit CA-15; pages 3A-1 and 3A-2 of exhibit ORA-1A; and a portion of the hearing transcript containing related testimony. ORA has filed a Motion to Submit Under Seal Section IV.K of its Concurrent Brief relating to the same topic. ORA's motion will be granted.

Cost of Capital

In order to determine a fair rate of return for a utility, we determine the proportion of long-term debt and equity in its capital structure, estimate what the effective cost of each will be, and then take a weighted average. The resulting rate of return is used to determine the revenue requirement in the summary of earnings for each test year.

ORA is recommending 2.50% be deducted from CalAm's rate of return for TY2003, TY2004 and AY2005 as a penalty for deteriorating customer service.

Since we reject ORA's service penalty recommendation in a later section of this order, we deal here only with ORA's return figures before the 2.50% reduction.

Capital Structure

CalAm's application-proposed capital structure consisted of the following proportions of long-term debt and equity: for TY2003, 56.40% and 43.60%; for TY2004, 56.75% and 43.25%; and for AY2005, 56.99% and 43.01%. ORA concurred. That capital structure is reflected in our adopted rate of return, Table 3 below.

Cost of Debt

CalAm initially projected that its average embedded cost of long-term debt for TY2003, TY2004, and AY2005 would be 7.30%, 7.12% and 6.93% respectively. These figures were based on its existing debt issuances at known interest rates, and new debt issuances at coupon rates of 175 to 200 basis points above the forecasted 10-year Treasury bond rate.

ORA accepted CalAm's estimate of the amount of future long-term debt financing[50] and updated CalAm's new debt coupon rate estimates by adding 175 basis points[51] to DRI's most recently forecasted 10-year Treasury bond rate. This resulted in ORA's initial projections of new long term debt costs of 7.88%, 8.47% and 8.49% over the three years.

At the evidentiary hearings, CalAm produced a new forecast of long term debt costs: "CalAm accesses the debt market through AWCC [American Water Capital Corporation]. Currently we anticipate that AWCC would be able

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[50] ORA and CalAm apparently concur on the amount and embedded cost of outstanding long-term debt and debt retirement.

[51] 100 basis points is equivalent to 1%.

to borrow in the capital markets at approximately 150 basis points above the 10-year Treasury bond rate. This would result in an estimated cost of new long-term debt of 7.30% in 2003, 7.40% in 2004 and 7.50% in 2005."[52]

Applying CalAm's updated projected cost of new borrowing to CalAm's estimate of future long-term debt financing, embedded cost of outstanding debt, and retirements produces the adopted costs of long-term debt shown in Table 3 for TY2003, TY2004, and AY2005, respectively: 7.43%, 7.38%, and 7.28%.

Cost of Equity

Cost of equity is typically the most contested component of rate of return in water general rate cases. It is a direct measure of the company's after-tax return on equity (ROE) investment, and its determination is by necessity somewhat subjective and not susceptible to direct measurement in the same way capital structure and embedded cost of debt are.

Both CalAm and ORA acknowledge the well established legal standard for determining a fair ROE, and we have many times cited that same legal standard. In the Bluefield Water Works case,[53] the Supreme Court stated that a public utility is entitled to earn a return on the value of its property employed for the convenience of the public, and set forth parameters to assess a reasonable return. That return should be "...reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economic management, to maintain and support its credit

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[52] Exhibit CA-22, page 7.

[53] Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia (1923) 262 US 679.

and enable it to raise the money necessary for the proper discharge of its public duties."

As the Supreme Court also noted in that case, a utility has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. In 1944, the Court again considered the rate of return issue in the Hope Natural Gas Company case,[54] stating, "[T]he return to the equity owner should be commensurate with returns on investments in other enterprises sharing corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."

The Court went on to affirm the general principle that, in establishing a just and reasonable rate of return, consideration must be given to the interests of both consumers and investors.

With these foundation principles in mind, we examine ORA's recommended ROE, and then CalAm's.

ORA's Recommended Return on Equity

To determine the appropriate ROE for CalAm, ORA performed a quantitative analysis and then assessed the level of business and financial risk CalAm faced. In its quantitative analysis, ORA used two financial models, DCF (discounted cash flow) and RP (risk premium), to estimate investors' expected ROE.[55] ORA applied both models to a group of comparable

[54] Federal Power Commission v. Hope Natural Gas Company (1944) 320 US 591.

[55] The DCF model is a financial market value technique based on the premise that the current market price of a share of common stock equals the present value of the expected future stream of dividends and the future sale price of a share of stock, discounted at the investor's discount rate. By translating this premise into a mathematical equation, the investor's expected rate of

Footnote continued on next page

water utilities selected based on two criteria: (1) water operations account for at least 70% of the utilities' revenues, and (2) the utilities' stocks are publicly traded. The comparable group was comprised of seven companies: American States Water, American Water Works, California Water Service, Connecticut Water Service, Middlesex Water, Philadelphia Suburban, and San Jose Water. ORA used this comparable group for both its DCF and RP analyses.

