ALJ/MAB/avs **Date of Issuance 7/10/2009**

Decision 09-07-021 July 9, 2009

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U210W) for Authorization to Increase its Revenues for Water Service in its Monterey District by $24,718,200 or 80.30% in the year 2009; $6,503,900 or 11.72% in the year 2010; and $7,598,300 or 12.25% in the year 2011 Under the Current Rate Design and to Increase its Revenues for Water Service in the Toro Service Area of its Monterey District by $354,324 or 114.97% in the year 2009; $25,000 or 3.77% in the year 2010; and $46,500 or 6.76% in the year 2011 Under the Current Rate Design.	Application 08-01-027 (Filed January 30, 2008)
And Related Matters.	Application 08-01-024 (Filed January 30, 2008)

(See Appendix E for List of Appearances.)

FINAL DECISION AUTHORIZING RATE INCREASE IN MONTEREY WATER DISTRICT AND TORO SERVICE AREA

TABLE OF CONTENTS

Title **Page**

FINAL DECISION AUTHORIZING RATE INCREASE IN MONTEREY WATER DISTRICT AND TORO SERVICE AREA 2
1. Summary 2
2. Procedural History 2
3. Summary of the Applications Addressed in this Decision 4
3.1. A.08-01-024 (General Office Application) 4
3.2. A.08-01-027 (General Rate Case Application) 5
4. Burden of Proof 6
5. Summary of the Testimony Presented at the Public Participation Hearings and Written Comments 7
6. Resolution of Remaining Issues 8
6.1. Utility Plant in Service 9
6.1.1. American Water Company Asset Investment Strategy 9
6.1.2. Water Supply Capacity 12
6.1.2.1. Winter Maximum Day Demand 16
6.1.2.2. Summer Maximum Day Demand 18
6.1.2.3. General Issues With Comprehensive Planning Study 21
6.1.2.4. Potential for Stranded Assets 23
6.1.2.5. Playa Well No. 4 24
6.1.2.6. Conclusion 24
6.1.3. Well Rehabilitation 25
6.1.4. Storage Tanks 31
6.1.5. Fireflow Program 34
6.1.6. Pipeline Replacement 36
6.1.7. Polybutylene Services 40
6.1.8. Combining and Coordinating the "Low Hanging Fruit" Proactive Infrastructure Replacement Programs 42
6.1.9. Interconnections 43
6.1.10. Meter Replacement 44
6.1.11. Unaccounted for Water 49
6.2. Expenses: Operations and Maintenance, Administrative and General, and Payroll 58

Title **Page**

6.2.1. Purchased Water 58
6.2.1.1. Sand City Desalinization Plant Lease- Background and Positions of the Parties 59
6.2.1.2. Sand City Desalinization Plant – Discussion 63
6.2.2. Regulatory Expense 71
6.2.2.1. Fine for Failure to File Reports Ordered in Decision 76
6.2.3. Tank Painting 79
6.2.4. Payroll 80
6.2.5. Seaside Basin Adjudication Costs 90
6.2.6. Forecasting Corrections 92
6.3. General Office 92
6.3.1. Commission Direction for Evaluating Cal-Am's General Office Proposed Cost Increases 94
6.3.2. DRA's Proposed Adjustments 96
6.3.2.1. Annualize Labor Expense Based on May 31, 2008, Actual Staff Levels, Reduces 2009 Revenue Requirement by $338,581 97
6.3.2.2. Reducing Incentive Compensation to 2007 Actual Award Levels Reduces Revenue Requirement by $589,158 100
6.3.2.3. Remove Business Development Expense of $383,185 102
6.3.2.4. Corporate Contributions and Sales and Marketing Expenses 103
6.3.2.5. Legislative Influence 104
6.3.2.6. Unsupported NSC Functions 107
6.3.2.7. Local Service Company Employees Re-Assigned to CalCorp 107
6.3.2.8. Service Company Allocations to Cal-Am 109
6.3.2.9. Customer Service Center 111
6.3.2.10. Payroll Reserve 114
6.3.2.11. Reverse Double Counting of CalCorp Rate Case Expense 115
6.3.2.12. Four-Factor Methodology - California District Allocations 115
6.4. Monterey Peninsula Water Management District 116
6.4.1. Background 117
6.4.2. Discussion 119

Title **Page**

7. Rate Design Settlement 123
7.1. Summary of the Rate Design Settlement 123
7.2. Comments on the Rate Design Settlement 125
7.3. Evaluating and Approving the Rate Design Settlement Agreement 127
8. Water General Rate Case Partial Settlement 128
8.1. Description of the Settlement Agreement Provisions that Apply to the Water General Rate Case 128
8.2. Evaluating and Approving the Water General Rate Case Settlement Agreement Provisions 130
9. Reducing Use of Potable Water for Landscape Irrigation 131
10. Comments on Proposed Decision 132
11. Assignment of Proceedings 136
Findings of Fact 136
Conclusions of Law 145
FINAL ORDER 152
APPENDIX A - Conservation Rate Design Settlement Agreement
APPENDIX B – Comparison Tables
APPENDIX C – Cal-Am General Office Table
APPENDIX D – Tariffs
APPENDIX E – List of Appearances

Adjudication Costs Balancing Account to track the amortization of the costs and the interest on the unamortized balance.

