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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

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

1. Summary

This decision authorizes California American Water Company (Cal-Am) to increase rates in its Monterey Water District and Toro Service Area as follows:

Monterey District[1]		
Year	**Revenue Increase Over Last Adopted**	**Percentage Increase Over Last Adopted**
2009	$11,201,000	36.39%
2010	$1,077,900	2.53%
2011	$1,572,200	3.62%

Toro Service Area of Monterey District		
Year	**Revenue Increase Over Last Adopted**	**Percentage Increase Over Last Adopted**
2009	$365,524	118.6%
2010	$25,600	3.8%
2011	$47,000	6.7%

2. Procedural History

On January 30, 2008, Cal-Am filed three applications: Application (A.) 08-01-023 (the Wastewater application), A.08-01-024 (the general office application), and A.08-01-027 (the Monterey Water District general rate case application).

Protests to one or more of the applications were filed by the Division of Ratepayer Advocates (DRA), the San Lorenzo Valley Water District, the Independent Reclaimed Water Users Group, and the Monterey Peninsula Water

[1] The Monterey Water District includes Cal-Am's Monterey Main System as well as the Ambler, Bishop, Chualar, Hidden Hills, and Ralph Lane subsystems. For ratemaking purposes, the recently acquired Toro Service Area is separate.

Management District. The United States Department of Defense and other Federal Executive Agencies filed motions for party status in all three proceedings. On June 3, 2008, the Hidden Hills Subunit Ratepayers Association moved for intervenor status in A.08-01-024, and A.08-01-027.[2] By ruling dated June 13, 2008, the request was granted. Hidden Hills was also granted permission to late-file a Notice of Intent to seek intervenor compensation.

The assigned Administrative Law Judge (ALJ) convened a prehearing conference on March 20, 2008, for these three proceedings. The assigned ALJ for A.07-12-010, which addresses Cal-Am's proposed conservation and water rationing programs, also convened a prehearing conference that day to enable the assigned ALJs and parties to coordinate processing for all four proceedings. At the prehearing conferences, issues were divided among the proceedings, with the expectation that all three proceedings would be consolidated.

Public Participation Hearings for the three proceedings as well as A.07-12-010 (Monterey district conservation programs) were concurrently scheduled and held on May 28, 2008, in Chualar, and on May 29, 2008, in Monterey.

The assigned Commissioner and ALJ issued their Ruling and Scoping Memo on June 27, 2008, which consolidated these three proceedings and issued the hearing schedule. The parties distributed testimony during August and September 2008, and evidentiary hearings were held October 14 – 24, 2008. The

[2] Hidden Hills also sought party status in A.07-12-010, which was granted.

application, formal evidentiary hearing exhibits, transcripts, and briefs that comprise the record in this proceeding exceed 5,000 pages.

On November 24, 2008, Cal-Am and DRA filed two settlement agreements. The first agreement resolved several disputed issues in the Monterey Water District general rate case and all issues in the wastewater proceeding.[3] The second agreement resolved rate design issues in the water general rate case. We address both agreements as related to the water general rate case in today's decision.

On December 8, 2008, Cal-Am filed, pursuant to Pub. Util. Code § 455.2, a Motion for Interim Rate Relief, and requested an effective date of January 1, 2009, for the rates ultimately adopted in this proceeding. The assigned Commissioner and ALJ denied the request pursuant to § 455.2 but authorized Cal-Am to file an advice letter for interim rates pursuant to the Rate Case Plan, section II (B), as adopted in Decision (D.) 07-05-062.

All issues in the wastewater general rate case, A.08-01-023, are addressed in the first settlement agreement, which we consider in a separate companion decision. Accordingly, consolidation of the wastewater application with the general rate case and general office proceedings has been set aside.

3. Summary of the Applications Addressed in this Decision

3.1. A.08-01-024 (General Office Application)

In this application, Cal-Am asked for Commission authorization to increase the allocation to its Monterey district customers from: (1) the National

[3] The entire settlement agreement and motion addresses issues in both the wastewater and Monterey District water general rate cases. A complete copy may be viewed at http://docs.cpuc.ca.gov/efile/MOTION/94575.pdf.

Service Company, which provides services to a broad range of American Water Company entities across the country, (2) the Local Service Company, which serves all corporate entities in the five western states, and (3) Cal-Corp, which serves only Cal-Am. The additional revenue sought for these three levels of management was about $5.5 million, or 33% more than current general office levels. Cal-Am stated that about $1.5 million is for business development and retention bonuses at the corporate headquarters level which the Commission has previously rejected as costs properly borne by shareholders, not ratepayers.

3.2. A.08-01-027 (General Rate Case Application)

Cal-Am sought the following increases in general rates for water service in its Monterey District and the Toro Service Area of that District:

Monterey District		
Year	**Revenue Increase Over Last Adopted**	**Percentage Increase Over Last Adopted**
2009	$24,718,200	80.30%
2010	$6,503,900	11.72%
2011	$7,598,300	12.25%

Toro Service Area of Monterey District		
Year	**Revenue Increase Over Last Adopted**	**Percentage Increase Over Last Adopted**
2009	$354,324	114.97%
2010	$25,000	3.77%
2011	$46,500	6.76%

Cal-Am explained in its application that the primary factors leading to the $24 million requested 2009 increase for the Monterey District are: (1) about $61 million increase in rate base, which results in about $8.3 million increase in revenue requirement, (2) purchased water cost increases of over $6 million, (3) payroll and allocated General Office cost of about $5 million and (4) a revenue

requirement increase of nearly $1.2 million to offset loss of consumption due to conservation.

Also in that application, Cal-Am made 11 separately stated "special requests" for various costs items and ratemaking treatment. Among these requests are proposals to create a special surcharge to recover certain distribution system capital costs, to move about $65 million of San Clemente dam retrofit costs into rate base, and to establish a memorandum account for Endangered Species Act violation assessments.

Cal-Am subsequently requested permission to withdraw its request to move the San Clemente dam retrofit costs into rate base. Such permission was granted but due to Cal-Am's delay in making the request, other parties incurred unnecessary expense in preparing testimony and, as a condition of its withdrawing the request, Cal-Am reimbursed the parties for their wasted efforts. Cal-Am also withdrew its request Number 1 for an Infrastructure System Replacement Program. Four of the special requests were moved to the conservation docket, A.07-12-010. The remaining five special requests are resolved in the Settlement Agreement on water issues.

4. Burden of Proof

Cal-Am bears the burden of proving by a preponderance of the evidence that the proposed rates are just and reasonable. We will review Cal-Am's presentation in the context of the increasingly severe water supply limitations in Cal-Am's Monterey district and the significant financial burdens imposed on residential and business customers by the substantial rate increases sought by Cal-Am in these consolidated applications. This context requires that proposed expenditures be demonstrably necessary for reliable service and provide value to customers. We understand that the cost of providing an efficient and safe water

supply is rapidly increasing and we will, where necessary, approve substantial increase in expenditures, but we intend to carefully scrutinize Cal-Am's justifications for such proposals.

5. Summary of the Testimony Presented at the Public Participation Hearings and Written Comments

Public Participation Hearings were held on the evening of May 28, 2008, in Chualar, and on May 29, 2008, in Monterey with an afternoon and evening session. Approximately 45 persons presented testimony. In addition, the Commission received 250 written comments. The written comments largely opposed the proposed increases and requested that the Commission require Cal-Am to cut costs.

At the Chualar hearing, several speakers were customers served by the Spreckels wastewater system and they objected to Cal-Am's proposed tripling of their wastewater bill. At the conclusion of the public participation hearing, Cal-Am agreed to prepare additional spread sheets explaining the wastewater rate increase proposal and to meet with the customers to provide further explanation.

On May 29, 2008, public participation hearings were held in Monterey in the afternoon and evening. Representatives from the Hidden Hills subsystem opposed consolidation with the main Monterey system and explained that their system had its own supply and was not interconnected with the main system. Their attorney stated that the Cal-Am purchase agreement for the Hidden Hills system precluded Cal-Am from charging these customers for any costs associated with the main system. Representatives of the Toro and Bishop subsystems expressed similar sentiments.

Customers expressed substantial dissatisfaction with Cal-Am's telephone system, which has numerous levels of options that make it difficult to reach an

actual person. Their biggest frustration is that, even after successfully navigating the telephone system, the company representative is located far away and is often uninformed about issues pertinent to the Monterey district. No option is available for a local contact, only the "888" number. This issue attracted much agreement from customers present at the hearing.

Ratepayers also criticized this Commission as being overly responsive to Cal-Am's excessive requests, especially with regard to stranded costs of unapproved dam projects.

One set of representatives of the Monterey peninsula hospitality industry spoke in support of Cal-Am's operations and customer service. Another set of representatives explained that they had made expensive investments in water conserving fixtures and equipment and had greatly reduced water consumption, but the large rate increases and the way Cal-Am calculates water use, were imposing burdens on their businesses.

Customers also described receiving numerous expensive printed mailings from Cal-Am that contained little useful information and seemed a wasteful expense.

Many wastewater customers also attended the Monterey hearings and expressed opposition to the ratemaking consolidation proposal and resulting 66% to 160% increases.

6. Resolution of Remaining Issues

The parties reached agreement on many issues including rate design but significant issues remain in dispute. We address the remaining disputed issues below, beginning with plant in service, moving on to expenses, including general office, and conclude with evaluating the two settlement agreements.

6.1. Utility Plant in Service

For 2008, 2009, and 2010, Cal-Am proposes Plant Additions totaling $97,427,123. DRA has agreed to $36,296,154 of the proposed projects, has proposed to modify the recovery mechanism but agreed to $21,505,000 in additional projects, and has agreed with Cal-Am to reduce funding of $7,051,000 for other projects. In total, DRA has agreed to $64,851,000 in Plant Additions out of Cal-Am's requested $97,427,123, or about two/thirds of the proposal.[4] Over the three years, DRA has agreed to annual Capital Additions averaging over $21 million per year. This is more than a 100% increase in Cal-Am's historical 2003 -2007 annual Capital Additions average of $10 million.

Below we address each of the projects which remain in dispute between the parties, grouped by supply capacity, storage tanks, pipeline replacement, and meter replacement, generally following the process of water through Cal-Am's system. Unaccounted for or non-revenue water and the new purchased water from the Sand City Desalinization Plant complete the section on plant in service. We begin, however, with a "big picture" policy discussion, where we agree with many of the directives from American Water management.

6.1.1. American Water Company Asset Investment Strategy

Cal-Am's parent company, American Water, has adopted a strategy to guide its many subsidiaries in determining whether to approve capital additions for water and wastewater systems. Through discovery, Cal-Am provided to DRA a series of internal memoranda setting forth guidelines for strategically evaluating a variety of capital and expense projects. These memoranda are

[4] Hearing Exh. 21 at pp. 7–1 to 7–5.

included in Hearing Exhibit 22, at the second tab "H." We will focus on the Asset Investment Strategy for Capacity, dated May 8, 2006, found at pages 8 through 12 of tab "H." This document squarely addresses several issues presented for our consideration in today's decision. We find the analysis and rationale in this memorandum to be persuasive, and several of the measures we adopt today are patterned on these directives. We also note that these directives reflect policies that can be applied to other Class A water utilities.

The memorandum begins by stating that the purpose of the strategy is to guide investment necessary to serve growth and to maintain or improve the level of service for existing customers. The primary overall aim of the strategy is to "deliver timely and cost-effective solutions to serve new growth" and to "attain continuous improvement against key benchmarks."

Investment projects that address capacity needs under normal year conditions are given priority. Projects that are needed only under severe drought conditions are to be "assessed in consideration of the regulatory requirements and the community support for this level of service. Where supported by customers, temporary customer demand management measures in severe drought may represent a more appropriate and cost effective level of service." One of the "opportunities" related to this assessment process is engaging the regulators and community on willingness to pay for capacity improvements and "understanding customer expectations related to service during drought conditions."

In Section 5 of the memorandum, American Water switches to a question and answer format to address implementation issues. The first question asks whether water use restrictions are acceptable to balance the timing of capacity expansions. In the answer, American Water states that its general objective is to

provide capacity to meet projected growth and that customer restrictions should not be considered a permanent solution to meeting capacity need. It explains, however, that in areas with limited available resources, innovative solutions may be warranted, and that demand management measures, especially non-restrictive or voluntary conservation, may be used as a tool to balance the needs of the community with its resources or when financial conditions dictate. Priority will be given to projects that reduce capital needs through reduction in non-revenue water.[5]

The answer to the second question contains a passage that is especially pertinent to the Monterey system: "In areas where projected growth is minimal, [non-revenue] water . . . should be closely scrutinized to determine if investment in these areas could offset facility and supply expansion." The final answer is also helpful for Monterey customers: where existing capacity closely matches growth projections, American Water encourages its subsidiaries to offer "innovative solutions" including water audits and developing irrigation wells.

We agree with many of American Water's objectives and directives. The Monterey system has extreme supply challenges and local residents and businesses, which already experience elevated rates with expensive capital projects on the horizon, cannot be expected to withstand limitless rate increases. We agree that dialogue between customers and Cal-Am is essential to understanding customers' priority needs and their view of cost versus service level trade-offs. American Water's support for innovative solutions could

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[5] The difference between water supplied to the system and water actually billed to customers is referred to as "non-revenue water" or "unaccounted for water."