American Water Works, CalAm's parent company, announced in September 2001 that it is being acquired by RWE Aktiengesellschaft, Thames Water Acqua Holdings GmbH (RWE). Because that pending acquisition had inflated American Water Works' stock price, ORA used stock price data from the period prior to September 2001.

ORA's DCF analysis yielded an average expected ROE of 8.19%. Its RP analysis produced an initial result of 11.31%, later corrected to 11.51%. It averaged the two results to produce a composite model return of 9.75%.[56] To this it added a 22-basis point ROE incentive to account for CalAm's practice of maintaining a higher ratio of long-term debt to total capital.[57] ORA's

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return can be found as the expected dividend yield (the next expected dividend divided by the current market price) plus the future dividend growth rate.

The RP model is a risk-oriented financial market value technique which recognizes that there are differences in the risk and return requirements for investors holding common stock as compared to bonds. An RP analysis determines the extent to which the historical return received by equity investors in utilities comparable to the utility at issue exceeds the historical return earned by investors in stable, long-term bonds. This difference, or "risk premium," is then added as a premium to the estimated cost of long term debt to derive average expected return on equity for the test period.

[56] Although ORA corrected the average to 9.85%, it did not change its earlier 9.75% recommendation.

final recommended ROE for CalAm is 9.97% (excluding its recommended service penalty).

In addition to its DCF and RP quantitative analyses, ORA also assessed the level of financial and business risk CalAm faces. In concluding that CalAm's business risk, which ORA related primarily to regulatory risk, was low, ORA cited the Commission's many risk-reducing mechanisms available to water utilities, including balancing accounts for purchased water, purchased power, and pump taxes, memorandum accounts for Safe Drinking Water Act compliance, 50% fixed cost recovery, and CWIP in rate base.

CalAm's Recommended Return on Equity

CalAm used a variety of analytical techniques, including, as ORA did, DCF and RP models, but ran them on different, more varied sets of data. Using data available in January 2002, CalAm presented two DCF estimates (one based on water utilities and the other on gas utilities), three RP analyses (one on water utilities and two on gas utilities), and a capital asset pricing model (CAPM). In addition to using more, and more varied, data sets, CalAm also relied at several points on ROE adders and adjustments intended to conform the analyses more closely to CalAm's situation.[58] CalAm shows estimated equity

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[57] Debt financing is less expensive for ratepayers than equity financing because debt interest is tax-deductible while common equity returns are not. The marginal cost of debt, however, also increases with increasing leverage, and the two effects tend to offset within a reasonable capital structure range.

[58] E.g., in the gas utility DCF model, CalAm adjusted equity costs downward by a seemingly arbitrary 50 basis points; in its water RP analysis it assumed that equity costs are 40 basis points higher than authorized ROEs; in its gas utility RP analysis, it again assumed that the cost of equity for a typical water utility is 50 basis points less than for a typical gas utility. And, at the end of each of its analyses, it added 25 basis points on the belief that CalAm was more risky than the typical large water utility.

costs ranging from 10.6% to 11.6% by the DCF method, and 10.9% to 11.6% for the RP method. In each case, the highest estimate in the range resulted from analyses using gas utility data. The CAPM method produced a cost of equity ranging from 10.6% to 12.0% using data from the Value Line Industrial Composite. CalAm concluded that its cost of equity is in the range of 10.9% to 11.8%,[59] and its final recommendation is an 11.0% ROE.

Return on Equity Discussion

ORA and CalAm each attack perceived shortcomings in the other's ROE showing. CalAm correctly pointed out the error that led ORA to increase its DCF result by 20 basis points. CalAm criticizes ORA's analysis as not reflecting in its DCF a difference between the recommended ROE and the average costs of Baa bonds, and the spread between its DCF and RP result as being too wide. CalAm believes ORA biased its results by being inconsistent across the two studies in choosing its sample companies. CalAm criticizes ORA's "blanket rejection of data on risk and required returns for companies not in the water industry." And CalAm sees increased regulatory risk for itself in California's regulatory climate, most particularly from the Commission's policy of capping step rates if a utility is over earning and the possible outcome of the Commission's R.01-12-009 water balancing account rulemaking. CalAm also sees additional risks that set it apart from other California Class A water utilities: its per-capita rate design in the Monterey Division; that not all construction projects are included in CWIP; and that when AFUDC is allowed, it is applied at the 90-day commercial paper rate.

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[59] Exhibit CA-10, Table 20.