6.2.6. Forecasting Corrections

DRA recommended corrections to Cal-Am's Test-Year 2009 forecasts for 24 accounts, ranging in size from a $14 increase to a $98,000 reduction. DRA's total adjustments reduced Administrative and General Costs by $528,985.[176]

Cal-Am presented persuasive testimony on six accounts showing that $312,549 of DRA's proposed adjustments were biased to create low estimates.[177]

We will adopt DRA's proposed adjustments with the exceptions of the six accounts – Accounts 703, 743, 754, 756, 766, and 799 – on which Cal-Am refuted the adjustments.

6.3. General Office

The Monterey District's revenue requirement includes cost allocations from three levels of corporate general office. For test year 2009, the proposed total general office allocation to the California districts is $16,858,609, a 49% increase over authorized 2006.[178] Of this total, Cal-Am proposes to allocate $5,407,279 to the Monterey water district.[179]

---

[176] *See* Hearing Exh. 90 at pp. 3-4. The increase in Account 713 was omitted because it is due to a change in accounting treatment for well rehabilitations, not forecasting.

[177] Hearing Exh. 11 at pp. 6-8.

[178] General Office Application, Exhibit B, Chapter 1, Section 3, Table 1. This table is also the source for the proposed increases for the corporate entities used in this section of today's decision.

[179] Hearing Exh. 90, p. ES-3. This total includes Toro, Chualar, Ambler, and Ralph Lane. We rely on DRA's testimony because nowhere in Cal-Am's application is this amount clearly presented.

Each corporate entity and proposed increase associated with that entity is described below:

1. American Water Works Service Company, Inc., ("National Service Company") – with headquarters located in New Jersey and customer call centers in Alton, Illinois, and Pensacola, Florida, this corporate entity is responsible for finance, treasury, customer service, information technology, procurement, and water quality for all the American Water Company corporate affiliates.

In its application, Cal-Am proposed to increase the California share of National Service Company costs by 51%, from $5,532, 550 authorized for 2006 to $8,357,126 for test year 2009. The primary cause of this increase is the Call Center, where the costs have more than doubled from 2006.

2. Local Service Company – Belying its name, this corporate entity provides services to American Water Company corporate affiliates located in the western region of the United States. Offices are located in Phoenix, Arizona, and "various offices in California."[180] Services provided to American Water subsidiaries include: managerial, budgeting, public relations, water quality, administration, risk management, human resources, rates, finance, and engineering.[181]

Cal-Am proposed to increase the California share of this level of corporate service company by 8.6%, from $3,226,800 in 2006 to $3,546,988 for test year 2009.

3. American Water California Service Company ("CalCorp") – providing services only to California Water Company's seven California districts, including

---

[180] Application Exhibit B, Chapter 3, Section 1, p. 2.

[181] *Id.*

Monterey, this corporate entity is located in offices in Chula Vista, Sacramento, and Los Angeles, California.

Cal-Am proposed to increase the expenses for this California corporate entity by 98%, from $2,499,000 in 2006 to $4,954,495. The primary cause for this increase is increased personnel.

In its application, Cal-Am also presented several metrics comparing its proposed level of general office allocations with authorized allocations for 2006. The number of general office employees per customer is up by 40%,[182] and payroll is proposed to increase by 71%.[183] The higher payroll increase is explained by the 24% increase in the number of managers and supervisors.[184]

6.3.1. Commission Direction for Evaluating Cal-Am's General Office Proposed Cost Increases

Confronted with "seemingly endless" increases in administrative costs, the Commission has adopted the rate of customer growth as a guideline for evaluating proposed increases in Administrative and General Costs such as those proposed by Cal-Am in its General Office application. Although not an absolute cap, proposed increases that exceed the rate of customer growth must meet a "heavy burden" to demonstrate reasonableness.[185] Inflation is often added in as well, resulting in inflation plus the rate of customer growth as the overall standard beginning point for analysis of this type of proposed increases. For

---

[182] General Office Application, Exhibit B, Chapter 6, Section 1, Table 3.

[183] General Office Application, Exhibit B, Chapter 6, Section 1, Table 4.

[184] General Office Application, Exhibit B, Chapter 6, Section 1, Table 7.

[185] California Water Service Company, D.03-09-021, *mimeo.* at pp. 35 -37, and decisions cited therein.

corporate entities that also perform non-regulated utility activities, the utility's evidentiary burden is even heavier.[186]

The Commission last considered Cal-Am's general office operations and costs in 2006 in D.06-11-050. The general office rate case was settled, and the settlement included provision for an audit. The Commission approved the settlement with the audit provision, and further directed Cal-Am to make a specific showing in the next general office filing, which is this proceeding:

> Relying on the informed consent of DRA, combined with the agreement for a comprehensive outside audit in connection with the 2009 GO GRC, we find that it is reasonable to accept the overall level of GO expenses allocated by the settlement to the California districts.
>
> We direct Cal-Am as part of its 2009 GRC filing to show the California regulated amount for each expense category and to provide a comprehensive direct showing in support of any expense item that has increased at a rate greater than inflation and customer growth. Decision 06-11-050, *mimeo.* at p. 89.