Footnote continued on next page

include temporary supply restrictions targeted at outdoor landscape irrigation during periods of peak demand. We also share American Water's focus on reducing non-revenue or unaccounted for water as a means to delay or offset capital supply projects, and we will adopt the requirement that such opportunities be "closely scrutinized." Most importantly, we support American Water's objective of innovative solutions, particularly for the Monterey system. We would like to see Cal-Am propose more projects designed to utilize unique features of the Monterey system to meet customer needs cost-effectively.

In today's decision, we adopt ratemaking measures that are closely synchronized with American Water's directives, especially on reducing non-revenue or unaccounted for water and using temporary service restrictions as a means to delay supply projects.

6.1.2. Water Supply Capacity

Cal-Am seeks $3,766,000 for four replacement wells in the Lower Carmel River valley, with a total capacity of 1.5 Million Gallons/Day (MGD). Cal-Am would also like to drill a new well in the Lower Carmel River Valley, which it estimates will also produce about 1.5 MGD and will cost about $789,000. Cal-Am bases its request for these wells on tabulations of its supply needs. In addition to drilling the wells, Cal-Am states that it will need to upgrade its existing Begonia Iron Removal Plant with ultraviolet disinfection to treat the water from the five wells, at a cost of $2,499,601.[6] The total cost for the five wells and associated disinfection upgrade is $7,054,601.

Throughout the record of this proceeding parties have used the latter term, which we use in today's decision. American Water, however, uses the former term.

[6] Cal-Am Opening Brief at p. 74.

DRA contended that Cal-Am failed to justify these projects, and recommended disallowance of all of these costs.

Cal-Am stated that the current firm capacity of the Monterey District is approximately 15.7 MGD, and that in this general rate case Cal-Am is requesting projects to increase the firm capacity to 19.4 MGD.[7] Cal-Am justifies this 24% increase in firm capacity with its Comprehensive Planning Study, which projected 2007 Maximum Day Demand at 19.5 MGD. The Comprehensive Planning Study used system demand data for 2002 – 2006 to forecast the 2007 maximum daily demand.[8]

Based on its Comprehensive Planning Study, Cal-Am explains that its "tried and true" forecasting methodology predicts customer demand and that it is essential to have facilities available to meet this demand "adequately, dependably, and safely."[9] Cal-Am states that it modified the usual historical period from 10 years to five to account for customer conservation patterns in the Monterey district.[10] The Study concluded that resources need to be available to meet a Maximum Daily Demand of 19.5 MGD. The Study also recognized "the need to balance the benefits of the capital improvement projects with the rate impact on customers and affordability is a reality."[11] In today's decision, we address that reality and strike a balance between the costs and the benefits of the proposed projects.

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[7] Hearing Exh. 11 at p. 9.

[8] *Id.* at pp. 3–6.

[9] Hearing Exh. 11 at pp. 8 and 20; Hearing Exh. 14.

[10] Hearing Exh. 11 at p. 5.

[11] Hearing Exh. 10 at p. 1-1.

Cal-Am forecasts this increase in Maximum Daily Demand despite: (1) anticipating no customer growth, (2) a history of declining demand on the Monterey system, and (3) this Commission's policy supporting decreasing demand through conservation programs and rate design. Specifically, Cal-Am's Comprehensive Planning Study found: "No significant growth in customers or demand is anticipated in the Main Monterey system for the foreseeable future."[12] In fact, actual measured demand appears to be decreasing. The Comprehensive Planning Study shows that Cal-Am's Maximum Daily Demand decreased 6.2% from 2003 to 2006, and that Average Daily Demand has fallen by 20% from 2001 to 2006.[13]

This Commission has a long-standing policy supporting reduced water consumption and has adopted significant ratepayer-funded conservation programs for all Class A water utilities. Specifically, we adopted consumption reduction targets of 3 to 6% per three-year rate case cycle in Investigation 07-01-022. For Cal-Am, in A.07-12-010, the parties have reached a settlement agreement providing for a 3% consumption reduction target over the course of the three-year rate case cycle.

Cal-Am's Comprehensive Planning Study, and the significant capacity increases it recommends, appear to be inconsistent with the lack of customer growth, the history of declining consumption, and the Commission's policy of water conservation. Cal-Am bears the burden of demonstrating convincingly that the proffered justification for these expensive capital projects is a sound planning approach for the Monterey System.

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[12] Hearing Exh. 10 at p. E-ii.

The parties have agreed to two projects that will increase summer and winter pumping capacity in the Lower Carmel River Valley which will address much of the claimed gap between forecasted Maximum Daily Demand and available capacity, at little or no capital cost. Obtaining a seasonal permit to operate the currently non-operational San Carlos Well only during the summer will add 1.5 MGD to Cal-Am's summer pumping capacity.[14] In response to Cal-Am's application to the California Department of Health for a seasonal permit, the Department issued a one-month interim permit, and promised to "make it a priority to complete the permit amendment to allow San Carlos Well 2 to be used as a seasonal groundwater source" as of July 26, 2007.[15] The San Carlos Well will increase Cal-Am's summer capacity by 1.5 MGD or 9.5% for little or no capital costs.[16] During the summer the well is not subject to surface water influence and thus will not necessitate the ultraviolet disinfection upgrade to the Begonia Iron Removal Plant that would be required for winter pumping.[17] With the addition of the San Carlos Well, Cal-Am's summer capacity will be increased to 17.2 MGD from its current 15.7 MGD of firm capacity for the summer.

The Scarlett Well No. 8 is also located in the Lower Carmel River Valley but, unlike the other existing and proposed wells, this well is designed to allow

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[13] *Id.* at chart shown after pp. 1-11; DRA Opening Brief at p. 67.

[14] Hearing Exh. 11 at pp. 2-3.

[15] Hearing Exh. 23 at second "B" tab, data response NKS-27.

[16] Hearing Exh. 11 at pp. 3 and 17.

[17] The ultraviolet disinfection upgrade to the Begonia Iron Removal plant is necessary to allow winter pumping of the Lower Carmel River Valley because during the winter the wells are under the influence of surface water which must be disinfected.

water to be chlorinated and pumped directly into the distribution system, without treatment in the Begonia Iron Removal Plant. This well is currently not in use due to positive tests for coliform bacteria. Cal-Am proposed, and DRA supported, a $157,000 sanitary seal project to correct this condition and allow the well to be operated during the winter months. The well may operate during the summer season only in "dire emergencies" but produces about 1.76 MGD during the winter.[18] This represents a 14.4% increase in winter capacity for the Monterey system.[19]

Thus, the agreed-upon capacity upgrades will increase Cal-Am's summer capacity by 9.5% to 17.20 MGD and winter capacity by 14.4% to 14.52 MGD. These significant capacity increases are occurring in a district with no customer growth for the foreseeable future and a history of declining consumption. In this context, Cal-Am seeks further capacity expansion projects totaling $7.0 million. We will assess these requests by analyzing customer demand.

6.1.2.1. Winter Maximum Day Demand

We begin by analyzing winter demand projections and focus on the level of reliability needed for the Aquifer Storage and Recovery project. By using a lower standard of reliability for the winter storage component of the Project, Cal-Am can meet its system demands.

Cal-Am tabulated its total winter capacity as 16.46 MGD, removed its largest well, Begonia No. 2 at 2.43 MGD as well as an average well typically taken off-line in winter at 1.77 MGD, and determined that it had 12.26 MGD in

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[18] *Id.* at pp. 3 and 21; Hearing Exh. 21 at pp. 7-40.

[19] Hearing Exh. 11 at pp. 3 and 24.

firm capacity available to meet its winter demand of 12.00 MGD.[20] Cal-Am did not include the Scarlett Well No. 8 in its tabulation. Thus, in winter, Cal-Am has sufficient capacity resources to meet its expected Maximum Daily Demand for its existing customers.

Cal-Am next addressed the 4.32 MGD in winter capacity needed for the Aquifer Storage and Recovery Project, in which additional water will be extracted from the Carmel River during the high flow winter season and stored in the Seaside Basin aquifer for retrieval during the summer months. This increase in demand is partially offset by the expected upgrade to the Scarlett No. 8 well which will allow 1.76 MGD in increased winter capacity. This leaves 2.56 MGD in unmet forecasted need for the Aquifer Storage and Recovery Project, which Cal-Am concludes justifies additional winter well capacity. Unique features of that Project, however, and the way firm capacity is calculated provide a reasonable means to address this theoretical gap.

The Project is not a typical "customer" of Cal-Am where the water is for immediate consumption or use. Rather, the water is being stored for use in the following season. Accordingly, interrupting or reducing water being pumped to the Project for a short period of time due to a system emergency that occurs on the Maximum Demand Day will not represent the same level of public inconvenience or health and safety threat that would be caused by interrupting a typical residential or commercial customer.

Moreover, firm capacity is calculated by assuming an unplanned outage in the largest well and, in this case, a planned outage of one well for rehabilitation.

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[20] Hearing Exh. 11 at p. 24.

Accordingly, under normal circumstances, Begonia Well No. 2 with its 2.43 MGD will be available to serve the Aquifer Storage and Recovery Project. Thus, normal winter operations will provide Cal-Am with 16.45 MGD[21] in capacity to serve 16.32 MGD in Maximum Daily Demand, a slight surplus. Should an emergency interruption in supply capacity occur, however, service to the Aquifer Storage and Recovery project can be temporarily reduced until the emergency is resolved.

Thus, accepting Cal-Am's winter forecast and based on this analysis, we conclude that Cal-Am has sufficient winter resources, with the Scarlett No. 8 upgrade, to meet its traditional customer demand "adequately, dependably, and safely" and can reasonably meet the requirements of the Aquifer Storage and Recovery Project.

6.1.2.2. Summer Maximum Day Demand

The summer analysis is different because the Aquifer Storage and Recovery Project will be operating as a resource, pumping water out of the Seaside Basin Aquifer into the distribution system.

We balance the benefits of the proposed capital improvement projects against the $7 million cost. We find that the risk of not being able to meet summer Maximum Daily Demand on the Monterey system has been reduced by capacity additions not included in the Comprehensive Planning Study, and that the remaining risk can be sufficiently mitigated such that Cal-Am has not justified at this time its proposed four replacement wells, one new well, and associated disinfection upgrade to the treatment plant.

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[21] 12.26 MGD (firm capacity) + 1.76 MGD (Scarlett No. 8) + 2.43 MGD (Begonia No. 2) = 16.45 MGD.

Turning to the specific resources, with the San Carlos well operating as discussed above, Cal-Am's summer firm capacity is increased from 15.7 MGD to 17.20 MGD. The addition of the San Carlos well represents a 9.5% increase over currently available firm capacity, with no significant increase in customer demand. In addition, the Sand City Desalinization Plant is scheduled to come on-line during 2009, which could add up to 0.267 MGD.[22] Thus, as compared to the capacity reflected in the Comprehensive Planning Study, Cal-Am has significantly improved its capacity position.

Cal-Am analyzed the risk of failing to perform the recommended capital projects and identified the most likely outcome. The Comprehensive Planning Study addressed the "Do Nothing" option and concluded that "mandatory water conservation measures" would likely be needed during peak demand periods, and could include limiting landscape irrigation.[23]

We agree with Cal-Am's Study that reducing or prohibiting the use of potable water for outdoor landscape irrigation during peak demand periods is a reasonable means of addressing short-term supply limitations. Unlike residential and commercial consumption or sanitary uses, outdoor landscape irrigation does not require potable water, and reclaimed and other forms of non-potable water are common substitutes. We conclude, therefore, that use of potable water for outdoor irrigation is not entitled to the high standard of reliability we require for residential and commercial consumption and sanitary

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[22] Hearing Exh. 11 at p. 20.

[23] Hearing Exh. 10 at pp. 1-10.

uses. We observe, as well, that outdoor landscape irrigation may play a large role in bringing the system to Maximum Daily Demand.[24]

As American Water recognized in its capacity additions strategy discussed in Section 6.1.1., developing a program to implement a lower standard of availability for outdoor irrigation will require significant work with customers to address numerous issues. Because most residential and commercial customers do not have separately metered landscape irrigation, among the issues requiring resolution is creating an efficient and feasible means to timely initiate and enforce landscape irrigation prohibitions. Effective customer communication to establish an emergency interruption program well in advance of an actual system emergency will be essential to success. We encourage Cal-Am to fully develop such a proposal in consultation with its customers and landscape professionals. Conservation programs can be considered and developed to provide short-term alternatives immediately, and will provide an incentive for long-term non-potable alternatives. In this way, we see overall system benefits to the approach of mitigating risk by developing, adopting, and publicizing a program to reduce or prohibit the use of potable water for outdoor irrigation when the system is at or near Maximum Daily Demand.

In conclusion, we find that Cal-Am's firm summer capacity will be increased by summer operation of the San Carlos well and the Sand City Desalinization plant and that these additions will enhance Cal-Am's ability to

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[24] The rate design changes adopted in today's decision severely diminish Cal Am's lot size and seasonal discounts, which have historically insulated customers from the high cost of outdoor irrigation, and should also provide customers significant price signals to decrease the use of potable water for outdoor irrigation. (*See* Hearing Exh. 75 at pp. I-14 to I-20.)

meet its summer Maximum Daily Demand. These additions, however, do not fully meet the demand forecasted by the Comprehensive Planning Study, which we discuss further below.