ORA, in turn, charges that CalAm's ROE analyses are contrary to Commission policy in that its models use gas utilities and industrial companies as part of the comparable groups, whereas the Commission has refused repeatedly to use comparisons of energy utilities in its determination of cost of capital for water utilities, and has likewise rejected comparisons with businesses other than regulated utilities.[60] CalAm's reducing the results by 50 basis points when comparing itself with gas utilities is, in ORA's view, an unconvincing adjustment in light of the Commission's specific rejection of such comparisons. ORA also rejects CalAm's claim that the Commission's balancing account rulemaking proceeding significantly increases CalAm's risk, considering that it only covers one of many special recovery mechanisms available to water utilities. ORA views the Commission's step rate policy as fair because it always results in using the most current rate of return, and, in any case, if the utility earns more than its authorized rate of return, it is never required to refund its overearnings to ratepayers. And ORA attacks CalAm's characterization of weather-related risk as being accounted for in the market-based models and something an investor would consider as affecting all water utilities, not just California utilities. Lastly, ORA argues at length on brief that CalAm has been inconsistent in presenting its need for a higher ROE in this proceeding while it is at the same time presenting a much more favorable picture in its then-pending A.02-01-036 proceeding to merge with RWE.[61]

[60] ORA cites D.92-01-025, in re: Southern California Water Company.

[61] Other than passing mentions in the evidentiary hearings and on brief, the RWE merger record is not part of this record. The merger has not been consummated, and reference to the record there will be given no weight here.

We find much to like in both parties' cost of equity analyses, and some we do not. First, both use as their bases the DCF and RP models that we have consistently accepted in the past for water companies. We are not impressed with CalAm's attempt to analyze water company costs of equity by using gas utility and other, non-utility companies' data; that approach, as ORA notes, we have consistently and unequivocally rejected in the past. CalAm makes a point, however, when it criticizes ORA's observation that no consistent relationship exists between interest rates and authorized ROEs. Unless by consistency ORA means lockstep adherence with a mathematical certainty, any competent analysis of authorized equity returns compared to interest rates must observe that, all else being equal, authorized ROEs tend to rise and fall with the rise and fall of interest rates, albeit more slowly in both directions. On the other side, CalAm's view notwithstanding, our R.01-12-009 balancing account rulemaking does not mean the elimination of all balancing and memorandum account protections that California's water utilities have come to rely so heavily on over the years. First, at the time of this writing the Commission had yet to issue its first interim order in that proceeding. Second, no water utility that is neither earning over its authorized return nor beyond its rate case cycle by its own choosing (frequently because it is over earning), would be affected by the policies proposed. Third, no rule or policy change proposed in that rulemaking would require any water utility to return any amount of overearnings to its ratepayers; only that a utility not be afforded rate increases when it is already at or above its authorized return. As for the extraordinary risks CalAm sees for its Monterey Division, we note that the longstanding WRAM account which we are extending by this decision is intended to mitigate CalAm's risk from the per-capita rate design; and that also by this decision we return CalAm to our standard water utility policy of including CWIP in rate base.[62]

At the conclusion of its rate of return section on brief, CalAm provides one final statement. The minimum supportable ROE for CalAm in this case, it argues, would be based on the 8.55% cost of Baa rated bonds averaged with ORA's 11.51% corrected RP figure, or 10.03%. To that CalAm would add ORA's suggested 22-basis point capital structure incentive (i.e., a risk premium) to arrive at a 10.25% minimum supportable rate of return. In reviewing the parties' DCF and RP models, we have come to the conclusion that CalAm's analyses produce results that fail our reasonability test: investors in the economic climate of today and over the forthcoming rate case cycle will not require returns in the range of 10.9% to 11.8% to make equity investments in water utilities. Projecting an 8.55% Baa bond rate is also suspect when we compare that with CalAm's projection that it will be able to raise new long-term debt capital at 7.30% to 7.50% over the next three years. When we review the historical authorized returns on equity for California's Class A water companies,[63] we see that even CalAm's 10.25% lowest figure (which CalAm does not advocate) is well in excess of water company returns authorized during the past three years. The number of those returns is few, however, and at least some are based on settlements. Ultimately, the choice of a proper ROE must be a matter of judgment and the record. Subjective judgment alone would say that CalAm's

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[62] We note also that the current, more risky AFUDC and CWIP situation that CalAm decries results from its having entered voluntarily into a settlement with ORA and others in its last GRC.

[63] Exhibit ORA-2, Table 4-2; and Exhibit CA-25, Table 9.

equity return need not be as high as 10.25% in today's investment climate to attract capital, but no party has made a reasoned analysis on the record that would lead to a lower figure. Thus, on the basis of the record before us, we adopt a 10.25% ROE for TY2003, TY2004 and AY2005.