Cal-Am has not experienced significant customer growth since its last general rate case in 2006; total California districts customer growth has been about two percent. Using DRA's published weighted average labor and non-labor escalation factors for 2006 to 2009, yields 14.3%.[187] Adding customer growth to inflation suggests that for a proposed increase over 16.3%, Cal-Am must overcome a heavy burden to establish that the proposed increases will result in reasonable rates. Cal-Am's proposed increase is 49%, and Cal-Am has

---

[186] *Id.*

[187] Based on DRA's published escalation factors, the weighted average based on 60% of Non-labor and 40% of labor compensation per hour is computed for 2006-4.82%, 2007-3.42%, 2008-5.5%. For the 2006 to 2009 time period, the overall escalation is 14.3%.

numerous non-regulated efforts served by the same employees, augmenting Cal-Am's already heavy burden to show the reasonableness of its proposed increases.

For Cal-Am's next general office rate application, we provide further directives. All proposed general office allocation increases to California ratepayers must be justified by a specific demonstration of benefit to California ratepayers. The demonstration must address all proposed personnel increases on a position-by-position basis to show that the increases are necessary to meet new or unmet requirements to serve California ratepayers. Proposed general office increases which do not meet this evidentiary standard will be denied.

6.3.2. DRA's Proposed Adjustments

DRA thoroughly analyzed Cal-Am's total General Office expenditures, and Cal-Am's proposed California share, to make 14 specific proposed adjustments, which would reduce the California General Office increase from $16,858,609 to $13,226,419 for test year 2009. This increase of $1,928,069 is about a 17% increase over authorized 2006 California General Office costs of $11,298,350. DRA's adjustments bring Cal-Am's overall proposed increase into line with our standard for this general office filing, which we calculated above to be 16.3%. Consequently, as explained above, Cal-Am bears a heavy burden to overcome DRA's recommended adjustments. As set forth below, we have evaluated each of DRA's proposed adjustments and determined that $3,220,400 should be removed from Cal-Am's proposed increase. The adjustments are summarized in Appendix C.

6.3.2.1. Annualize Labor Expense Based on May 31, 2008, Actual Staff Levels, Reduces 2009 Revenue Requirement by $338,581

DRA opposed calculating labor costs based on Cal-Am's budgeted employee count, and recommended use of actual employee headcount on May 31, 2008, the most recent actual employee count data available. DRA reasoned that employee levels in Cal-Am's service companies have increased by about 26% since 2006, but that Cal-Am's regulated customers have increased only 2%. In addition, to meet its 2009 test year projections, Cal-Am would have to increase staffing levels by 9% from actual end-of-May numbers.[188]

Cal-Am countered that the three-year rate case period should be based on a forecast of employees needed, not an actual count on an arbitrary date that will, in effect, "freeze" employee levels for three years.[189] Cal-Am explained that many of its departments were in the process of hiring new staff up to budget levels and that these personnel were required to maintain high quality service.

DRA proposed to use the labor costs of the actual employee count on May 31, 2008 as the best predictor of actual employee count during test year 2009 and, consequently, the total labor cost.

Service Company	2006 Employee Count	May 31, 2008 Employee Count	% Change from 2006	Test Year Request	% Increase from 2006
National	1,111	1,402	26%	1,533	38%
Local	65	54	-17%	57	-12%
Cal-Corp	17	40	135%	51	200%
TOTAL	1,193	1496	25%	1,641	38%

[188] Hearing Exh. 90, pp. 2-3.

[189] Cal-Am Opening Brief at p. 137.

DRA's proposal accepts the American Water Service Companies' employee count growth from 1,193 in 2006 to 1,402 on May 31, 2008 - a 25% increase.

In rebuttal, Cal-Am isolates the unfilled positions implicitly excluded by using actual May 31, 2008, employee counts and contends that each is essential to its operations. Cal-Am criticizes DRA's proposal as a "recommendation to freeze labor expense at the May 31, 2008, level."[190]

Cal-Am seems to misunderstand DRA's recommendation. DRA takes the actual May 31, 2008, employee count and escalates labor costs associated with this count by four percent to calculate test year 2009 recommended service company labor. DRA's report does not appear to have as its objective a position-by-position evaluation of Cal-Am's staffing decisions; rather, it advocates using the actual employee count as a means of tempering "the inexorable, never-ending increases in service company resources allocated to the same number of regulated California customers."[191] DRA's recommendation is a device to cap labor costs, using employee count as a proxy. This recommendation allows the utility a 25% increase over 2006, almost two-thirds of its requested 38% increase.

Cal-Am's growing service company management ranks, up 33% from 2006,[192] have the duty and responsibility to carefully spend this labor funding to maximize service to regulated customers. DRA did not recommend and we do not adopt a position-specific analysis. We expect all levels of American Water

---

[190] Cal-Am Opening Brief at p. 139.

[191] DRA Opening Brief at p. 151.

[192] Application Exh. B, Chapter 6, Section 1, Table 7.

management to exercise their judgment to deploy this labor funding in a manner which best meets the needs of regulated customers.

We note that the bulk of Cal-Am's presentation on general office labor costs consists of general task descriptions,[193] without associated cost data, either historical or forecast. Employees added since the last general rate cases are not identified or their positions explained, much less cost justified. Employee count expansions are similarly not identified on a department by department basis, nor are specific new needs identified that might justify the proposed employee count expansion. As described by Cal-Am, the rate case cost projections were "developed by working with the key managers of the functions in the CAL-Corp organization to determine the staffing necessary to responsibly manage the business and to deliver services to our customers."[194] Organization charts depicting the new employees were prepared and salary costs determined.[195] At no point were proposed expenditures critically evaluated across the companies for necessity and cost justification.