6.1.2.3. General Issues With Comprehensive Planning Study

Cal-Am's "tried and true" system planning methodology as reflected in its Comprehensive Planning Study is based on Cal-Am's many years of experience with many water systems throughout the United States.[25] Cal-Am's Monterey system, however, has uniquely experienced significant supply restrictions and steeply increasing rates for many years. Coupled with aggressive conservation programs, the supply and rate history of this district have brought about an average 1% annual decline in customer demand for the last five years.[26] Due to residential and commercial development limitations, largely brought about by water supply limitations, the number of customers in the Monterey district has also not increased. In recognition of these unique features of the Monterey system, Cal-Am reduced the usual historical planning period from 10 to five years.[27] Cal-Am retained, however, the overall approach of assuming that Maximum Daily Demand "fluctuates widely from year to year" despite the Monterey district's consistent pattern of demand reductions and used the 95% confidence interval for calculating the historical Maximum Daily Demand.[28]

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[25] Hearing Exh. 11 at p. 20.

[26] Hearing Exh. 10 at p. E-ii.

[27] Hearing Exh. 14 at p. 4.

[28] *Id*.

We are not satisfied that Cal-Am has sufficiently reflected the unique features of the Monterey system in its Comprehensive Planning Study. A "tried and true" methodology developed on many other systems throughout the United States will not necessarily provide meaningful system planning forecasts on a dissimilar system. Cal-Am provided no information for the record on the number of systems in which it had experienced consistent demand reductions and used the Comprehensive Planning Study methodology to forecast capacity needs. Similarly, Cal-Am did not provide any historical analysis of the accuracy of this approach in systems with declining demand. We are compelled to note that the consequences of overestimating Maximum Daily Demand in a system with increasing demand is having plant available in advance of need, a consequence which time and demand growth ameliorate. In contrast, however, with stable or declining customer demand, overestimating Maximum Daily Demand can lead to overbuilding resources that may never be used.

In sum, we find that the Comprehensive Planning Study forecasted an extreme increase in Maximum Daily Demand that is inconsistent with the historical pattern in the Monterey district. Cal-Am's unquestioning reliance on its "tried and true" methodology in light of the anomalous results and serious consequences undermines the persuasiveness of the Study.

We note that Cal-Am provided for the record an alternative approach to reflecting conservation in long-term water facility planning, which may have been a superior alternative. Attached to Hearing Exhibit 14, Cal-Am presented an article from the American Water Works Journal entitled "Integrating Conservation and Water Master Planning" by Peter P. Macy. The article explains that conservation reductions are hard to predict and may not yield long term dependable savings, but concludes nevertheless that successfully integrating

conservation into facilities planning can reduce or postpone capital facilities, reduce operating costs, and improve efficiency.[29] The article goes on to state that numerous planning projects have shown that the most effective way to integrate conservation and planning is to have customers provide early input on conservation decisions that reduce the need for additional capital facilities.[30] With this information, water demand is managed with conservation programs and public support to correspond to logical facilities planning needs. The article emphasizes that monitoring whether demand meets planned reductions and adjusting by perhaps putting capital facilities in place sooner or later than anticipated are essential to properly implementing this approach.[31]

6.1.2.4. Potential for Stranded Assets

The purpose of Cal-Am's proposed five wells and treatment plant is to increase summer withdrawals from the Carmel River. As is well-known, Cal-Am is under increasingly severe limitations by the State Water Resources Control Board on withdrawals from the Carmel River,[32] and Cal-Am is actively pursuing the Coastal Water Project, a large scale desalinization plant, as a substitute for much of its current Carmel River withdrawals in A.04-09-019. The Coastal Water Project, if built, is forecast to begin operations as early as 2015.[33] Even allowing for delays, the Coastal Water Project will obviate the need for

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[29] Hearing Exh. 14 at Exhibit A, pp. 44–45.

[30] *Id*. at p. 45.

[31] *Id*. at p. 47.

[32] In addition to issuing Order 95-10 in 1995, the State Water Resources Control Board recently completed hearings on a Draft Cease and Desist Order which proposed significant immediate reductions in Cal-Am's Carmel River Diversions.

[33] Hearing Exh. 35.

much of the Carmel River pumping capacity well before the end of the 20-year useful life of the five proposed wells[34] and associated treatment upgrade. In that event, the $7 million in investment may not be useful to provide service to customers. Thus, customers may not realize the full benefit of the investment in these wells and treatment plant.

6.1.2.5. Playa Well No. 4

Although currently out of service due to contamination, Playa Well No. 4, with modifications, may also be a low-cost resource on the Seaside Basin. A relatively inexpensive test could assess this potential, but Cal-Am has not yet followed through on a study's recommendation. Cal-Am's study concluded that the well "might represent an easily implemented source of supply if treatment can be simplified. Sealing the bottom 100 feet of the well might significantly reduce the concentration of hydrogen sulfide, greatly simplifying the treatment. It is recommended that the current depth of the well be confirmed. If the well depth is as originally constructed, it is recommended that the well be sealed, test pumped and sampled. If water quality is substantially improved, the treatment options for this well should be revisited."[35] The record shows that this inexpensive test ($15,000 to $20,000) was not performed. Cal-Am should conduct this test as recommended by its consultant.

6.1.2.6. Conclusion

The risk of not meeting the Comprehensive Plan forecast can be successfully mitigated by developing and adopting a program for reducing or prohibiting the use of potable water for outdoor landscape irrigation during

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[34] *See* Hearing Exh. 11 at p. 4.

[35] Hearing Exh. 11 at tab "I" p. 11.

Maximum Demand periods. On balance, the cost of Cal-Am's proposed well and treatment projects exceed the benefit to be realized from having the additional capacity to pump water out of the Carmel River during the summer. We, therefore, conclude that Cal-Am has not met its burden of presenting evidence that all of its proposed capital projects are necessary and will provide value to ratepayers. We are persuaded, however, that Cal-Am has justified replacing two of the most deteriorated wells, which are currently producing at about 20% of original volume. Cal-Am's updated cost estimates for these replacement wells of $833,000[36] is reasonable and supports replacing these two wells. We, therefore, deny at this time Cal-Am's proposal for a new Lower Carmel River Valley well, two replacement wells also in the Lower Carmel River Valley, and ultraviolet disinfection upgrade to the Begonia Iron Removal plant.

6.1.3. Well Rehabilitation

Cal-Am requested $3,903,257 total for well rehabilitation in 2008, 2009, and 2010 to be included in revenue requirement as plant in service.[37] Cal-Am stated that the Monterey system has a total of 38 wells and that it proposed rehabilitating 10 wells each year, which would "provide the benefit of ensuring that the wells throughout the system operate at optimum production levels."[38]

DRA supported Cal-Am's proposal to perform well rehabilitation, but challenged Cal-Am's proposal as excessive in cost, frequency, and contingency allowance.[39] DRA used Cal-Am's historical cost of well rehabilitation to arrive at

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[36] Cal-Am Comments on Proposed Decision at p. 3.

[37] Application Exhibit A, Chapter 9, Table 12.

[38] Hearing Exh. 2, Testimony 8 at Tab "J."

[39] Hearing Exh. 20 at pp. 7-41 to 7-44.

an estimate of $34,000 per rehabilitation, rather than Cal-Am's $90,000. Similarly, DRA determined that Cal-Am's historical rate of well rehabilitation is 3.55 per year, not the 10 per year Cal-Am had assumed.

For the contingency factor, Cal-Am proposed 20%. DRA objected to this high contingency factor for well rehabilitations, with which Cal-Am has extensive experience. DRA determined that Cal-Am does not prepare a working drawing for each well rehabilitation, and thus DRA concluded that well rehabilitations were at the "final working drawing stage" for which 3% is the accepted contingency factor. DRA concluded that a reasonable annual well rehabilitation cost would be $170,462.

DRA also opposed including the well rehabilitation amount in rate base because it is not a capital item but rather an operating expense as defined in the uniform system of accounts. DRA also stated that California Water Service Company treats well rehabilitation as an expense.

In rebuttal, Cal-Am stated that it had provided "substantial documentation for this project and its cost in the direct testimony of John Kilpatrick" and in a data response which was attached to the rebuttal testimony.[40] Reviewing the referenced testimony, however, shows only the proposed annual cost of $1,301,000 and a four-year total of $5,204,000, and the attached data response shows no cost data whatsoever but does include projected improvements in well capacity after rehabilitation for four wells.

[40] Hearing Exh. 13 at p. 18, and tab B.

Cal-Am further explained in rebuttal that well rehabilitation includes inspection and replacement, where necessary, of well pumps and motors. These are capital items with an expected service life of 10 to 15 years.[41] Cal-Am concluded that well rehabilitation work is "definitely capital work as it includes the possibility of adding new column, replacement of pumps and motors, replacement of electrical equipment, major repairs to buildings, and other replacements."[42] Cal-Am went on to state that "most of the cost of the well rehabilitation program is to replace worn out equipment, not simply to acid wash or wire brush wells as stated by DRA."[43] Cal-Am also disputed DRA's 3% contingency factor and demonstrated that, particularly in older wells, investigation may reveal that extensive and unexpected repairs are necessary as part of a well rehabilitation. Due to this uncertainty, Cal-Am recommended an "engineering smart" contingency factor of 20%.[44]

In its opening brief, DRA analyzed the actual rehabilitation costs for the Rancho Canada well in the Lower Carmel Valley from 1997 to 2007 and determined that about 30% of the costs was for well patches and properly treated as capital expenditures, with the remaining 70% of the costs for acid treatments which should be reflected as an expense.[45] The purpose of acid treatment is to reduce iron bacteria fouling, which diminishes the production capacity of a

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[41] *Id.* at p. 21.

[42] Hearing Exh. 20 at p. 22.

[43] *Id*.

[44] *Id*. at p. 24.

[45] DRA Opening Brief at p. 76.

well.[46] Based on this analysis, DRA changed its position and concluded that 30% of the well rehabilitation costs should be included in rate base and 70% as an expense. DRA did not change its position on the total annual amount that should be allowed for well rehabilitation.

Cal-Am restates in several places its proposal to rehabilitate 10 wells per year but offers no justification for this number. In a data response to DRA, Cal-Am states that "historical well rehabilitation has been much less than optimal" and sets out its historical rate, which shows that for the last four reported years, 2004 to 2007, Cal-Am did two well rehabilitations per year.[47] Cal-Am's proposed 10 well rehabilitations per year is five times the rate at which it has performed rehabilitations over the most recent four recorded years. While two per year may not be "optimum," Cal-Am does not explain why 10 would be necessary. DRA averaged the historical number, which yielded 3.55, and rounded up to get the estimate of four well rehabilitations per year. DRA's recommendation is twice Cal-Am's most recent recorded actual rate.

The record is not clear as to Cal-Am's estimated cost for each well rehabilitation. DRA contends that it is $90,000 including mobilization and demobilization.[48] The record does show that Cal-Am proposes to spend about $1.3 million per year for 10 well rehabilitations, which works out to $130,000 per well rehabilitation.

DRA calculated Cal-Am's average historical cost of a well rehabilitation as $19,000, which becomes $34,000 including mobilization and demobilization.

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[46] Hearing Exh. 13 at tab B.

[47] Hearing Exh. 23 at second tab "G."

[48] DRA Opening Brief at p. 74.

DRA recommends an annual total of $170,462 for four well rehabilitations, including the three percent contingency. Removing the three percent contingency and dividing by four results in a per well estimate of $41,337.03.

The only actual well rehabilitation cost data in the record was supplied by DRA and reproduced in its brief. It shows actual well rehabilitation costs for the Rancho Canada well from 1996 to 2006, which vary from $5,152.22 to $47,664.88.[49] These data tend to support DRA's average, but also show a wide range of variability. While the more recent acid treatments cost about $15,000 to $20,000, an "ss patch" costs nearly $50,000.

For revenue requirement purposes, we need an average cost per well rehabilitation, recognizing that some rehabilitations will cost more and some less. Although not included in the formal record for this proceeding, Cal-Am's testimony refers to a cost estimate included in its Comprehensive Planning Study, its overall capital improvement plan. Such a plan, unlike forecasted ratemaking, may have calculated a maximum cost for each well rehabilitation, rather than an average. This could explain why the amount is so much higher than Cal-Am's recorded costs.

On the issue of the appropriate contingency factor, Cal-Am has presented persuasive evidence that the total cost for each well rehabilitation may vary significantly depending on the repairs needed. This contention is supported by the actual well rehabilitation data presented by DRA. We, therefore, reject DRA's contention that well rehabilitations are "highly predictable" such that a

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[49] *Id*. at p. 76.

3% contingency is appropriate. We adopt Cal-Am's request for a 20% contingency factor for these projects.

Applying Cal-Am's 20% contingency factor to the historical average cost calculated by DRA results in a per well rehabilitation cost estimate of $49,604.44.

We find that the record supports DRA's proposed 30/70 split between capital and expense. DRA arrived at this split by analyzing actual cost data from the Rancho Canada well. These data show that about 70% of the actual costs were for acid washing, and about 30% were for capital repairs. These data directly contradict Cal-Am's assertions that most of the well rehabilitation costs are for replacing worn out equipment. We, therefore, adopt DRA's recommended split between capital and expense.

Turning to the issue of the number of well rehabilitations that should be included in test year 2009 revenue requirement, we find that the record shows that DRA supports rehabilitating wells to improve performance. Due to disallowances elsewhere in today's decision, maintaining and, ideally, improving the performance of Cal-Am's existing wells will have enhanced importance in the years to come.