Rate of Return

With the capital structure, cost of debt, and cost of equity components determined above, the straightforward calculation in Table 3 derives the rate of return on rate base:

Table 3

Cost of Capital

	Adopted		
	Capital Structure	Cost	Weighted Cost
TY2003			
Long-Term Debt	56.40 %	7.43 %	4.19 %
Common Equity	43.60 %	10.25 %	4.47 %
Total	100.00 %		8.66 %
TY2004			
Long-Term Debt	56.75 %	7.38 %	4.19 %
Common Equity	43.25 %	10.25 %	4.43 %
Total	100.00 %		8.62 %
AY2005			
Long-Term Debt	56.99 %	7.28 %	4.15 %
Common Equity	43.01 %	10.25 %	4.41 %
Total	100.00 %		8.56 %

Step and Attrition Increases

Water company general rate cases typically authorize a set of rates for the first test year, and step increases to those rates for the second test year and third (attrition) year. The Commission's longstanding practice for large water utilities has been to apply a pro-forma earnings test at the beginning of the second and third years to determine whether the utility has been earning more than its authorized return, and if it has, to deny or reduce the step increases. In this case, ORA and CalAm each propose modifications to the way that practice has been implemented, and each opposes the other's change. ORA advocates using commercial customers' recorded sales rather than adopted sales in calculating revenues for the pro-forma earnings test. CalAm advocates changing the Commission's practice of comparing a company's pro-forma return to the lower of that company's most-recently authorized return for the year in question, or the return authorized in the decision that granted the step increase. We will not repeat all of their arguments for and against here. Instead, we reject both proposals based on the reasoning CalAm sets forth for opposing ORA: "The current procedure for processing rate increases, including step rates, may not be perfect, but it has proven effective for a number of years. Any change in the current procedures needs to [be] open to formal discussions with all water utilities and members of Staff. Changes in these longstanding procedures should not be made in one company's rate case application."[64] That is not to say that we would decline in every general rate case to consider making changes in that case only, but neither party has made a persuasive argument for its proposed change here.

ORA and CalAm each made an additional step increase-related request that would not have policy implications for other companies. First, ORA recommended that the Commission in this decision eliminate Monterey Division's TY2004 step increase, based on ORA's reading of the proposed settlement that was pending in CalAm's A.02-01-036 proceeding to merge with RWE at the time. That proposed settlement is not part of the record in this

[64] Exhibit CA-22, pages 38 and 39.

proceeding. It is neither necessary nor advisable to attempt to impose a tentative RWE merger-related settlement provision here. Second, CalAm points out that it has pending with the Commission four general rate case applications[65] for its former Citizens districts, and the rate of return to be determined in those proceedings may be based on a different capital structure than that for its non-Citizens districts, including Monterey. CalAm contends that it would not be appropriate to apply the rate of return resulting from those applications in the pro-forma earnings test for the Monterey Division's 2004 step rate or 2005 attrition rate filings. ORA has not directly addressed this topic on the record. We agree with CalAm.

Rate Design

By D.00-03-053 as modified by D.01-10-014 in CalAm's last GRC, we approved the current per-capita rate design to promote conservation. For residential customers, the per-capita rate design has five sharply ascending blocks, and for others, two ascending blocks. The Hidden Hills and Ryan Ranch area and the Ambler Park and Bishop area do not draw on the same water supply sources as the remainder of CalAm's Monterey customers and have rate designs different from Monterey's.

CalAm proposes to continue the per-capita rate design where it now applies. ORA concurs. The Department of Defense and Federal Executive Agencies (DOD) concurs but seeks minor modifications as explained below. No party disagrees, nor do we.

For the heavily residential Hidden Hills and Ryan Ranch area, CalAm proposes a four-block rate design. CalAm states that it is in danger of exceeding

[65] A.02-09-030, -031, -032, and -033.

MPWMD-imposed water production limitations in the area, and absent a conservation-promoting rate design there may come a time in the near future when it is unable to serve the remaining residential lots. ORA concurs with CalAm's proposal, and no party objects. We will authorize CalAm's Hidden Hills and Ryan Ranch rate design proposal.

Ambler Park and Bishop are currently under separate tariffs. CalAm proposes to combine them into one tariff with the increase based on the general increase to Ambler Park tariff rates. They are geographically near to one another, draw from the same aquifer, and would have similar rates once recent Ambler Park plant additions are reflected in rate base. ORA believes CalAm's request is reasonable and will reduce administrative costs. No party is opposed. We adopt CalAm's proposal.

DOD, while concurring generally with CalAm's rate design proposals, seeks three modifications: a small increase to the lowest block in the residential per-capita rate design; a different method of recovering WRAM balancing account balances; and a greater increase than CalAm proposes for temporary water sales.