Cal-Am made a broad proposal that 38% more personnel were required to the meet the needs of essentially the same level of customers as in 2006. Responding with a link to reality, DRA agreed to accept employees actually hired as of May 31, 2008, a 25% employee count increase over 2006.

---

[193] For example, the Shared Service Center was implemented in 2001 to "support the financial function of California American by performing essential daily transactional services for ongoing accounting, financial reporting, payroll processing, project accounting and reporting…" Hearing Exh. 45, Tab 2, p. 7.

[194] Hearing Exh. 45, Tab 4, p. 5.

[195] *Id.*

We agree and adopt DRA's recommendation for purposes of this General Office rate case in the context of DRA's overall adjustments which bring the proposed total increase into line with our standard.[196]

6.3.2.2. Reducing Incentive Compensation to 2007 Actual Award Levels Reduces Revenue Requirement by $589,158

Cal-Am proposed incentive compensation for its three levels of service companies: $7.2 million for the National Service Company, $0.8 million for the local service company, and $0.5 million for Cal Corp.[197]

DRA reduced incentive compensation at the service companies to reflect 2007 actual award levels, rather than the 100% payout rate that Cal-Am assumed. DRA used the following payout rates from 2007:

National Service Company	12% of budget
Local Service Company	63% of budget
Cal Corp	56% of budget

Cal-Am explained that DRA's unusually low payout rate for the National Service Company in 2007 is due to an error in a Cal-Am data response, which gave the number of employees receiving an incentive payout for only one business unit in the National Service Company, not the whole company. Cal-Am, therefore, disputed DRA's reduction based on the erroneous information. Cal-Am also contended that it sets incentive compensation at "achievable" levels, and that payouts can be as high as 120% with superior

---

[196] Our resolution of this issue impacts overall General Office allocations and will be accounted for as an overall adjustment, rather than assigned to specific departments or a particular service company.

[197] Hearing Exh. 90 at pp. 2-4.

performance. Accordingly, Cal-Am concluded, a 100% payout level assumption for test year 2009 is reasonable.[198]

DRA's reliance on the erroneous 2007 amount is not supportable, but neither is Cal-Am's conclusion that the record supports a 100% payout assumption. Cal-Am does not dispute that in 2007 the payout rates for the Local Service Company and Cal Corp were 63% and 56%. Cal-Am's correction to the data response shows that about 76% of the National Service Company employees received an incentive payout in 2007.[199]

These data are the most recent full year payout rates available for each service company. Cal-Am has not presented any evidence that the incentive pay program has been changed to ensure 100% payout, or that the 2007 payout rates, with the corrected data response for the National Service Company, would not be a reasonable forecast of the test year 2009 incentive compensation payout rates.

We conclude, therefore, that the 2007 incentive compensation program actual payout rates should be used for forecasting incentive payout for test year 2009. Based on these payout rates, Cal-Am's proposed incentive compensation costs from the three service company levels is $243,632 for the National Service Company, $499,101 for the local service company, and $303,463 for Cal Corp.

---

[198] Hearing Exh. 46, pp. 1–9.

[199] *Id.* at p. 5, showing payouts to 535 employees divided by 700 National Service Company employees, source Exh. 90, pp. 2-7.

6.3.2.3. Remove Business Development Expense of $383,185

DRA proposes removing business development expenses of $30,439 from the National Service Company and $352,746 from the Local Service Company from California's General Office allocation. DRA stated that the record does not include any evidence that ratepayers benefit from business development activities through added customers or revenue.

Cal-Am countered that its business development staff was essential to achieving the Commission's Water Action Plan goal of consolidating small water systems into Cal-Am's larger operations, and that its staff brings the "commercial acumen" necessary to negotiate and conclude an acquisition.[200] Cal-Am stated that it business development personnel had concluded six system acquisitions in the last 10 years.[201] Cal-Am also explained that its business development group is included in efforts to partner with local agencies in the areas of recycled water, desalinization and groundwater basin storage.[202] Cal-Am proposed to include as business development expense the Business Development Manager, Executive Assistant, Project Financial Manager, and a share of the Vice President of Business Development.[203]

Cal-Am did not quantify the costs it proposed to include in general office revenue requirement or any specific financial benefits to utility customers from business development staff. For example, Cal-Am's direct testimony does not

---

[200] Hearing Exh. 45, Tab 1, p. 7.

[201] *Id.*

[202] Hearing Exh. 50, pp. 4–5.

[203] Hearing Exh. 45, Tab 1, p. 2.

even specify the amount at issue or the number of new customers added through this department's efforts.[204] Cross-examination suggests that "coordinating" non-regulated operations and maintenance agreements are also an important function of these personnel.[205]

The Monterey District is facing severe water supply limitations and its business and residential customers are burdened with substantial rate increases; consequently, Cal-Am must demonstrate that its proposed expenditures are "necessary for reliable service and provide value to customers."[206] Cal-Am's presentation on business development expense fails to quantify or demonstrate specific benefits to customers from the substantial amounts Cal-Am forecasts spending on business development.

We, therefore, conclude that Cal-Am has not met its evidentiary burden for including these costs in the revenue requirement of its California districts. These costs will be excluded from our final approved California revenue requirement.