Cal-Am has not, however, made a persuasive presentation that it can and will actually increase its well rehabilitations from about two per year to 10. Cal-Am has prioritized the Lower Carmel River Valley wells, planning to rehabilitate four out of these eight wells each year. We have authorized replacement of two of those wells elsewhere in today's decision. For the other 30 wells, Cal-Am proposes to rehabilitate a total of six each year. We will adopt Cal-Am's prioritization of the Lower Carmel River Valley wells but reduce the number to two wells per year due to the well replacements authorized above, and authorize two additional wells per year. This will give Cal-Am funding for

four well rehabilitations per year, double its most recent annual rate. This program should enable Cal-Am to rehabilitate its key wells, move significantly toward an optimum level of well rehabilitation for its overall system, and provide an opportunity to establish a frequency and cost record that could better support a requested level of well rehabilitation in the next general rate case.

We, therefore, grant in part Cal-Am's request for an increased well rehabilitation program. Cal-Am's test year 2009 revenue requirement shall include funds for four well rehabilitations at an average cost of $49,604.44 each, or $198,417.76 total. For ratemaking purposes, this amount shall be split between plant in service, 30%, and expense, 70%. Actual well rehabilitation costs shall be recorded consistent with our accounting rules.

6.1.4. Storage Tanks

Cal-Am requested $8,689,847 for 10 new or replacement storage tanks in the Monterey district. DRA agreed to nine, one with a significant cost reduction and would require three to come into rate base via an advice letter filing when completed; two of the advice letters require documentation that the local fire officials required the upgraded fire flow:

Tank	Size (gallons)	Cost	New or Replacement?	DRA Position
Segunda		$2,905,598	New	Advice Letter
Hidden Hills	2 x 30,000	$322,000	Replace 16,000 gallon tank	Allow
Upper Rimrock		$479,000	Replacement	Advice Letter/Fire Flow
Chualar	150,000	$832,000	New	Advice Letter/Fire Flow
Withers	100,000	$200,044	Replacement	Allow
Carmel Woods 1, 2, and 3	100,000 replaced	$750,000	Repair and Replacement	Allow
Oaks (Ambler Park)	2 x 200,000	$1,962,971	Replace 2 x 20,000 gallon tanks	Allow tanks, but reduce by $1,100,000
Lower Rancho Fiesta	150,000	$1,238,234	Replace 10,000 gallon tank	Deny
TOTAL		$8,689,847		

DRA supported the two 200,000 gallon tanks at Ambler Park but recommended rejection of slightly more than half the costs. DRA argued that the Commission approved these tanks in the last rate case to be placed in rate base via Advice Letter with the amount capped at $1,000,000, which Cal-Am has now nearly doubled in its current request.

In rebuttal, Cal-Am explained that the cost to construct a road to its originally intended site proved to be excessive and a new site for the tanks had to be selected. The delay and new site increased the cost to $1,962,971, but only about $10,000 of that is for the wasted effort on the original site, not the full $1,100,000 as argued by DRA. We will disallow the costs associated with the original site, $10,000. However, we find Cal-Am's cost increase explanation to be persuasive and will allow the project to be included in rate base via Advice Letter up to a maximum of $1,952,971.

DRA opposed the Lower Rancho Fiesta tank upgrade, contending that Cal-Am had not adequately justified this tank and that local residents opposed it for aesthetic and view reasons. In rebuttal, Cal-Am stated that the original

purpose of replacing the tank was due to "inadequate failure response time of the associated electrical and/or mechanical equipment supplying this tank" which was found during a system gradient analysis in 2002.[50] Because Cal-Am was upgrading the tank for that purpose, Cal-Am was also required by GO 103 to also meet the governing fire flow standard, as requested by the Carmel Valley Fire Protection District.

The primary purpose of this expensive tank appears to be fire flow. We do not approve it at this time, but will require that it be considered by the task force we create on the next section of today's decision.

DRA agreed that the Upper Rimrock and Chualar tanks could be included in rate base via advice letter, which must include documentation that the local fire official required the upgraded fire flow.[51] Cal-Am objected to filing an advice letter as being unnecessary because the two tank projects were certain and completion is within Cal-Am's control.[52] We find that these two requirements will impose minimal obligations on Cal-Am for these $1.3 million tanks. As discussed below, the fire flow coordination task force should provide Cal-Am with a convenient administrative mechanism for obtaining the required documentation of fire flow requirements.

We, therefore, authorize Cal-Am to construct a new 150,000-gallon tank in the Chular system, with cost not to exceed $832,000, and to replace the Upper Rimrock storage tank at a cost not to exceed $479,000. These items will be included in rate base upon approval of an advice letter demonstrating

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[50] Hearing Exh. 6 at p. 4.

[51] DRA Opening Brief at p. 86.

[52] Cal-Am Opening Brief at pp. 75-76.

construction of the tanks, actual costs up to the applicable limit, and fire flow requirements by the local fire official. We also approve the Withers and Carmel tanks, and the Segunda tank with the filing of an advice letter.

6.1.5. Fireflow Program

Cal-Am requested approval for a new program to develop and implement annual upgrades "to enhance fire protection capabilities throughout the system in coordination with local fire agencies." Cal-Am proposed to spend $478,000 per year on fire protection upgrades, or $1.4 million over the course of the three-year rate cycle for this project.[53] In support of this request, Cal-Am provided a list of 14 service area gradients that currently do not have sufficient storage or pumping capacity to meet fire protection requirements. Cal-Am also included a list of preliminary recommendations as well as potential alternatives of storage and pumping to address the deficiencies. Cal-Am did not provide cost estimates for each measure but stated that the project total was based on preliminary estimates.[54]

DRA supported the proposed fire protection upgrade program but would require that the actual projects, when more definite and certain, be submitted via advice letter, and supported by written signed documentation from the local fire protection agency stating exactly what level of fire flow is being required.[55]

Cal-Am's list of fire flow deficiencies includes areas that will be addressed by tanks requested and approved elsewhere in today's decision, *e.g.*, a tank at Chualar. Consequently, Cal-Am's list of potential projects needs to be updated.

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[53] Hearing Exh. 2, Tab 8, subtab "F."

[54] *Id*.

[55] DRA Opening Brief at p. 83.

We are also concerned about the cost of the project alternatives, which may include replacement of significant lengths of main to support an additional booster pump.

We fully support Cal-Am's direction to coordinate with local fire agencies and to "review project specific fire protection requirements with the local fire district to determine if local reductions are feasible."[56] We are mindful, however, of Cal-Am's observation that: "Fire flows are not 'exact.' Any fire chief will tell you that more is always better. The fire flow requirements that fire chiefs settle for is a combination of what they can live with and what is practical to build."[57] In addition, a specific project may have benefits for the overall system in addition to the fire flow improvements. The pipeline replacement in Seaside discussed below is an example of such a project.

We find that formalizing Cal-Am's proposed coordination with local fire officials will assist Cal-Am in prioritizing the specific projects it will conduct pursuant to this new program. We, therefore, direct Cal-Am to convene and provide logistical and staff support for a fire official task force to provide input on prioritizing fire protection upgrade projects and specific fire flow requirements. Consensus recommendations should be adopted in writing. To provide for meeting expenses and support, we will authorize $10,000 in expenses for test-year 2009.

With this input, Cal-Am can then prepare and justify a specific plan of fire flow projects requiring urgent attention. Due to the novelty of this task force and the preliminary and changing nature of the list of recommended projects,

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[56] Hearing Exh. 2, Tab 8 at subtab "F."

Cal-Am will need significant time to prepare a revised list of potential projects with solid details and convene the task force. The time delay and the lack of any specific project cost detail in the application require that the total cost for projects be limited to $150,000 for this three-year rate period. This formalized process should enable Cal-Am to better document and support specific fire flow upgrade projects in its next general rate case.

6.1.6. Pipeline Replacement

In its application, Cal-Am proposed three new pipeline replacement programs. Cal-Am does not now have specific programs for replacing pipeline, other than as part of a repair. Cal-Am requests authorization to initiate a six-year program to replace 25.5 miles of two-inch pipeline, with an annual budget of $2,696,000. Cal-Am similarly requests authorization to initiate a 21-year program to replace 114.4 miles of four-inch pipeline, with an annual budget of $3,263,000. Both the two- and four-inch pipeline will be replaced with eight-inch polyvinylchloride (PVC) pipe.

Cal-Am proposes to replace approximately three miles per year of six to ten inch pipeline, with a budget of $454,000 in 2009 and $1,170,000 each year thereafter for 99 more years. This pipeline will also be replaced with eight-inch PVC pipe.

In support of its requests, Cal-Am prepared a Condition Based Assessment of Buried Infrastructure.[58] Cal-Am states that it requires these new programs to replace obsolete and break-prone pipeline as identified in the Assessment. Cal-Am lists the benefits of these programs as: reducing water leakage in the

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[57] Hearing Exh. 11 at p. 40.

[58] Hearing Exh. 2, Tab 8, at tab "W."

system, increasing service reliability, improving fire protection and water quality, and reducing the expense of main break repairs.[59] Cal-Am explained that the Assessment developed a "working hypothesis" of the need for pipeline replacement in the Monterey system by using industry standard replacement forecasts based on estimated life expectancies and various statistical analyses to create its requested pipeline replacement programs.[60] The Assessment also recommended that Cal-Am improve its data collection to support further refinements to the Assessment. Cal-Am cautioned, however, that it was not necessary to await further data because the Assessment has identified sufficient pipeline in need of urgent replacement without further data collection.[61]

Cal-Am's primary focus for urgent replacement was pipeline in the City of Seaside. The Assessment found that the rate of main breaks in Seaside North and South is as high as 3.5 breaks/mile/year. In comparison, the Monterey system-wide average is 0.28 breaks/mile/year and the national average is 0.25 breaks/mile/year.[62] In addition to the largely theoretical "working hypothesis" developed in the Assessment, Cal-Am consultants conferred with the system operators and confirmed that the pipelines located in the City of Seaside were unusually prone to breaks.[63]

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[59] *Id.* at tab "X."

[60] Hearing Exh. 3 at p. 14.

[61] *Id.* at p. 20.

[62] *Id.* at p. 21.

[63] When the Seaside wells are turned on, the resulting change in the Seaside system causes so many pipeline breaks that well operators first contact the distribution repair crews, who deploy in advance to Seaside to see "who can find the breaks first." Hearing Transcript at p. 247.

DRA opposed all three pipeline replacement programs as being unsupported by the record, and recommended that Cal-Am improve its break data collection to better prioritize a future pipeline replacement proposal.

This is Cal-Am's first proposal for a pipeline replacement program, and the total recurring annual amount proposed, $7,129,000, makes this the most expensive capital project included in this general rate case, exceeding Cal-Am's request for five wells and associated water treatment upgrade at $7.0 million but less than the $8.7 million for storage tanks. The amount proposed and novelty of these programs for Cal-Am enhance Cal-Am's evidentiary burden to justify these programs. As set forth below, we find that Cal-Am has met this burden with regard to the Seaside pipeline but that additional factual and operational support is required for a system-wide program.

The record reveals no evidence that Cal-Am has ever proposed any type of comprehensive or systematic pipeline replacement, whether in a defined area or for a defined pipeline product, in the Monterey system. The purpose of the Condition-Based Assessment is to provide the factual predicate to enable Cal-Am to initiate a well-thought-out program. While Cal-Am has made a great start at compiling the necessary data, more than a "working hypothesis" is required to justify projects of this cost and duration.

As a guide, we note that Cal-Am's system-wide average of 0.28 breaks/mile/year is only slightly above the national average, and some of that excess can be explained by the Seaside pipeline and its extremely high rate. Cal-Am's witness stated that the water utilities throughout the United States typically replace between a tenth to one percent of system pipeline miles per

year. With a total system pipeline of about 600 miles, the resulting range is between 0.6 and 6 miles.[64] Here, however, Cal-Am is proposing to replace over 11.3 miles in each of the next six years, and seven miles per year thereafter. This is a rate of nearly double the highest point on the nationwide average.

Fortunately, the record provides us with "low hanging fruit" to which Cal-Am might direct its immediate pipeline replacement efforts, while it collects and analyzes better break data to guide future pipeline replacements.[65]

Cal-Am persuasively demonstrated that the Seaside pipeline, more specifically described in Hearing Exhibit 3, at tab D, is about 12.1 miles of largely unlined metallic pipe with excessive break rates. Cal-Am's expert persuasively testified that no additional data is required to identify this pipeline as most in need of urgent replacement in the Monterey district. We note that the proposed replacements will more than triple the current fire flow available in this area. Cal-Am proposed to begin its pipeline replacement programs with this pipeline.

We agree that Seaside is the place to begin, however, at a more financially and operationally measured pace. As we have noted several times throughout today's decision, the Monterey district had elevated water rates prior to the increases resulting from this general rate case. The desirability of additional capital investment and expenditures must be tempered with the understanding of the financial burdens being placed on ratepayers.

Spreading estimated $7.1 million Seaside project over the three-year rate case period will create a gradual stepping up of rate base and resulting increase in revenue requirement, while allowing the project to go forward with certainty.

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[64] Hearing Transcript at p. 247.

This time period will also allow Cal-Am to improve its data collection on breaks and prepare a more system-specific pipeline replacement program for future general rate cases. Improved data collection and analysis will be essential to justifying any future pipeline replacement proposals.

Therefore, we find that Cal-Am has justified replacing the pipelines in Seaside North, South, and Pacific Grove Country Club Heights, as presented in Hearing Exhibit 3 at tab D. The pipeline should be replaced over the three-year rate case period, and rate base increases for each year shall be limited to no more than $2.4 million for these replacements. Other than this pipeline replacement project, we deny Cal-Am's pipeline replacement projects at this time.