The pricing formula for the per capita rate design sets the rate for the first block at 50% of the second block rate. At the company's A.02-04-022 requested rates, DOD maintains that the first block rate falls about 3% below CalAm's overall variable commodity cost. DOD suggests the first block rate be increased about 9% to recover the variable costs and provide some contribution to fixed costs. CalAm, while not commenting on the analysis, resists the change on the basis that the highly inverted per-capita rate design was implemented to produce a much needed conservation response, and has done so. The second and higher blocks provide an increasingly strong contribution to fixed costs, and only those customers who are the very lowest users fall exclusively into the first block. While DOD's suggestion is perhaps sound from a standard ratemaking viewpoint, we are not inclined to alter what has been shown to be a simple and effective rate structure, and particularly not so when it works to reduce conservation incentives. We will not order the change.

CalAm and ORA take no position on DOD's suggestion to recover WRAM balancing account undercollections exclusively from residential customers. DOD would not limit its recommendation to prospective surcharges, but would also have the Commission order refunds to non-residential customers (e.g., commercial, industrial and public authority users, notably including the Presidio of Monterey represented by DOD) for approximately $500,000 in WRAM surcharges they have paid since July, 2000. The record is not sufficiently clear as to the mechanics of the WRAM balancing account to assure us that residential customers are solely responsible for WRAM undercollections. What is clear is that residential customers pay commodity rates ranging as high as 400% of the standard rate, while non-residential customers' highest rate tops out at 200% of the standard rate. It can hardly be said that the per-capita rate design favors residential customers over others, and we are not inclined to shift such a large portion of the revenue requirement to them as DOD requests. We will not adopt DOD's suggestion.

We do adopt DOD's third modification: a greater increase than CalAm proposes for temporary water sales. Temporary sales are normally made from hydrants or standpipes, for example, construction water. We agree with DOD that this could be considered a premium service. Temporary sales are today charged at the standard rate, which is the first and lowest non-residential rate block. DOD suggests they should be charged 50% to 100% more. We will adopt its suggestion and direct that all sales under the temporary service tariffs be priced at 150% of the standard rate (other non-residential usage in the second block is priced at 300%). Not only will this produce additional revenue to help contain other rates, but it will provide an added conservation incentive for temporary service users.

Service Quality

ORA and MPWMD contend that CalAm's Monterey Division service has deteriorated to an unacceptable level. ORA cites customer service problems as support for its proposed 2.50% rate of return penalty. MPWMD's service presentation is more directed at showing a general deterioration in the quality of CalAm's management of its Monterey Division and system, thus bolstering its justification for the "extraordinary requests" discussed in the next section.

On brief, ORA cites what it calls two objective standards demonstrating service problems: "dramatic increases in the number of complaints received at the Commission, and the number of boil orders against CalAm's main system." In addition, ORA's testimony pointed to statistics showing a rise in the number of customer inquiries (which ORA characterized as complaints) CalAm has received each year since 1996.

The number of complaints CalAm customers have submitted to our CAB has indeed increased recently: There were 77 complaints during the first seven months of 2002, compared to 24, 27, and 28 for all of 1999, 2000 and 2001 respectively.[66] The great bulk of those complaints (55 of the 77 total complaints in 2002), and of the increase in complaints during 2002, was categorized by CAB as "disputed bill." By relating the CAB complaints to what was happening in CalAm during the first half of 2002 (which ORA apparently did not do), CalAm

[66] These CAB statistics are for all of CalAm. ORA did not attempt to break out the figures for Monterey Division.

was effective in refuting ORA's conclusions. As CalAm points out, 60,700 former Citizens customers were added to its 106,000-customer system in January 2002, a 57% increase. With the transition from Citizens to CalAm, those customers were exposed to a billing format that was new to them and could be expected to generate a higher number of inquiries and complaints. CalAm also points out that its parent company opened a new national call center in mid-January 2002. Former Citizens customers were routed to the call center in January, and other CalAm customers in April. CalAm cites statistics showing that CAB complaints rose in March and April, peaked in May, and decreased significantly thereafter. CalAm implies that complaints should be returning to more normal levels as startup problems in the call center are worked out, and as former Citizens customers have their concerns addressed and become more familiar with their new bill format.

MPWMD's witness testified that there were eight "boil orders" in CalAm's main system through approximately August 2002, compared to two for all of 2001.[67] MPWMD attributes the increase to the loss of key employees "experienced with CalAm's aging and inadequate distribution system." Further, according to MPWMD, the Department of Health Services (DHS) has issued a compliance order requiring CalAm to take long-term action to make the Monterey system more reliable and eliminate the outages that lead to boil orders. ORA cites these boil orders and the DHS compliance order as further evidence of inadequate service. Only one boil order was in any way described: power failure to a pump allowed a tank to drain and a portion of the system near

[67] Boil orders result when a water distribution system loses pressure, possibly permitting contamination to enter. Customers are advised to boil the water they consume until the system has been tested and once again declared safe.