6.3.2.4. Corporate Contributions and Sales and Marketing Expenses

Cal-Am proposed to allocate $20,623 of its corporate charitable contributions and $72,056 in sales and marketing expenses to California districts. Based on long-standing Commission precedent, DRA opposed these proposals. Cal-Am did not address either issue in its brief. To the extent either issue

---

[204] *Id.*

[205] Hearing Transcript at pp. 773–775.

[206] Assigned Commissioner's and ALJ's Ruling and Scoping Memo, at p. 10 (June 27, 2008).

remains in dispute, we reiterate that utility charitable contributions and sales and marketing expenses must be recorded below the line.

6.3.2.5. Legislative Influence

DRA adjusted Cal-Am's proposed General Office allocation to remove $218,212 for legislative influence expense. DRA explained that the Commission has historically disallowed such expenses, most recently in Cal-Am's last General Office rate case in 2003.

Cal-Am explained that its legislative influence expense is company employees and expenses for a firm hired to "facilitate communication with key federal agencies and other stakeholders that can affect the Company and its customers" by providing "guidance and facilitat[ing] access to regulatory agencies, Congressional staff and members of Congress."[207] Cal-Am also employs a Director of Government Affairs at the National Service Company, with responsibility for "improving communication with our customers and other important stakeholders, such a environmental and health regulators, municipal and other local and state officials, community organizations, and other state agencies that impact water quality and resource issues," as well as helping to "bridge communication and relationship gaps with stakeholders, leading to better understanding and more effective conflict resolution."[208] DRA determined through discovery that the firm and Director are expected to cost the National Service Company $459,562 in test year 2009, of which $22,564 is allocated to California.[209]

---

[207] Hearing Exh. 60 at p. 13.

[208] *Id.*, at pp. 14-15.

[209] Hearing Exh. 90 at pp. 2-10.

Cal Corp also created a new California Government Affairs position, which it filled in May of 2008. In testimony, Cal-Am described this position as its "front line resource to improve communication, education, coordination, and collaboration with and among our key stakeholders."[210] Rather than legislators, Cal-Am explained that the incumbent in this position works with "agencies that regulate our operations," such as this Commission, and is "key to making sure that we understand and acknowledge new and changing regulation, that regulators understand our operations, and that we are better able to meet the environmental goals of the California Governor's Climate Change Initiative . . . and other supply constraints in California."[211]

In the position description included in the record, however, Cal-Am describes the "key accountabilities" as including "monitors and provides input to positively influence proposed legislation and emerging issues that could affect the Company."[212] On cross-examination, however, Cal-Am dismissed this position description as being "used throughout all of our subsidiaries that have government affairs directors" and "not specific to the California position."[213] Cal-Am offered, however, no other written job description for the record.

As noted by DRA, this job description is substantially similar to that presented by Cal-Am to justify its Director of Government Affairs position in its 2003 general office rate case. When previously considering this job description, we concluded that "With already high rates and a greater than 30% increase

---

[210] Hearing Exh. 52 at p. 3.

[211] *Id.*, at pp. 3-4.

[212] Hearing Exh. 53 at p. 2.

[213] Hearing Transcript at p. 798.

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."[214]

Cal-Am's rate case testimony suggests that the primary focus of the California Director of Government Affairs will be communications with regulatory agencies, specifically, "to update" levels of government other than elected officials or legislators.[215] These duties, however, sound more like regulatory affairs, for which Cal-Am seeks substantial funding and we address regulatory affairs elsewhere in today's decision. Most importantly, the record contains no documentation of this version of the position's duties existing prior to the rate case testimony; so far as the record shows, the primary governmental "updating" duties appear to have been developed for the first time as part of this rate case presentation.

We conclude that Cal-Am's presentation in this proceeding has revealed inconsistencies in its documentation and rate case testimony. In 2003, Cal-Am's presentation suffered from the same type of inconsistencies:

> "On cross-examination, however, it became clear that the company has not well thought out just what this new position would do, or if it has, the description is not consistent through its presentation here."[216]

As in 2003, we find that Cal-Am's assertion that the California Director of Government Affairs position does not include lobbying is contradicted by the

---

[214] In the Matter of the Application of the California-American Water Company, D.03-02-030, *mimeo.*, at pp. 23-24 (February 13, 2003).

[215] Hearing Transcript at p. 798.

record. We, therefore, exclude from General Office revenue requirement both the $195,648 in test year 2009 Cal Corp expenses, and the $22,564 in National Service Company lobbying expenses, for a total of $218,212.

6.3.2.6. Unsupported NSC Functions

DRA identified $545,959 for 2008 and $82,520 for test year 2009 in National Service Company costs that did not meet regulatory standards for ratepayer recovery. This total is comprised of three components: (1) 2008 "NSC Functions," (2) $1 million risk reserve, and (3) Non-departmental External Affairs Director.[217] Cal-Am did not dispute these adjustments in the brief and we will adopt DRA's proposed adjustments. Cal-Am similarly did not dispute two corrections DRA identified that increased the General Office revenue requirement: non-departmental interest income and income tax ($38,195) and including Operating Risk Department salaries ($30,801). We will adopt both of these corrections as well.

6.3.2.7. Local Service Company Employees Re-Assigned to CalCorp

DRA proposed that Cal-Am's general office allocation to California be reduced by $334,197 in test year 2009 due to employee re-assignment. DRA argued that in 2006 and 2007 American Water reassigned 17 employees from the Local Service Company to CalCorp but that 12 of those employees did not experience any meaningful change in duties. By moving those employees to CalCorp, DRA contended that Cal-Am shifted costs to California ratepayers that

---

[216] In the Matter of the Application of the California-American Water Company, D.03-02-030, *mimeo.*, at pp. 23-24 (February 13, 2003).