6.1.7. Polybutylene Services

Cal-Am seeks Commission authorization to initiate a five-year, $6,488,000 program to replace the approximately 3,500 polybutylene service connections in its Monterey system.[66] Cal-Am explains that while such service connections comprise only eight percent of the service connections in the Monterey system, these service connections are responsible for 52% of all service connection failures. The break rate for this material is about ten times the failure rate for service connections made of other materials. The resulting loss of water is about 1.8 million gallons/year or 5.5 acre-foot/year.

Over the past 10 years and as a part of its regular operations, Cal-Am has replaced about 1,500 polybutylene service connections; continuing at that rate would mean 25 more years before all these connections are replaced. Cal-Am contended that the high level of breaks in these connections is very disruptive to

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[65] Hearing Transcript at p. 218.

[66] All the program details are found in Hearing Exh. 2, Tab 8, at tab "CC."

system operations and that replacing these connections represents a high priority or "low hanging fruit" means to improve operations.[67]

DRA opposes this enhanced level of service connection replacement due primarily to its cost.[68] DRA contends that Monterey district ratepayers should not be required to bear the cost of this project during these difficult economic times given the other expensive capital projects being included in this rate case, and anticipated from Cal-Am's companion conservation application, A.07-12-010, the San Clemente Dam seismic retrofit, and the Coastal Water Project. DRA also notes that the water to be saved from this project is only about 0.04% of Cal-Am's total water production.

We agree that replacing the polybutylene service connections is a worthwhile proactive project. However, for the reasons stated by DRA, we will adopt a more financially and operationally measured pace. As we noted above in relation to Cal-Am's proactive pipeline replacement projects, Monterey district ratepayers have historically experienced high rates and more increases are on the horizon. The desirability of additional capital investment and expenditures must be tempered with the understanding of the financial burdens being placed on ratepayers.

Spreading this estimated $6.5 million project over a 10-year period, rather than the five-year program requested, will gradually increase rate base while at the same time greatly accelerating replacement of these problematic service connections.

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[67] Hearing Transcript at p. 320.

[68] DRA Opening Brief at pp. 87–88.

Therefore, we find that Cal-Am has justified initiating a proactive program to replace the remaining 3,500 polybutylene service connections in its Monterey system. Cal-Am's average cost per service replacement is $1,853.71 ($6,488,000/3500 connections) x 350 connections per year yields $648,000.00 as the annual budget needed to fund a proactive polybutylene service connection replacement program.

We, therefore, grant Cal-Am's request for a proactive, *i.e.*, not based on connection failure, program to replace polybutylene service connections at the rate of 350 connections per year and an annual cost not to exceed $648,000.

6.1.8. Combining and Coordinating the "Low Hanging Fruit" Proactive Infrastructure Replacement Programs

As noted above, Cal-Am proposed two multi-year and multi-million dollar "proactive" programs to improve system operations, and that the obvious initial targets of these programs – both described as "low hanging fruit" – were the Seaside pipeline and polybutylene service connections. Cal-Am separately proposed and justified these programs but did not present prioritization between the two programs. We infer from Cal-Am's proposal to complete the Seaside pipeline replacement in one year, which we extend to three, as compared to the proposed five-year polybutylene program, which we extend to 10, that Cal-Am believes that customers will benefit more from improved system operations caused by the Seaside pipeline replacement as compared to the service connection replacements. Cal-Am has not, however, articulated a rationale for this implicit prioritization. The record suggests, moreover, a combined assessment of these two programs. In Hearing Exhibit 3, at tab "D," when evaluating the proposed Seaside replacements, Cal-Am includes a column for "Approx. No. PB Services to be Replaced," which we surmise means number

of polybutylene connections to be replaced as part of the pipeline replacement. This suggests that Cal-Am may be considering both replacement projects in its decision-making. Maximizing attainment of both project goals will similarly maximize value to ratepayer. We will adopt ratemaking treatment for these two projects to provide Cal-Am the flexibility to continue to replace pipeline and polybutylene service connections efficiently.

To provide Cal-Am a maximum amount of engineering latitude in which to implement these two programs, we allow Cal-Am to combine the annual total for these two proactive replacement programs and to allocate funds within the total based on engineering efficiency.

For Cal-Am's longer term capital planning, we would like to see these urgent proactive replacement programs completed prior to the contemplated major plant additions such as the Coastal Water Project. This will provide ratepayers a limited reduction in rate base additions to offset some of the major expected additions in the future.

6.1.9. Interconnections

Cal-Am proposed to construct a 300-foot, 12-inch diameter main interconnection between the Ryan Ranch and Bishop systems for $277,000. Another interconnection, 1,200 feet of six-inch main between the Hidden Hills system and the Monterey main system, is proposed for $546,000. The purpose of both interconnections is to increase system reliability.[69]

DRA does not oppose the interconnections or object to the amounts. DRA points out that the interconnections must first be approved by the Monterey Peninsula Water Management District, and that while Cal-Am has

requested the approvals, they remain pending. DRA recommends that the projects be added to rate base upon completion via an Advice Letter, rather than through this general rate case.

Cal-Am objects to using the Advice Letter process because, it contends, the projects are certain and will be constructed within weeks of the Water District's approval, which Cal-Am is confident will be forthcoming.[70]

We find that the Advice Letter process is appropriate for these projects. At the moment, Cal-Am is prohibited from constructing the interconnections; consequently, the projects are not certain. When the approval is obtained and the projects are used and useful, it will be a minor matter for Cal-Am to file the Advice Letters. The amount to be included in rate base shall be capped at the amounts requested as set out above.

In comments on the Proposed Decision, the Hidden Hills Subunit Ratepayers Association recommended that the $546,000 be spent on pipeline replacement to bring down the amount of unaccounted for water in this subsystem rather than for an expensive emergency connection which will rarely be used. Cal-Am agreed with this proposal in its reply comments.

Therefore, we will authorize Cal-Am to install up to $546,000 of replacement pipeline in the Hidden Hills subsystem as an alternative to the interconnection.

6.1.10. Meter Replacement

Cal-Am proposes to greatly increase its meter replacement program. From 1997 to 2007, Cal-Am replaced between a high of 4,563 meters in 1999 and a low

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[69] Hearing Exh. 13 at p. 27.

[70] Cal-Am Opening Brief at p. 84.

of 947 meters in 2002.[71] The most Cal-Am spent on meter replacement during any of the years 2003 to 2007 was $303,193.[72] In this proceeding, Cal-Am proposes the following meter replacements, with associated costs:[73]

	2008	**2009**	**2010**
Number of Meters	2,700	7,500	7,500
Total Cost	$517,509	$1,437,525	$1,437,525

Cal-Am explained that it has fallen behind the meter replacement levels necessary to maintain compliance with the inspection and replacement schedule in GO 103 over the years, and that replacing meters will enhance billing accuracy and reduce apparent unaccounted for water.

DRA did not disagree with Cal-Am's objectives of bringing its meters into compliance with GO 103 and reducing apparent water losses. DRA accepted in concept Cal-Am's proposal for its on-going or recurring meter replacement program, but disagreed with the price of the meters and with the number of meters included in the annual meter program.

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[71] Hearing Exh. 11 at Exhibit L, p. 3.

[72] *Id.*, at Exhibit L, p. 2.

[73] *Id.*, at p. 35.

DRA Recommendations[74]

	2008	2009	2010
Recurring Meter Replacement	$517,509		
Annual Meter Replacement	$61,736	$483,105	$483,105
Total Cost	$579,245	$483,105	$483,105

Cal-Am's request for the three-year rate period is $3,392,559 and DRA's total for the rate period is $1,545,455.

DRA disputed the number of meters Cal-Am needs to replace or test in this three-year rate period to remain current with applicable standards. Cal-Am's standards require that all meters one inch or less in size be replaced or tested every 15 years, and larger meters every 10 years.[75] GO 103 allows meters smaller than one inch to be tested or replaced every 20 years. Cal-Am proposed to test or replace 17,700 meters over the rate period, and DRA estimated that 13,545 would bring Cal-Am into compliance. The difference between the two estimates is 4,155 meters.

DRA used a price of $107 per meter and Cal-Am's rebuttal testimony presented a well-supported estimate of $191.67, of which the majority of the costs are for the associated radio read transmitter and electronics. Adopting Cal-Am's updated cost per meter raises DRA's total for the rate period to $2,596.170. Applying the updated price to the 4,155 meter difference explains the $796,388 difference between DRA and Cal-Am.

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[74] Hearing 11 at p. 34.

[75] DRA Opening Brief at p. 79.

We conclude that the record supports a finding that Cal-Am needs to increase its rate of meter testing or replacement to meet its own standards and GO 103 standards. The record also shows that the price of a meter with radio read transmitter and electronics is $191.67.

To comply with GO 103, Cal-Am states that it states that it needs to replace 2,060 of its 41,228 less than one-inch meters each year for 20 years, 360 of its 5,361 one-inch meters each year over 15 years, and 210 of its 2,106 greater than one-inch meters each year over 10 years.[76] We adopt these annual amounts for a total of 2,630 meters per year.

DRA calculated the backlog by subtracting Cal-Am's recorded number of meter replacements from 2,630 for each year 1997 to 2007, and summed the differences to get 7,538 as the estimated meter replacement backlog.[77] To eliminate the backlog of 7,538 meters over four years, DRA proposes 1,885 meters per year.[78]

We deduce that Cal-Am proposes to eliminate the backlog by replacing 4,870 meters per year for three years or a total of 14,610 meters by subtracting the 2,630 needed to stay current from Cal-Am's proposed 7,500 meters per year.[79] In Exh. 11, Cal-Am states that the backlog is quantified in "Table 2" but that table addresses winter water production. (*See* Hearing Exh. 11 at p. 24.)

Absent an alternative and persuasive quantification of the backlog, we conclude that Cal-Am's proposal exceeds the number of meter replacements

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[76] Hearing Exh. 11 at p. 34.

[77] DRA Opening Brief at p. 79.

[78] *Id.*

[79] Hearing Exh. 11 at p. 34.

required to clear the backlog. We will therefore adopt DRA's recommendation of 1,885 meters per year for four years to eliminate the backlog in meter replacements.

Cal-Am has not explained how it fell behind in compliance with GO 103, nor has it shown that it reduced its adopted revenue requirement to reflect its actual level of meter replacement. We will, therefore, require that Cal-Am present in all its future general rate cases a comparison of authorized capitol projects, including meter replacements, with actual expenditures. The comparisons should identify and explain each deviation from authorized amounts.

Due to the magnitude of increase in this program and Cal-Am's history, protecting ratepayers requires that we adopt a ratemaking mechanism to ensure that ratepayers are only charged for the level of meter replacements Cal-Am actually delivers. At the same time, due to the importance of reducing meter error, we want to provide Cal-Am every incentive to actually install the new meters at its planned rate. We will adopt an annual "tracker" account for the supplemental meter replacement costs. Specifically, in each year of the rate period – 2009, 2010, and 2011 – the maximum number of supplemental meter replacements is 1,885 after the 2,630 in the permanent program. Cal-Am may file an annual advice letter to include the costs of the actual number of meters installed under its temporary supplemental program, up to this maximum at a per meter cost of $191.67, when the meters are installed and operational.

Cal-Am should implement a permanent annual program of meter replacement at a rate not to exceed 2,630 meters/year to remain current with GO 103 and should implement a temporary supplemental program to replace

1,885 meters/year to eliminate its current backlog over four years at a per meter cost of $191.67.

6.1.11. Unaccounted for Water

Unaccounted for water reflects the difference between water produced by a utility and water billed to customers; the more contemporary term for this difference is "non-revenue water." The difference is a reflection of the utility's operational efficiency and has been used by this Commission and others to assess utility operations.

We traditionally address unaccounted for water in general rate cases, but the adopted amount has no direct ratemaking impact. That is, the unaccounted for water amount does not directly affect the revenue requirement upon which rates are set. The consequences of unaccounted for water, however, are imbedded in the production costs and projected revenue and, in this way, have a significant role in ratesetting.

Cal-Am stated that the average unaccounted for water in its Monterey system from 2003 to 2007 was 11.59%. The smaller associated systems ranged from 10% to 21%.[80] Cal-Am proposed to adopt the historical average percentage and volume for each system as the unaccounted for water assumption for the three-year rate period.[81] Cal-Am admitted that the industry standard for unaccounted for water is 10% and that the Monterey Peninsula Water Management District mandates 7%.[82]

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[80] Application Exhibit A, Chapter 5, Table 4A.

[81] *Id.*, at Table 4B.

[82] Hearing Exh. 33 at pp. 5–6.

As a volumetric standard, Cal-Am proposed using the historical average percent to determine the expected unaccounted for water for each year of the rate period, about 1,585 acre foot/year.[83] Thus, Cal-Am's proposal is to assume that it continues to experience its historical levels of unaccounted for water during the rate period.

DRA objected to using an historical average and instead recommended 8.5% to "create some incentive to lower the four-year average."[84] The primary focus of DRA's analysis of unaccounted for water was to develop a simplified least cost planning methodology to evaluate Cal-Am's proposals to reduce unaccounted for water.[85]

Traditionally, unaccounted for water is expressed as a percentage. Cal-Am argues persuasively, however, that volumetric expression is a superior metric.[86] Unfortunately, regardless of the metric used, unaccounted for water in the Monterey system has increased over the historical period 2003 to 2007:

Monterey System Historical Unaccounted for Water[87]

Unaccounted for Water	2003	2004	2005	2006	2007
Percentage	11.2%	9.5%	13.2%	10.7%	13.3%
Acre-foot	1,666.4	1,417.5	1,886.2	1,522.6	1,899.4

For this three-year rate period, Cal-Am proposes to retain the average of these measures, 11.59% or 1,585.2 acre-foot/year, as its going-forward standard. This proposal is at odds with the water supply and ratemaking facts confronting

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[83] Application Exhibit A, Chapter 5, Table 4B.