Carmel to lose pressure. While boil orders and DHS compliance orders can be indications of serious system problems, there is no further information on the record relating to them, so we are unable to assign causes or firmly connect them to either MPWMD's or ORA's claims of deteriorating service.

ORA also cited statistics attempting to show a dramatic rise in the number of customer complaints CalAm itself received during January through July 2002. On further examination, however, it became clear that the most recent figures were not accumulated on a basis consistent with those from earlier. What ORA characterized as complaints in fact included other customer contacts as well, and it made no attempt to separate complaints from routine contacts. The inconsistency and need for analysis is most clearly illustrated in the figures for "other customer inquiries" ORA cites for 1998 through 2002: 1800, 52, 18, 26, and 5946 respectively.

We take CAB complaints and DHS compliance orders seriously; when properly analyzed and presented, they can be strong evidence of inadequate service. While there are indications in the record that all may not be well in CalAm's Monterey Division, no party has made a competent showing of what the underlying problems might be, or how they should be corrected. Other than imposing a 2.50% rate of return penalty, ORA's only suggestion was, "ORA is concerned with the increase in complaints and CalAm should improve its level of customer service." We decline to adopt a 2.50% rate of return penalty. We deal separately with MPWMD's requests, which are arguably marginally related to its customer service allegations, in the following section.

MPWMD's "Extraordinary" Requests

In addition to the positions MPWMD took on the GRC issues addressed above, it is requesting the Commission grant what it characterizes as "extraordinary relief to recognize the unique condition of the CalAm system, and to promote rapid and cost-effective solutions to the water supply problems affecting the Monterey Peninsula." MPWMD's brief listed that extraordinary relief as:

> An order directing CalAm to share available data in a timely manner with the District and other public entities.
>
> An order that CalAm coordinate its Carmel Valley operations and activities with management and regulatory requirements set by the District and other state or federal regulatory agencies.
>
> An order directing CalAm to develop and participate in a formal process designed to promote cooperation and to cause early resolution of disputes relating to the issues of conservation, provision of data, ASR (Aquifer Storage Recovery) project implementation, and resource management.
>
> An order clarifying that expenditures aimed at obtaining water rights for CalAm's own benefit are not recoverable from ratepayers.

It is apparent from the testimony in this proceeding that relations between CalAm and MPWMD are frayed. We need not describe each charge MPWMD advances here, but underlying most or all of them seems to be its belief that CalAm is attempting to thwart feasibility testing for MPWMD's ASR project. According to MPWMD, CalAm's actions and expenditures are motivated by CalAm's desire to obtain for itself (as opposed to public ownership through MPWMD) all water rights for the project. Each of MPWMD's extraordinary requests bears some relation to that conflict. CalAm's response confirms that a contest over water rights, and perhaps a differing approach to solving the area's water supply problems, lies at the heart:

> The problem is not lack of cooperation. The problem is not changes in CalAm personnel. The problem is that the Company *disagrees*

> with the District over ownership and control of CalAm's valuable water rights. The problem is that the District is very unhappy and upset with the fact that CalAm is determined to solve the long-term water supply issue in its Monterey Division over the District's long history of unsuccessful efforts and that in order to accomplish that goal Applicant is committed to protecting and preserving and continuing to pursue and to own the necessary and valuable water rights.... That CalAm philosophy runs directly [] contrary to the goals of the strong "no growth" majority of the MPWMD Board of Directors.
>
> * * *
>
> It is totally inappropriate for the District to seek to use this ratemaking forum as leverage to improve its legal position against the Company. CalAm has legitimate legal issues with the District and in the best interest of its ratepayers must now oppose the District's continuing flawed efforts on the subject of water rights and imbedded opposition to a long-term water supply solution. The SWRCB, not this Commission, is the appropriate forum to resolve water rights disputes. The Commission's interest, if any, can and will be fully explored in A.97-03-052.[68]

At the outset of this decision, we gave a brief overview of the Monterey Peninsula's longstanding water supply problems. The Commission, through A.97-03-052 and other proceedings in the recent past, has been deeply involved in CalAm's efforts to meet its customers' water supply needs. The orders MPWMD would have us issue through its "extraordinary requests" are outside the intended scope, and not sufficiently supported by the record, of this GRC proceeding. We make no judgment here whether those would be appropriate requests in A.97-03-052, but rather leave that determination to the assigned

[68] CalAm brief, page 84. Emphasis in original.

Commissioner and ALJ in that proceeding if and when MPWMD chooses to advance them there.

Comments on Proposed Decision

The principal hearing officer's proposed decision was filed with the Commission and served on all parties in accordance with Section 311(d) of the Public Utilities Code and Rule 77.1 of the Rules of Practice and Procedure. ORA filed comments. CalAm filed only a reply opposing ORA's suggested changes and supporting the proposed decision as written. No other party filed comments or replies.