[217] Hearing Exh. 90 at pp. 2-10 to 2-11.

would have otherwise been allocated among jurisdictions.[218] DRA proposed allocating to California the same share of these employees as previously, which results in the disallowance of $334,197 in test year 2009.

In rebuttal, Cal-Am explained that, when American Water was owned by RWE/Thames Water, a large number of personnel were assigned to the Local Service Company "to provide flexibility in support of a wide range of activities in the Western Region and to support non-regulated business activities in the West."[219] Since being divested from RWE/Thames, American Water adopted a "strong state structure" which led to the reassignment of personnel from the Local Service Company to CalCorp. The ratemaking consequence of the "strong state structure" is to ensure that all costs of the 12 employees at issue are fully allocated to California ratepayers. In contrast, when the employees were assigned to the Local Service Company, only time actually spent on California activities was billed to California ratepayers, and any other time was billed to other jurisdictions or non-regulated operations.

Cal-Am offered a position-by-position analysis of the employee re-assignments:[220]

- Three of the 12 employees are engineers who have historically billed virtually all of their time to California so DRA's proposed adjustment for these personnel is trivial.
- The labor costs of the President of Cal-Am have always been exclusively billed to California.

---

[218] *Id.*, at pp. 5-13 to 5-14.

[219] Hearing Exh. 54 at p. 7.

[220] Hearing Exh. 54 at pp. 8–10.

- Two positions, Manager of Customer Service and Project Engineering Manager, have previously provided services to other jurisdictions, but have now been fully dedicated to meeting increasing customer service and engineering needs in California.
- The job duties of Director of Business Performance have been modified to include assisting in the preparation of general rate cases and other rate filings, as well as operational and financial projects.
- The remaining five positions are for rate personnel due to the increasing complexity of the regulated environment, coupled with Cal-Am's need to improve its filings.

Based on Cal-Am's thorough analysis, we find that Cal-Am has met its burden of justifying the reassignment of personnel from the Local Service Company to the California-only service company, CalCorp. Therefore, we deny DRA's requested adjustment of $334,197.

6.3.2.8. Service Company Allocations to Cal-Am

DRA proposed to reduce the National and Local Service Company allocations to Cal-Am by $767,334 in test year 2009. DRA explained that American Water's proposal fails to fairly allocate costs to unregulated operations.[221] DRA notes the anomalous allocation to Cal-Am of 5.41% of National Service Company costs, despite Cal-Am having only 5.18% of regulated customers, the factor upon which the costs are supposedly allocated to regulated customers.[222] DRA also demonstrated for the record that American Water

---

[221] Hearing Exh. 90 at pp. 2-15 to 2-19. DRA also recommends using updated customer counts.

[222] American Water's total of regulated customers is 3,308,296, with California comprising 170,114, of which 40,060 are water customers of the Monterey district. *Id.*, at pp. 3-15 and 8-2.

allocated no costs at all to over 100 non-regulated municipal contracts which are provided services from the National Service Company.

To correct the allocations to non-regulated operations, DRA obtained expense and revenue data, tabulated by regulated and non-regulated operations, from American Water's May 12, 2008, filing with the United States Securities and Exchange Commission. Averaging the shares for revenue and expense, DRA calculated that 12% of National Service Company costs should be allocated to non-regulated operations. With this share removed from total National Service Company costs, Cal-Am's corrected allocation is 4.56% for most National Service Company costs.[223]

Cal-Am argued that its methodology to allocate National Service Company costs to its non-regulated affiliate, American Water Enterprises, Inc. (AWE), recognizes that many National Service Company departments do not provide services to AWE; that is, these costs should not be assigned to AWE.[224] The methodology starts with direct billed charges, then allocates Tier 1 and Tier 2 common costs based on cost causation, and also includes allocated overheads. Under this methodology, Cal-Am concludes, AWE pays only for services it actually receives.[225]

Cal-Am's argument misses the point that DRA has made. DRA has demonstrated, and Cal-Am has not disputed, that over 100 municipal contracts

---

[223] *Id.*, at pp. 2-18. DRA accepts American Water's allocation of 4.7% of Human Resources and 6.48% of Procurement, and notes that if the Customer Service Center allocation is limited to 2003 levels as DRA recommends, then no additional limitation is required.

[224] Hearing Exh. 60 at pp. 3–7.

[225] *Id.*, at p. 11.

are serviced by National Service Company personnel and that Cal-Am allocates no costs to these efforts, effectively shifting these costs to utility customers. Whatever the proper cost allocation to these contracts, and any other non-regulated operations, it is certainly not zero, which appears to be Cal-Am's position. Careful cost allocation to non-regulated operations is essential to ensure that regulated customers are not subsidizing non-regulated, and that regulated utilities are not engaging in unfair competition with firms that lack a monopoly customer base.

Cal-Am bears the burden of convincingly demonstrating that it has allocated costs consistent with our principles. Cal-Am's presentation in this proceeding has not met that standard. We will rely on DRA's non-regulated allocation calculated from the SEC filing because that filing is the best evidence before us.