[84] Hearing Exh. 22 at pp. 2–3.

[85] *Id.*, at Chapter 4.

[86] Hearing Exh. 33 at p. 7.

[87] Application Exhibit A, Chapter 5, Table 4A.

the Monterey system. Cal-Am is facing dramatic supply limitations which urgently require continuous reductions in water waste on both the utility and customer sides of the meter. Similarly, price signals, *i.e.*, steeply inverted tiered rates, are a key component of consumer conservation measures. Inaccurate accounting for water in the system substantially undermines these essential programs.

Cal-Am's approach to reducing unaccounted for water does not reflect the necessary level of urgency. For example, because it had failed to meet the Monterey Peninsula Water Management District's 7% standard, Cal-Am was required to engage an outside firm to perform a review of unaccounted for water in the Monterey system. The August 2007 Report calculated apparent losses due to customer meter error as 659 acre-foot/year, and real losses at 1,024 acre-foot/year. This review, however, was based only on water audit software developed by the American Waterworks Association, and did not include any field inspections, although a limited number of small and large meters were tested. The preliminary report included 10 specific immediate recommendations and proposed a Phase II, with 18 points for further work.[88]

Following up the August preliminary report, the firm wrote to Cal-Am on September 28, 2007, proposing to begin immediately on Phase II. The letter targeted leakage reduction through pressure management, with an estimated saving of 150 to 350 acre-foot/year, and "proactively and diligently reducing apparent losses from customer meter error" providing 100 to 300 acre-foot/year

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[88] Phase I Water Loss Audit, Final Report, August 31, 2007, by Goff Water Audits and Engineering, reproduced in Application Exhibit A, Chapter 3, Section 1, Table 2 ("Goff Report").

in reductions to unaccounted for water. The letter suggested that the field work begin immediately, with an initial contract price of $10,000.[89]

The record shows no further action on Cal-Am's part to proceed with Phase II, and Cal-Am derided the Phase I work as a "largely academic exercise."[90] The record does not reflect an alternative, urgent program by Cal-Am to reduce unaccounted for water, and its proposal for the rate period is a "business as usual" historical average.

One recommendation from the consultant firm's report is particularly striking. Recommendation 7 states: "A process is needed to audit the customer database to assess its completeness. When omissions are found, a root-cause analysis should be performed. When the reasons for omissions are understood and corrected the integrity of the database will be enhanced and revenue maximized." This recommendation is preceded by a finding that "a significant number of meters tested do not appear in the user account database and are apparently not generating revenue."[91]

In short, the report questions whether the Monterey district customer database is complete. Accurately tracking and billing customers is essential to prudent utility operations, and is required to prevent discrimination among customers.[92] This report suggests that customer account database failures may have a role in explaining the Monterey district's high unaccounted for water. While we understand the inherent difficulties in addressing real water losses,

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[89] Application Exhibit A, Chapter 3, Section 1, Table 3b.

[90] Cal-Am Reply Brief at p. 29.

[91] *Id.*, at Recommendations, pp. 1 and 2.

[92] *See* Public Utilities Code § 453.

e.g., locating leaks, no such impediments exist for locating customer accounts properly associated with metered water use.

In this proceeding, Cal-Am admitted that its unaccounted for water "remains high" but argued that this is "due to factors outside the control of California American Water."[93] Cal-Am offered three factors that it claims are outside of its control, which we analyze below.

Cal-Am first stated that using a percentage metric artificially inflates the Monterey district unaccounted for water due to the relatively low levels of consumption. Cal-Am contends that even if "absolute losses are constant," a percentage metric will appear to vary due to changes in water use. However, as shown above, Cal-Am's absolute losses are not constant but rather are increasing over time and the absolute losses seem to closely track the percentages. So, even if we accept Cal-Am's metric and use a volumetric measurement, the record does not support Cal-Am's assertion that it has exercised "diligent efforts" to reduce its unaccounted for water.

Cal-Am next contended that its system requires more flushing, which drives up its unaccounted for water because water used for system flushing is not metered. The record shows, however, that Cal-Am records "non-revenue usage" of water, and it offers no explanation for its decision not to include at least estimates of the amount of water used for system flushing in this account.

Cal-Am's final system feature that it claimed is beyond its control is the pressure in its system. Cal-Am states that its service area has significant

[93] Cal-Am Opening Brief at pp. 38-3; Reply Brief at p. 31.

elevation changes which increase system pressure and contribute to leaks, which increases its unaccounted for water.

Cal-Am's engineers, however, are familiar with system pressure regulation techniques, have installed pressure regulating facilities, and are analyzing the system for possibly constructing additional pressure regulation facilities.[94] Given Cal-Am's pressure regulation expertise, the record does not support Cal-Am's contention that its system pressure is beyond its control.

In sum, Cal-Am's outside firm estimated in 2007 that significant real and apparent losses could be reduced through recommended measures, but Cal-Am took no further action with the firm, and Cal-Am's current proposal is to retain its historic average for the rate period. Cal-Am's claimed lack of control over its system is not a persuasive rationale for maintaining the status quo. We, therefore, conclude that system supply constraints and conservation rate design in the Monterey district mandate the highest quality program to reduce unaccounted for water, and that Cal-Am has not successfully implemented such a program.

Adopting Cal-Am's proposed historical average would financially insulate Cal-Am from its failure to reduce unaccounted for water. We reject Cal-Am's proposal as being inconsistent with the water supply and rate design needs of the Monterey district. We find that the public interest requires an appropriate financial incentive for Cal-Am to improve its unaccounted for water performance. We will adopt unaccounted for water allowances that necessitate improvement.

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[94] Hearing Transcript at pp. 678–81.

DRA recommends an 8.5% allowance for unaccounted for water, which would represent a significant shift in Cal-Am's operations and move Cal-Am much closer to the Monterey Peninsula Water Management District's goal of 7%. While we agree that Cal-Am's performance on unaccounted for water must improve significantly, moving from 11.59% to 8.5% is too sharp of a change. We find, however, that a significant improvement is necessary for the main Monterey system and we will adopt 9% as the target for that System. The Bishop and Chualar Subsystems are currently at 10%, so we will reduce these two systems to 9%. For other subsystems, which vary from 16.16% to 21%, we will require that Cal-Am improve the system operations to cut in half the difference between the subsystem current unaccounted for water level and the industry average of 10%.

To assist Cal-Am in achieving this improvement in unaccounted for water, we have authorized Cal-Am to implement an annual meter replacement program to comply with GO 103 standards, as well as a supplemental program to eliminate the backlog. These programs should enable Cal-Am to reduce its unaccounted for water.

We will, therefore, adopt a financial incentive mechanism with the following unaccounted for water allowances for the systems of the Monterey district:

System		Cal-Am Proposed	Adopted
Bishop		10%	9%
Hidden Hills		16.16%	13.8%
Monterey		11.59%	9%
Ambler		17.04	13.5%
Ralph Lane		21%	15.5%
Chualar		10%	9%
Estimated Revenue ($2,018.95/AF)			

In the rate design settlement approved elsewhere in today's decision, we adopt a Water Revenue Adjustment Mechanism which ensures that Cal-Am will recover all its fixed and variable costs regardless of the amount of water billed. The purpose of this mechanism is to decouple Cal-Am's revenue from water sales and to thereby remove any financial disincentives created by aggressive water conservation programs. This mechanism, however, also fully insulates Cal-Am from any financial consequences of unaccounted for water. Therefore, we must also adopt an explicit means to provide Cal-Am with strong financial incentives to reduce unaccounted for water to the standards set out above.

Specifically, we will create an unaccounted for water penalty/reward program to be calculated based on Cal-Am's most recent annual unaccounted for water percentage. To the extent Cal-Am exceeds the standards above, Cal-Am will earn a financial reward and should Cal-Am fail to achieve those standards, Cal-Am will incur a financial penalty. The per acre-foot amount to be used to calculate the financial reward or penalty is $2,018.79/acre-foot.[95] In its annual WRAM filing, Cal-Am will report the difference between its systems' water production and billed water. To the extent this amount is less than the

[95] Hearing Exh. 75, at p. I-14, Cal-Am's proposed "standard rate" is $4.6345/CcF.

percentage adopted above, Cal-Am will earn a reward, which will be included in the amount to be amortized to ratepayers as part of the WRAM Advice Letter filing. If the difference between production and billing is greater than the adopted percentage, then a similarly calculated penalty will be offset against any amount to be collected under the WRAM.

We, therefore, adopt the following additional requirements for Cal-Am's annual WRAM filing:

1. For the Bishop, Hidden Hills, Monterey, and Ambler systems,
    a. Provide the total water production for each system for the preceding calendar year.
    b. Calculate each system's adopted unaccounted for water quantity by multiplying the adopted percentage from the table in Section 6.1.11 in this Decision by the actual production quantity for the period from item a. above.
    c. Calculate the actual unaccounted for water for the period by determining the difference between each system's production meters and the sum of all the system's customer meters.
    d. Subtract the actual volume of unaccounted for water from the adopted volumes calculated in item b. above for each system.
    e. Multiply the difference calculated in item d. above $2,018.79/ acre-foot based on the standard rate of $4.5345/Ccf.
    f. If the result of item e. is positive, i.e., actual unaccounted for water is less than the standard, then this is a reward amount that will be added to the balance to be included in rates via WRAM Balancing Account amortization.
    g. If the result of item e. is negative, i.e., actual unaccounted for water is greater than the standard, then this is a penalty amount that would be entered as a

debit to the amount to be recovered from ratepayers through the WRAM Balancing Account

For the Ralph Lane and Chualar systems, which are not included in the WRAM, the penalty/reward amounts will be calculated as above but will be assessed to customers by a separate one-time surcredit/surcharge.

6.2. Expenses: Operations and Maintenance, Administrative and General, and Payroll

For these three expense items, Cal-Am requested $24,533,800[96] and DRA recommended $16,357,700.[97] We will address the disputed issues in Operations and Maintenance and Administrative and General together, and then address Payroll.

DRA's three largest proposed adjustments to Operations and Maintenance and Administrative and General are in (1) Purchased Water (Account 704), $6,188,628 reduction, (2) Regulatory Expense (Account 797), $642,810 reduction, and (3) Tank Painting (Account 760), $309,552 reduction. DRA accepted Cal-Am's position on the appropriate medical insurance escalation, 9%, and increased its recommendation by $220,100.

6.2.1. Purchased Water

Cal-Am agreed to DRA's proposed resolution of the Seaside Basin Replenishment fee,[98] such that Cal-Am's purchased water request can be reduced by $4,629,555, leaving $1,559,073 in dispute. Similarly, DRA did not seriously

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[96] Application Exh. A, Chapter 6, Section 1, Table 1b.

[97] Exh. 21, pp. 3-1.

[98] The parties have agreed to plan on the watermaster granting Cal-Am's request that these fees be off-set by expenses for the Coastal Water Project. To the extent such treatment is not granted, the parties agree that Cal-Am may file an advice letter to amend its purchased water account. (*See* Cal-Am opening brief at p. 12.)

contest Cal-Am's proposal to include $794,073 in purchased water for Seaside Basin Non-replenishment fees, bringing DRA's amount for purchased water up to $794,073. Accordingly, the only seriously disputed issue between the parties is the Sand City Desalinization Plant lease, which Cal-Am included in its application at $765,000 annually, but which has subsequently grown to about $1 million annually.

6.2.1.1. Sand City Desalinization Plant Lease-Background and Positions of the Parties

Cal-Am seeks authorization to include in its 2009 test year revenue requirement the costs of water purchased from the Sand City Desalinization Plant under a lease agreement with Sand City. In its application, Cal-Am estimated $765,000 per year in payments to Sand City as the owner of the plant. Cal-Am has updated this amount to $850,000, in addition to $203,000 in Operations and Maintenance expenses that Cal-Am will incur directly. Cal-Am justifies these expenses based on the urgent need to augment its water supplies. DRA argues that cost of this water supply is too high. As set out below, we find that Cal-Am has failed to meet its burden of proving that the Sand City Desalinization Plant lease is reasonable and prudent; however, with limitations on the inclusion of costs under the lease in Cal-Am's revenue requirement, water may be reasonably purchased pursuant to this lease.