ORA's comments reargue its positions on regulatory commission expense, legal service expense, CWIP, ESA expenditures, cost of capital, and service quality. Rule 77.1 provides, "Comments shall focus on factual, legal or technical errors in the proposed decision.... Comments which merely reargue positions taken in briefs will be accorded no weight and are not to be filed." No changes have been made in those areas.

We have accepted ORA's suggestion to reiterate that "working cash" in the Depreciation Expense and Reserve, and Rate Base section refers to "operational working cash."

ORA alleges that there are errors on three pages of the Appendix B adopted tariff sheets. On page 1 of 18 ORA has misquoted the figures; they are correct as shown. On page 5 of 18, ORA believes it has detected a rate error of \$0.0001 per 100 cubic feet in CalAm's favor, and on page 7 of 18 an error of \$0.0002 per 100 cubic feet in the ratepayers' favor. CalAm disagrees with ORA's corrections. We have not changed the figures because ORA provides no explanation of why it believes these rates are in error, because the differences at issue are minuscule, and because even if the figures were wrong they would tend to offset one another.

Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and James C. McVicar is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. CalAm's WRAM balancing account protects both CalAm and its ratepayers.
2. Allowing all of CalAm's past and ongoing capital expenditures on its San Clemente dam retrofit project, and its Carmel River dam project, as CWIP in rate base is fair to both CalAm and its ratepayers.
3. The adopted summaries of earnings presented in Appendix A, and the quantities and calculations included as Appendix D which underlie them, are reasonable for ratemaking purposes.
4. It is not necessary at this time to establish an additional memorandum account to track funds CalAm may be required to expend on Plan B.
5. There is insufficient information in the record to determine in this proceeding that the amounts in CalAm's WRAM balancing account, its State Water Resources Control Board Order WR 95-10 memorandum account, its ESA memorandum account, and its expense balancing account, are reasonable and should be recovered from ratepayers.
6. The capital structure, cost of debt, rate of return on equity, and rate of return on rate base shown in Table 3 are reasonable for ratemaking.
7. No party has made a persuasive argument for changing the Commission's standard method for determining whether to postpone or reduce step increases.

8. CalAm's per-capita rate design is still needed and should be continued in those Monterey Division areas where it now applies.

9. CalAm's proposed four-block rate design is needed to promote conservation in the Hidden Hills and Ryan Ranch area.

10. Combining Ambler Park and Bishop into one tariff will reduce administrative costs and be fair to affected customers.

11. Maintaining the quantity rate for the first block at 50% of the second block rate in the per-capita rate design is justified as a simple and effective means of providing a conservation incentive.

12. Temporary water sales may reasonably be priced at higher than the standard rate to produce additional revenue and to provide a conservation incentive.

13. Recovering WRAM balancing account undercollections from all customers despite the fact that only residential customers give rise to them is fair to non-residential customers, in part because non-residential customers' quantity rates in the highest block are lower than those for residential customers.

14. The TY2003 rates and the TY2004 and AY2005 step increases in Appendix B have been designed to produce revenues consistent with the Monterey Division summaries of earnings adopted in this order.

15. There is some evidence of service quality problems in Monterey Division, but it is not sufficient to justify a rate of return penalty. There is no persuasive evidence of what the underlying causes of CalAm's service problems might be, or how they should be corrected.

16. The orders MPWMD would have us issue through its "extraordinary requests" are outside the scope and not sufficiently supported by the record of this GRC proceeding.

Conclusions of Law

1. The ratemaking treatment the Commission accepted in approving settlements in CalAm's previous Monterey Division general rate cases carries no precedential value for the Commission's determination of similar or related issues in this proceeding.

2. Allowing CalAm to recover in rates the past, one-time startup costs associated with American Water Works Service Company's Shared Services Center and Customer Call Center would be prohibited retroactive ratemaking under Public Utilities Code Section 728.

3. The revised rates and step increases set forth in Appendix B are justified.

4. CalAm should be authorized to implement the rate changes set forth in this order.

5. ORA's Motion to Submit Under Seal Section IV.K of Its Concurrent Brief should be granted.

6. This decision should be made effective immediately to allow CalAm an opportunity to earn the return found reasonable for it in TY2003.

O R D E R

IT IS ORDERED that:

1. California American Water Company (CalAm) is authorized to file in accordance with General Order 96, and make effective on not less than five days' notice and not earlier than January 1, 2003, the revised tariff schedules for 2003 included as Appendix B to this order. The revised tariff schedules shall apply to service rendered on and after their effective date.