For the following National Service Company rate filing categories, Cal-Am shall be allocated 4.56% of costs: Belleville Lab, Customer Service Center, Finance, Information Technology, NSC Functions, Operations/Network, Shared Services. These changes reduce National Service Company expense allocated to California by $716,334 in test year 2009. Using up-to-date customer counts as recommended by DRA, and we approve, adjusts Local Service Company expenses allocated to California down by an additional $51,000 in test year 2009, for a total reduction of $767,334 in Cal-Am's request.

6.3.2.9. Customer Service Center

Cal-Am proposed to increase the California allocation from the National Service Company's Customer Service Center from $1,396,709

authorized for 2006 to $2,802,618 for test year 2009, a 101% increase from 2006 to 2009.[226] In addition to handling customer telephone calls, this center also provides billing services, collections actions, service orders, and miscellaneous customer service functions.[227]

DRA recommended that the Commission hold Cal-Am to 2003 per customer costs, plus inflation, for a Customer Service Center total amount of $1,971,507. DRA compared Service Center costs per customer of $9.85 in 2003 to Cal-Am's proposed $16.24 in test year 2009, and concluded that these increasing per customer costs paradoxically showed dis-economies of scale from American Water's nation-wide consolidation of its customer service function during that time.[228]

Cal-Am has two customer service centers, one in Alton, Illinois, and one in Pensacola, Florida. The centers provide customer service 24 hours per day, every day. Cal-Am created these two national call centers and consolidated its 22 local call centers between 2001 and 2004. Cal-Am asserts that the consolidated operations allow Cal-Am to provide service in 172 languages, use a single agency for collections and bad debts, and implement expensive call management technology.[229] In response to DRA's analysis of per customer costs, Cal -Am stated that calls per customer have increased from 2003 to 2007.[230] Cal-Am also challenged DRA's calculations, including DRA's inflation factor; Cal-Am

---

[226] Application, Exh. B, Chapter 1, Section 3, Table 1.

[227] Hearing Exh. 43 at pp. 3–4.

[228] Hearing Exh. 90 at pp. 2-13.

[229] Hearing Exh. 43 at pp. 3–6.

[230] *Id.*, at p. 7.

escalated 2001 per customer costs to determine a 2009 per customer cost of $15.35, which Cal-Am concludes "compares very favorably to the requested cost of $16.24 per customer."[231]

Elsewhere in today's decision we addressed the subject of National Service Company allocations to non-regulated operations and determined that 4.56% of most National Service Company departments, including the Customer Service Center, should be allocated to California. Reducing the California allocation of Customer Service Center expenses from 5.41% to 4.56% reduces the total Customer Service allocation by $445,566 to $2,357,052.[232]

DRA would further reduce this amount to $1,971,507 based on escalating 2003 costs per customer, but Cal-Am disputes using 2003 data. Cal-Am's analysis of last available stand-alone costs uses 2001 cost data, escalates based on our composite index, and calculates $15.35 per customer or $2,631,665 for a hypothetical stand-alone Customer Service Center. In comparison, Cal-Am requests $16.24 per customer or $2,784,250, about 5.8% more under a consolidated, nation-wide Customer Service Center.

Thus, Cal-Am's own analysis shows that rather than producing "economies of scale,"[233] its Customer Service Center is producing what DRA calls "diseconomies," of about 5.8%. Also completely absent from Cal-Am's showing is any evidence of productivity improvements from its extensive nationwide customer service consolidation. Cal-Am describes some of the benefits of consolidation as "leverag[ing] investment in leading edge training facilities" and

---

[231] Hearing Exh. 55 at p. 19.

[232] Hearing Exh. 90 at pp. 4–9 ($51,689,743 x .0456 = $2,357,052).

[233] General Office Application Appendix B, Chapter 2, Section 1, p. 1.

a "variety of self-service options using the latest natural speech recognition technology,"[234] but Cal-Am's own testimony shows higher costs under the consolidated model.

Adjusting Customer Service Center expenses allocated to California to remove the 5.8% of admitted excess cost will reduce Cal-Am's request to $2,222,700. This adjustment imposes some level of cost containment and/or efficiency improvements on the National Service Company's operation of the Customer Call Center. With this adjustment, we conclude that the Customer Service Center expenses allocated to California are reasonable.

6.3.2.10. Payroll Reserve

Cal-Am included a payroll reserve in its Local Service Company, with $30,801 in test year 2009 allocated to Cal-Am. The purpose of the reserve is to provide for "unexpected increases, promotional increases, and unanticipated market-driven" salary increases necessary to fill positions.[235]

DRA opposed the reserve as unnecessary, "layered on top of salary increases and incentive compensation."[236]

Cal-Am has not demonstrated that such a salary reserve is necessary to meet its obligations to provide public utility service. The across-the-board salary increases of 3% to 5%, in addition to the incentive compensation, should enable Cal-Am to fill its vacant positions. We, therefore, deny the request and reduce Cal-Am's allocation from the Local Service Company by $30,801.

---

[234] Hearing Exh. 43 at p. 6.

[235] Cal-Am Opening Brief at p. 148.

[236] Hearing Exh. 90 at pp. 2-13.

6.3.2.11. Reverse Double Counting of CalCorp Rate Case Expense

DRA contended that Cal-Am included CalCorp rate analysts' labor costs as both CalCorp allocations and as deferred rate case expense. This resulted in applying for more than 100% of the labor costs. DRA proposed reducing by $34,664 the allocation from CalCorp. Cal-Am did not dispute the reduction. We will adopt DRA's recommendation.