Sand City has constructed within its city limits the Sand City Water Supply Project, a reverse osmosis desalinization facility with a projected annual capacity of 300 acre-foot per year. The purpose of the plant is to "better serve the needs of its inhabitants for potable water."[99] Specifically, the plant is expected to serve

[99] Hearing Exh. 51, Lease Agreement, p. 1.

about 3 million square feet of new commercial and industrial space in Sand City.[100]

On November 5, 2007, Sand City and Cal-Am entered into a real property lease and operations and maintenance agreement whereby Cal-Am agreed to rent the facility for an initial term of 15 years for $850,000 per year, based on then-current projected costs. Cal-Am also agreed to operate and maintain the plant "consistent with Prudent Industry Practices, to produce potable water" for delivery to Cal-Am's Monterey distribution system. The water so produced may be used to offset water currently produced from Cal-Am's existing resources. Sand City, however, reserved the unilateral right to allocate up to the entire projected capacity of 300 acre-feet per year to "new and expanded uses within Sand City," for which it may charge a hookup fee, no portion of which shall be payable to Cal-Am.[101] DRA currently estimates that Cal-Am's operations and maintenance expenses for this plant will be about $203,000 per year, with the majority of that amount (76%) being for purchased electrical power. The lease payments and projected operations and maintenance expenses result in a total price of $3,510 per acre-foot/year for water produced from the facility.[102]

Cal-Am justifies the lease due to the extreme water supply limitations in its Monterey district. Cal-Am states that both of the sources of supply for the Monterey district – the Carmel River and the Seaside Basin – are subject to court

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[100] *See* http://www.owue.water.ca.gov/recycle/DesalPSP/Summaries_Awarded_2006.pdf.

[101] *Id.*, at p. 3; but see Hearing Exh. 35 which contends that "regulatory approvals obtained for the Plant" limit Sand City to 206 acre-feet.

[102] Hearing Exh. 21 at p. 12-1.

or agency orders reducing the water supply available for Cal-Am's customers, as set out below:

Monterey District Water Source Reductions Ordered or Proposed[103] (acre-feet per year)				
Source	Historical Draw	2009	2012	Ultimate
Carmel River	11,285	9,592	9,028	3,376
Seaside Basin Coastal Area	3,700	3,191	2,872	1,494
Seaside Basin Leguna Seca Area	430	271	244	0
TOTAL	15,415	13,054	12,144	4,870

Thus, to meet the ordered or proposed reductions in test year 2009, Cal-Am must reduce its historic draw by 2,361 acre-feet. Cal-Am explains that the 300 acre-feet Sand City Desalinization Plant is the only new water supply in the Monterey district that is expected to be fully operational and delivering water in 2009. Cal-Am concluded that "[f]ailure to secure this additional water supply. . . would not be prudent and would subject California American Water and their customers to potential fines in the future due to not obtaining the additional water supply that was readily available."[104] Cal-Am's data response justifying the plant as prudent and cost-effective included no cost data or analysis, such as cost comparisons.

DRA contends that the small amount of water potentially and temporarily available would not justify the costs, and that alternative projects could result in greater and permanent water savings. DRA argues that Cal-Am did not evaluate the cost-effectiveness of the Sand City Desalinization Plant against reduced water consumption from additional conservation programs or enhanced measures to

[103] Hearing Exh. 35, p. 5.

[104] *Id.,* at p. 4.

reduce unaccounted for water. The alternatives DRA contends that Cal-Am should have studied are summarized below. The data are found in Hearing Exh. 21, Chapters 4 and 12.

Comparison of Alternatives for Reducing Cal-Am's Draw on Carmel River and Seaside Basin			
Description	Amount Available (acre-feet/year)	Cost ($/acre-feet year)	Duration
Sand City Desalinization Plant	94	$3,510	15 years, possible extension for another 15 years
	206	$3,510	Uncertain, expected to be available for several years
Treated Wastewater for Urban Irrigation	1,500	$3,140	Permanent
Reducing Unaccounted For Water	Uncertain, up to 1,000	Unknown, (some costs one time)	Permanent
Electronic Leak Monitoring System (MLOG)	357	$1,646 plus implementation expenses	Permanent
Conservation	Uncertain up to 300	Unknown	Unknown

DRA points out that Sand City had obtained $2.9 million in California Proposition 50 grant funds for the plant but that this funding source is not used to offset Cal-Am's obligations under the lease. Pursuant to the terms of the lease, Cal-Am is obligated to pay 87% of the total capital costs in the first 15-year term of the lease. Accordingly, when the grant is factored in (29% of total cost) and Cal-Am has paid 87% of the total cost at the end of the 15-year term, Sand City will have more than recovered its entire capital outlay and will be realizing positive revenue from the lease. Sand City will also own the plant, which is expected to have another 10 years of useful life.[105]

DRA also questions whether the purpose of the Sand City Desalinization Plant was consistent with Cal-Am's goals of reducing its draw from the

[105] Hearing Exh. 21 at pp. 12-16.

Carmel River and Seaside Basin. As explained in the lease and its web site, Sand City's purpose in constructing the plant is to support residential and commercial development as provided in its general plan, which explains the City's retention of a right to use the majority of the plant's output to foster growth in Sand City.

DRA concludes that Cal-Am's time and energy would have been better directed toward developing larger scale and permanent water supplies, such as the Coastal Water Project or its North Marina alternative, which are intended to provide about 11,500 acre-feet/year of new water supply, or in pursuing additional demand-side management.

Cal-Am counters that it must develop 9,000 acre-feet of additional water supply to comply with the court and regulatory orders and that the 300 acre-feet from the plant is a "critical component" of its supply for the next 15 years.[106]

6.2.1.2. Sand City Desalinization Plant – Discussion

Pursuant to Public Utilities Code § 451 all rates and charges collected by a public utility must be "just and reasonable," and a public utility may not change any rate "except upon a showing before the commission and a finding by the commission that the new rate is justified." § 454. The Commission requires that the public utility demonstrate with clear evidence that the costs which it seeks to include in revenue requirement are reasonable and prudent.

Here, DRA contends that Cal-Am has failed to meet its burden of demonstrating the reasonableness of the Sand City Desalinization Plant lease. As set forth below, we find that Cal-Am has failed to demonstrate the reasonableness of certain components of the lease agreement.

The standard of reasonableness for managerial action is settled.[107] The reasonableness of a particular management action depends on what the utility knew or should have known at the time that the managerial decision was made, not how the decision holds up in light of future developments:

> "The term 'reasonable and prudent' means that at a particular time any of the practices, methods, and acts engaged in by a utility follows the exercise of reasonable judgment in light of facts known or which should have been known at the time the decision was made. The act or decision is expected by the utility to accomplish the desired result at the lowest reasonable cost consistent with good utility practices. Good utility practices are based upon cost effectiveness, reliability, safety, and expedition.
>
> "A 'reasonable and prudent' act is not limited to the optimum practice, method, or act to the exclusion of all others, but rather encompasses a spectrum of possible practices, methods, or acts consistent with the utility system needs, the interest of the ratepayers and the requirements of governmental agencies of competent jurisdiction."[108]

The standard of reasonableness does not derive from the consequences of managerial action, but the soundness of the utility's decision-making process that led to the decision and the consequences:

> "Thus, a decision may be found to be reasonable and prudent if the utility shows that its decision making process was sound, that its managers considered a range of possible options in light of information that was or should have been available to them, and that its managers decided on a course

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[106] Cal Am Opening Brief at pp. 129-31.

[107] *See* Investigation into the Natural Gas Procurement Practices of Southwest Gas Company, D.02-08-064, *mimeo.* at pp. 5-7, and decision cited therein.

[108] D.87-06-021 (1987 Cal. PUC Lexis 588, *28-29, 24 CPUC2d 476).

> of action that fell within the bounds of reasonableness, even if it turns out not to have led to the best possible outcome. As we have previously stated, the action selected should logically be expected, at the time the decision is made, to accomplish the desired result at the lowest reasonable cost consistent with good utility practices."[109]

Utility management must present persuasive evidence that its decision-making process and ultimate decision are reasonable and prudent:

> "The burden rests heavily upon a utility to prove with clear and convincing evidence, that it is entitled to the requested rate relief and not upon the Commission, its staff, or any interested party to prove the contrary."[110]

Applying these standards, we find that Cal-Am has failed to demonstrate that the terms of the lease are reasonable.

We begin with Cal-Am's analytical process in deciding to sign the lease. Cal-Am's witness explained that due to the required extreme reductions in draw from the Carmel River required by Order 95-10 and Seaside Basin, Cal-Am must obtain new water sources to serve its customers in the Monterey district, and the Sand City Desalinization Plant is the only new source available to deliver water in 2009.[111] Cal-Am's witness concluded that the need for this facility was so "obvious" that the costs did not require written justification in the rate increase application.[112] In response to a data request from DRA seeking an explanation as

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[109] Re San Diego Gas and Electric Company, 31 CPUC2d 236, 245-6, holding that management failed to reasonably evaluate a proposed capacity purchase contract and disallowing costs (D.89-02-074).

[110] *Id.*

[111] Hearing Exh. 34, pp. 4-5.

[112] Hearing Transcript at pp. 606-7.

to "why Cal-Am believes purchasing water from the Sand City Desalinization plant is a prudent and cost-effective action," Cal-Am provided no analytical cost data whatsoever and simply concluded that: "the cost of this water is justified since no other water is available."[113] The record does not contain any written analysis, dated prior to Cal-Am's execution of the lease, such as budget justification documents. Similarly, no evidence was presented of Cal-Am's evaluation or negotiation of the proposed terms of the lease, before entering into the lease.

Accordingly, we find that the record does not reveal a process under which Cal-Am evaluated the Sand City Desalinization plant lease. Rather than sound decision-making, the record suggests unquestioning support for this new water source, at any price, without regard to alternatives.

We next review the reasonableness of the actual terms and conditions of the Sand City Desalinization plant lease.

DRA objects to several terms of the lease.[114] DRA points out that over the 15-year term of lease, Cal-Am will pay, in net present value terms, almost 90% of the capital costs of the plant but will not own the plant. DRA also explains that Sand City did not incur all the costs of constructing the plant but obtained a grant in 2006 from the State of California for $2.9 million of the capital cost. The terms of the lease also show that further capital contributions in the form of customer hook up fees will also reduce the City's capital expenditures.[115] DRA

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[113] Hearing Exh. 35 at p. 4.

[114] Hearing Exh. 21 at pp. 12-6 to 12-28.

[115] Hearing Exh. 51 at p. 3.

concludes that Cal-Am imprudently agreed to a "cost-based" annual lease payment that did not reflect known offsets to Sand City's costs.[116]

The record shows no efforts by Cal-Am to negotiate these provisions, and Cal-Am offered no rationale for its decision to agree to them. Cal-Am justifies the overall price in the lease as being consistent with its "marginal cost of producing water" and concludes that the lease is "prudent and reasonable."[117]

DRA also challenges the terms of the operations and maintenance portions of the lease as placing excessive risk on Cal-Am. The lease obligates Cal-Am to operate the plant consistent with prudent industry practices "to produce potable water throughout the term." Pursuant to Section 11(b) of the lease, Cal-Am has agreed that it will "at its own cost and expense, keep and maintain [the desalinization plant] in the same condition as delivered . . . including taking, or causing to be taken, all actions necessary to maintain the [plant] in compliance, in all material respects, with any applicable Legal Requirements, including all applicable Environmental Laws and Environmental Permits." The definitions section of the lease further specifies that "Legal Requirements" include all applicable laws and regulations "now existing or . . . hereafter enacted or promulgated, of every government, municipality and of any agency thereof having jurisdiction over [Cal-Am or the plant]."[118] Moreover, the title to all plant

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[116] *Id.*, at Schedule B, ("The parties acknowledge and agree that the capital cost of the Leasehold Improvements will be at least NINE MILLION DOLLARS ($9,000,000). In the event the Leasehold Improvements exceed NINE MILLION DOLLARS ($9,000,000), the parties agree that the amount of Basic Rent shall be increased to amortize eighty seven percent (87%) of such increase in capital cost over the Basic Term of the Lease.")(Capitalization as in original).

[117] Cal–Am Opening Brief at p. 128.

[118] Hearing Exh. 51 at Schedule X, p. 4.

improvements that cannot be conveniently removed vests in Sand City.[119] Thus, Cal-Am is obligated to produce potable water at the plant and to incur all costs necessary to do so, including any required plant modifications. The lease contains no limitations to the amount Cal-Am must incur to fulfill its obligations to produce 300 acre-feet/year of potable water at the plant.

A hypothetical set of circumstances illustrates the potential windfall to the City that could result. If, in year 14 of the 15-year term, compliance with significant new environmental requirements necessitates multi-million dollar plant upgrades, Cal-Am will be obligated to absorb these costs in total and turn over the upgraded plant one year later. Similarly, if sky-rocketing operations and maintenance costs[120] render water produced at this plant uneconomic as compared to other sources then available, Cal-Am will nevertheless remain obligated to continue production for the term of the lease.

The length of the lease also raises questions. The "Basic Term" of the Sand City Desalinization Plant lease is 15 years, beginning when Cal-Am accepts the plant, expected to occur during 2009.[121] Thus, the Basic Term is anticipated to run through 2024. The Coastal Water Project (11,500 acre-feet/year) is currently

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[119] Section 11 (d) of the lease states that ownership of non-severable modifications "shall vest in the Lessor and be subject to this lease without any increase in Basic Rent." (Hearing Exh. 51 at p. 9.) The term "increase" seems odd as Cal-Am would have paid for the modification and, because it was non-severable, title would vest in the City, and the City agrees not to *increase* Cal-Am's rent. Having just received a valuable modification to its plant at no cost, it would seem more reasonable for the City to *decrease* Cal-Am's rent.

[120] Electricity, which currently comprises about 75% of the operations and maintenance costs, could be such an item.

[121] Hearing Exh. 34.

estimated to begin production in 2015, and the Aquifer Storage and Recovery Plant (920 acre-feet/year) in 2010, both well in advance of 2024, even allowing for delays. These two resources alone, even ignoring any system or customer efficiency savings or additional non-potable sources, could close most of the gap between Cal-Am's available supply and its customer demand. Thus, the length of the lease aggravates the one-sided risk allocation and there is no explanation why Cal-Am would obligate itself through 2024.