2. On or after November 5, 2003 and November 5, 2004, CalAm is authorized to file advice letters in conformance with General Order 96, with appropriate supporting workpapers, requesting the step rates authorized in Appendix B of

this decision for 2004 and 2005, respectively. If the rate of return on rate base for the Monterey Division, taking into account the rates then in effect and normal ratemaking adjustments for the twelve months ending September 30, 2003 and September 30, 2004, respectively, exceeds the lower of (a) the rate of return found reasonable by the Commission for any non-Citizens district of CalAm for the corresponding period in the most recent decision, or (b) the rate of return found reasonable in this order, then CalAm shall file for a lesser increase. The requested rates shall be reviewed by the Commission's Water Division and shall go into effect after Water Division's determination that they conform to this order. Water Division shall inform the Commission if it finds that the proposed rates do not conform to this order or other Commission decisions. The revised tariff schedules shall made effective no earlier than January 1, 2004 and January 1, 2005, respectively, and shall apply to service rendered on and after their effective date.

3. CalAm is authorized to file advice letters seeking Commission authorization for rate offsets in Monterey Division for the following capital projects when each has been completed and placed in service, no earlier than the year indicated and at costs not to exceed those indicated:

a. Sludge drying beds at Begonia plant (project #2). Test year 2004; maximum cost of $750,000.
b. New well and arsenic treatment at Hidden Hills (project 02-083). Attrition year 2005; maximum cost of $1,750,000.
c. Arsenic treatment at Ambler Park and Luzen wells (project 02-085). Attrition year 2005; maximum cost of $4,100,000.
d. Carmel Valley Road 24" main (project #14). Attrition year 2005; maximum cost of $5,000,000.

4. CalAm is authorized to continue its Water Revenue Adjustment Mechanism balancing account until the effective date of the Commission's

general rate case decision in Monterey Division's next general rate case cycle, currently anticipated to be for test year 2006.

5. CalAm is authorized to establish a rationing memorandum account once it is known that rationing is to be declared under Monterey Peninsula Water Management District (MPWMD) Ordinance 92, and thereafter to track in that account its rationing-related expenditures. Only those expense and capital amounts that are incremental to its normal operations and not otherwise already included in rates are to be tracked in the account. CalAm shall submit to the Commission's Water Division approximately 30 days before the effective rationing date notice that the memorandum account is being established and an estimate of the expenditures it expects to book in the account. Authorization to establish and make entries into the account is not intended to assure that any or all expenditures booked in it are recoverable in rates; the Commission will make that determination, and the method for any such recovery, only after it has received CalAm's subsequent request and reviewed its justification.

6. CalAm is authorized to establish a memorandum account to track costs billed to it by MPWMD for MPWMD's actual costs under the Ordinance 92 conservation and rationing plan; or, to the extent it already has such a memorandum account as a result of our prior authorization in D.00-03-053, to continue that account without the previous annual dollar limitation. Authorization to establish and make entries into the account is not intended to assure that any or all expenditures booked in it are recoverable in rates; the Commission will make that determination, and the method for any such recovery, only after it has received CalAm's subsequent request and reviewed its justification.

7. CalAm is authorized to further extend the memorandum account authorized by D.98-08-036 and extended by D.00-03-053 to record fines, if any,

due to failure by CalAm to meet the requirements of State Water Resources Control Board Order WR 95-10 and incurred not later than the effective date of the Commission's general rate case decision in Monterey Division's next general rate case cycle. Recovery in rates of any such fines may be allowed provided that the Commission determines that CalAm's management and operations related to those fines has been reasonable and their recovery is justified.

8. CalAm shall account for its Endangered Species Act-related capital expenditures for test year 2003 and beyond as Construction Work In Progress associated with the appropriate capital projects to which they relate.

9. The summaries of earnings presented in Appendix A, and the quantities and calculations included as Appendix D which underlie them, are adopted.

10. ORA's Motion to Submit Under Seal Section IV.K of Its Concurrent Brief is granted. Section IV.K of ORA's Concurrent Brief, along with exhibit CA-15, pages 3A-1 and 3A-2 of exhibit ORA-1A, and the portion of the hearing transcript placed under seal by the Administrative Law Judge, shall remain under seal and shall not be made accessible or disclosed to anyone other than Commission staff and parties to this proceeding except on the further order or ruling of the Commission, the Assigned Commissioner, the assigned Administrative Law Judge, or the Administrative Law Judge then assigned as Law and Motion Judge.

11. CalAm's requests in Application 02-04-022 are granted as set forth above, and in all other respects are denied.

12. Application 02-04-022 is closed.

This order is effective today.

Dated February 13, 2003, at San Francisco, California.

MICHAEL R. PEEVEY
President
CARL W. WOOD
LORETTA M. LYNCH
GEOFFREY F. BROWN
SUSAN P. KENNEDY
Commissioners

I will file a concurrence.

/s/ LORETTA M. LYNCH
Commissioner

Appendix A – Summary of Earnings

Appendix B – Authorized Tariffs and Step Rates

Appendix C – Bill Comparison

Appendix D – Adopted Quantities