6.3.2.12. Four-Factor Methodology - California District Allocations

Cal-Am proposed to use the Commission's four-factor methodology to allocate general office costs among its seven California districts.[237] The four factors are: customers, plant, operations and maintenance expense, and payroll. In previous applications, Cal-Am has used only the number of customers to allocate general office costs among the districts.

Using the four-factor methodology results in the following changes from the 2005 General Office allocation between Cal-Am's largest districts, Sacramento and Monterey:

	2005 GO Allocation	Proposed 2009 Allocation
Sacramento	33.4%	24.8%
Monterey	24.4%	31.0%

In the scoping memo, the parties were directed to further study these changes.

[237] Coronado, Los Angeles, Village, Monterey Water, Monterey Wastewater, Sacramento, and Larkfield.

DRA opposed applying the four-factor methodology here.[238] DRA explained that costs are allocated from the National and Local Service companies to California based only on customers, and switching to a four-factor methodology at "the state border" did not "make sense."

Cal-Am did not address this issue in its brief.

We decline to apply the four-factor methodology for California district allocations. As noted above, this change in methodology has the effect of shifting costs from the Sacramento district to the Monterey district. Moving from a single allocator – customers – for national and regional costs to four factors for California costs is inconsistent. Accordingly, we will allocate Cal-Am's general office costs among its California districts based on the most recently available customer count information.

In D.06-11-050, the Commission previously authorized Cal-Am to recover the costs of DRA's audit of Cal-Am's General Office in this rate case. Cal-Am states that the audit will cost $178,000, which should also be allocated among the districts based on the number of customers.

6.4. Monterey Peninsula Water Management District

The assigned Commissioner and ALJ included within the scope of this proceeding the Monterey Peninsula Water Management District (Management District) and the funding it receives from Cal-Am's ratepayers via a "user fee" surcharge imposed and collected through the Cal-Am bill and remitted to the Management District. No party presented testimony on this issue, but the Management District and Cal-Am addressed it in briefs.

---

[238] Hearing Exh. 90 at pp. 8-1 to 8-2.

APPENDIX C

Appendix C
CALIFORNIA AMERICAN WATER
General Office Operating Expense
(Dollars in thousands)

2009	DRA		CAL-AM		Adopted
Description	ORIGINAL	REVISED	REVISED	ORIGINAL	
CALIFORNIA ALLOCATIONS					
Service Co - Belleville Lab	229.7	229.7	302.9	302.9	238.5
Service Co - Call Center	1,971.5	1,971.5	2,760.9	2,802.6	2,220.3
Service Co - Finance	454.3	454.3	581.4	581.4	471.7
Service Co - Human Resources	249.1	249.1	296.6	296.6	258.7
Service Co - Information Tech	1,379.4	1,379.4	1,786.5	1,786.5	1,432.3
Service Co - NSC Other	858.9	858.9	1,026.2	1,026.2	891.8
Service Co - Operations/Network	185.3	185.3	267.6	267.6	192.4
Service Co - Shared Services	758.7	758.7	1,141.0	1,141.0	787.8
Service Co - Procurement	134.7	134.7	152.3	152.3	139.9
National Service Co. subtotal	6,221.7	6,221.7	8,315.4	8,357.1	6,633.5
					0.0
Local Service Company	3,099.1	3,099.1	3,547.0	3,547.0	3,099.1
					0.0
CalAm GO Function (Cal Corp)	3,905.6	3,905.6	4,954.5	4,954.5	3,905.6
					0.0
Total GO Operating Expense	13,226.4	13,226.4	16,816.9	16,858.6	13,638.2
Rate Base Comparison					
Rate Base	1,269.9			1,269.9	1,269.9
Revenue Requirement from Rate Base	140.1	140.1	140.1	140.1	140.1
Total Revenue Requirement	13,366.5	13,366.5	16,957.0	16,998.7	13,778.3
Revenue Requirement Allocation to District Operations					
Coronado	1,633.4	1,633.4	2072.1	1,835.9	1,683.7
Los Angeles	2,178.7	2,178.7	2764	2,301.6	2,245.9
Village	1,650.8	1,650.8	2094.2	2,276.1	1,701.6
Monterey Water	3,147.8	3,147.8	3993.4	5,407.3	3,244.8
Monterey Wastewater	176.4	176.4	223.8	387.6	181.9
Felton	0.0	0.0	0	261.8	0.0
Sacramento	4,394.9	4,394.9	5575.5	4,207.2	4,530.3
Larkfield	184.5	184.5	234	321.3	190.1
Total	**13,366.5**	**13,366.5**	**16,957.0**	**16,998.7**	**13,778.3**
Acquistion Adjustment Allocation to Districts					
Coronado	493.8	493.8	493.8	535.4	493.8
Los Angeles	672.3	672.3	672.3	729.0	672.3
Village	523.8	523.8	523.8	567.9	523.8
Monterey Water	984.0	984.0	984.0	1,066.9	984.0
Monterey Wastewater	0.0	0.0	0.0	0.0	0.0
Felton	0.0	0.0	0.0	44.3	0.0
Sacramento	1,743.8	1,743.8	1,743.8	1,890.8	1,743.8
Larkfield	73.4	73.4	73.4	79.6	73.4
Total	**4,491.1**	**4,491.1**	**4,491.1**	**4,914.0**	**4,491.1**

(END OF APPENDIX C)