Specifically, the record reveals no negotiation of risk allocation or demonstration of trade-offs among components of the lease agreement. Cal-Am has accepted virtually all the risks of ownership without the long-term benefits, and now seeks to transfer this risk to ratepayers.

In imposing a significant disallowance on San Diego Gas & Electric Company (SDG&E), we observed:

> What is striking about these early negotiations is how many of the important terms were essentially set at an early date, with little or no analysis by SDG&E and little consideration of SDG&E's requirements. So far as SDG&E's testimony reveals, the only analysis of the proposed capacity charge was a comparison with PNM's estimated costs. SDG&E apparently did not compare these proposed charges with other options or with the value that this capacity represented to SDG&E.[122]

Here, the record is similarly devoid of evidence that Cal-Am carefully analyzed the costs of its alternatives, or that it fully understood Sand City's costs.[123] Similarly, there is no record evidence that Cal-Am attempted to

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[122] Re San Diego Gas & Electric, 31 CPUC2d 272-3.

[123] Cal-Am's officer responsible for "due diligence" on Sand City lease was not aware of whether Sand City received the $2.9 million grant or any lease price off-set for the grant. Hearing Transcript at pp. 771–772.

negotiate a lower lease payment or limit its risk.[124] So far as the record reveals and the terms of the agreement bear out, Cal-Am acquiesced in all respects to Sand City's desired terms.

There may be circumstances that could justify the price and risk allocation terms of this lease and operating agreement. Cal-Am has not, however, presented such circumstances for the record. As stated above, Cal-Am bears the burden of proving that this lease would logically be expected, at the time it was signed, to accomplish the desired result at the lowest reasonable cost consistent with good utility practices.

We find that Cal-Am has failed to meet its burden of demonstrating that the price and risk allocation terms of the Sand City Desalinization Plant lease would logically be expected to accomplish the result of providing between 94 and 300 acre-foot/year of water for Cal-Am's customers at the lowest reasonable cost consistent with good utility practices. Cal-Am's explanation - severe supply limitations – provides no limit to price or risk allocation, and could be used to justify an unlimited price. Evidence of tough negotiations, a thorough analysis of alternatives for both buyer and seller, or a cost-of-service study for a cost-based lease price, could be used to show market reasonableness, and that this lease price was the lowest reasonable price consistent with good utility practices. This type of showing, however, was not included in Cal-Am's presentation.

We, therefore, must conclude that Cal-Am has failed to meet its burden of demonstrating that the terms of the Sand City Desalinization Plant lease are

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[124] *See* Re San Diego Gas & Electric, 31 CPUC2d 273 (The seller's initial proposal became the demand charge term.)

reasonable and prudent. Our conclusions are based on the record of this proceeding and do not preclude Cal-Am from filing a separate application to make the showing required for these or any revised payments and costs to be included in revenue requirement.

Therefore, we will deny Cal-Am's request to include the price of the Sand City Desalinization plant in revenue requirement without prejudice to Cal-Am filing another application justifying the price and risk terms.

6.2.2. Regulatory Expense

Cal-Am proposes annual amounts for regulatory expense for each district: $850,669 for Monterey Water and $34,027 for Monterey wastewater.[125] Cal-Am states that these amounts are based on actual expected regulatory costs for these general rate cases as well as the cost of capital proceeding, a total of $3,193,747, amortized over the three-year rate cycle.

DRA compared Cal-Am's proposed regulatory expense to rate case expense per customer and rate case expense as a percentage of revenue for several recent Cal-Am filings and determined that Cal-Am's proposal here exceeded both of these metrics, in some instances by 150%.[126] DRA also examined the American Water employee costs included in Cal-Am's tabulation of regulatory expenses and determined that five out of eight Cal-Corp employees were billing more than 100% of their time.[127] DRA concluded that Cal-Am's proposal was excessive and, based on a three-year average of recorded expenses

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[125] Hearing Exh. 2, tab 15, p. 2.

[126] Hearing Exh. 90 at pp. 7-1 to 7-2.

[127] *Id.*, at pp. 7-2.

adjusted for inflation, recommended an annual amount of $200,000 for the Monterey district.

The Independent Reclaimed Water Users Group (Reclaimed Water Group) opposed Cal-Am's proposal and DRA's recommendation as both being excessive. The Reclaimed Water Group argued that Cal-Am has a tendency to file applications that are incomplete, contain multiple errors, and request unjustified increases; and that, after filing, Cal-Am is then reluctant to negotiate reasonable resolutions of disputed issues.[128] The Reclaimed Water Users Group recommended using the last adopted regulatory expenses of $126,000 in 2006, adjusted for inflation.

Cal-Am objected to using the 2006 adopted amount because it was adopted as part of a settlement.[129] Consistent with our rules, we will not rely on the 2006 adopted amount because the settlement is not precedential, Rule 12.5.

Turning to the components of Cal-Am's proposal, we find that many are based on actual costs of litigating this proceeding:[130] for example, expert witness

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[128] Reclaimed Water Group Opening Brief at p. 15.

[129] Cal-Am Opening Brief at pp. 19–22.

[130] As support for using these actual costs as the basis for regulatory expense in revenue requirement, Cal-Am cites to Suburban Water Systems, Decision 03-05-078, *mimeo.* at p. 17 (allotting $80,000 for regulatory expense); Apple Valley Ranchos Water Company, 85 CPUC2d 319, 333-5 (D.99-03-032) (disallowing $6,210 from requested $140,000 calculated by "taking the $100,000 allowed by the Commission for Regulatory expense in its *last contested* rate case" and updating attorney and consultant rates and escalating miscellaneous items)(emphasis in original); Re Toro Water Service, Inc., 49 CPUC2d 636, 640 (D.93-06-054)(adopting regulatory expense of $535).

and case management, $187,266; outside counsel, $908,006; and $682,704, "cost of processing cost of capital application."[131]

The Commission, however, has directly addressed the use of actual regulatory expenses rather than test year forecasts for Cal-Am:

> [A]bsent a previously authorized memorandum or balancing account, the Commission's longstanding, consistent practice is to set rates based on forecasted expenses. In this regard, although certainly not determinative, expenses incurred in the present proceeding may be considered in the setting of future rates, along with all pertinent evidence, especially including similar expenses from prior proceedings. And, on the basis of this more comprehensive analysis, something close to the historical trend shown in Exhibit CA-1, Tab B, Table 6-5 will likely prove most predictive of future expenses.

California-American Water Company, Monterey Division, Decision 03-06-036, *mimeo.*, at pp. 4–5. In that decision, the Commission denied rehearing and held that Cal-Am failed to demonstrate that the Commission committed legal error in determining that regulatory expense of $40,000 per year was reasonable over the next three years, 2003, 2004, and 2005.

Cal-Am's showing to justify regulatory expense is largely limited to actual amounts for these proceedings, as well as the conservation (A.07-12-010) and the cost of capital proceedings. As quoted above, absent a memorandum account, the Commission may not grant a "three-year amortization period for regulatory expenses used in this proceeding" as requested by Cal-Am.[132] The Commission's

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[131] Hearing Exh. 2, tab 15, p. 2.

[132] *Id.*, at p. 4; *see* also, Hearing Exh. 55 at p. 14, ("Charges to rate case expense are deferred charges incurred in the processing of a case, amortized to expense over the rate case effective period.")

task instead is to forecast regulatory expense for the upcoming three-year rate period.

Cal-Am properly objects to using the 2006 settlement amount and resulting recorded entries limited to the settled amount. That leaves us with the 2003 litigated amount of $40,000 per year, which is too far removed in time to be useful.

Elsewhere in today's decision, we approve Cal-Am's request for five full-time rate staff and three engineers, who will devote a portion of their time to regulatory matters.[133] Support Services, such as information technology necessary to implement billing changes, are also funded through the service companies. Regulatory services necessary for day-to-day utility operations should be included in revenue requirement, and Cal-Am has used the increasing regulatory duties in California to justify committing additional personnel:

> "[T]hese personnel are fully dedicated to supporting California rate case, advice letter filings, WRAM and MCBA, conservation rate designs, and other rate matters that are required to meet the regulatory needs of the business. In addition, resources dedicated to California need to be enhanced in order to have staffing in place for the first statewide comprehensive filing that California American Water will submit in May of 2010."[134]

Based on this justification, we granted Cal-Am's request for additional staff elsewhere in today's decision. Consequently, and to avoid the "double-counting" phenomenon identified by DRA, we will not again add in "company labor" to meet these same enhanced regulatory needs under the line

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[133] Hearing Exh. 54 at pp. 8-10.

[134] *Id.*, at p. 10.

item of "regulatory expense." Cal-Am has requested and received authorization to include in revenue requirement significantly increased service company staff to meet enhanced and on-going regulatory needs.

Cal-Am's presentation on regulatory expense that is incremental to the costs already imbedded in Cal-Am's revenue requirement appears to be largely for outside services, *i.e.,* experts and legal counsel. Cal-Am contends that it will be using "outside counsel and witnesses much more extensively" due to the enhanced filing requirements of the Rate Case Plan.[135] Cal-Am, however, has not presented a forecast of outside service expenses, perhaps based on an historical trend, to support the reasonableness of the forecast.

Major general rate cases are typically a cause of significant incremental or unusual regulatory expense. Here, DRA's analysis of two metrics supports rate case expense of between approximately $500,000 and $1,000,000. Cal-Am's tabulation of actual expenses for this case shows about $1,000,000 for outside services, and its two most recent general rate cases for other water districts, Coronado and Los Angeles, have recorded expenses to date of just over $1,000,000.

Thus, we conclude that the record supports a forecast of about $1,000,000 in incremental regulatory expense for a general rate case, which is scheduled to occur every third year. Distributing this over the three-year rate period and rounding up, we will adopt $350,000 as the annual amount for incremental regulatory expense for the Monterey Water district. We address regulatory expense for the Monterey wastewater district in a companion decision.

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[135] Hearing Exh. 2, tab 15, p. 3.

6.2.2.1. Fine for Failure to File Reports Ordered in Decision

During the Public Participation Hearings for Cal-Am's 2006 general rate case, customers complained about Cal-Am's operations on topics ranging from "no water service, low water pressure, improper notification of boil orders, billing disputes, meter reading issues, hazardous construction practices, noise, a chemical accident, the inability to get prompt or courteous service from the call center in Illinois, the failure of the call center to resolve emergency issues and the failure of the call center to register complaint calls."[136] In response to these complaints, the Commission ordered Cal-Am to develop and file, on a quarterly basis, a customer complaint report with the Commission:

> Cal-Am shall develop (a) a new quarterly report that provides California-specific statistics, by district, from the national call center and that breaks out type of calls and final disposition of all complaints; and (b) a new quarterly report on all complaints received at district and regional levels and their final disposition. These reports shall be developed within 60 days of this decision and routinely filed on a quarterly basis with the Commission's Consumer Service and Information Division (CSID), and Water Division, and served on all parties to this proceeding.
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> Decision 06-11-050, *mimeo.*, Ordering Paragraph 9.

There is no factual dispute among the parties that Cal-Am filed one such report but did not timely file and serve the next four reports.[137]

DRA recommends a fine be assessed against Cal-Am for its four violations of the Commission order. DRA contends that the Commission's standards for

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[136] D.06-11-050, *mimeo*. at p. 34.

[137] DRA Opening Brief at p. 103; Cal-Am Opening Brief at p. 108.

assessing fines merit a fine of $80,000 because Cal-Am's actions harmed the regulatory process and ratepayers. DRA also argues that Cal-Am's failure to prevent the violations showed a "serious and systemic failure" of management to comply with Commission directions.[138] DRA concludes that a fine of $20,000 per violation, for a total of $80,000, is necessary to deter future violations.

Cal-Am disputes DRA's analysis of Commission standards and precedent in determining the appropriate level of fine. Cal-Am contends that DRA's recommended fine was excessive and not in line with a fine the Commission recently assessed against Cal-Am for failing to give required rate case notices for 10 to 20 years.[139] Cal-Am did not make a specific fine recommendation.

The Commission uses two primary factors in determining the proper level of fine necessary to deter future violations: (1) the severity of the offense and (2) the conduct of the utility.[140] Disregarding a statutory or Commission directive is accorded a high level of severity because compliance is absolutely necessary to the proper functioning of the regulatory process. The second factor focuses on the utility's efforts in preventing, detecting, and rectifying violations. Financial resources and precedent are also considered in setting fines.

Here, Cal-Am's conduct clearly undermines the proper functioning of the regulatory process because the Commission cannot identify and correct poor utility customer service without adequate data. As described above, Cal-Am's customers continue to testify at Public Participation Hearings that Cal-Am's

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[138] DRA Opening Brief at p. 106.

[139] Cal Am Opening Brief at p. 111.

[140] Re Standards of Conduct Governing Relationships between Electric Utilities and their Affiliates, 84 CPUC2d 155, 188 (D.98-12-075).

customer service is inadequate. The required reports, timely prepared and filed, would have assisted the parties and the Commission in properly evaluating this issue.

The record shows that Cal-Am did not detect this violation[141] but that it has endeavored to correct it and put in place protocols that will decrease the likelihood of recurrence. In assessing precedent, Cal-Am contends that its tardy reports are more like its failure to serve certain cities with its rate increase applications in D.07-08-030, than California Water's failure to obtain Commission authorization to serve new districts and approval of rates for those customers.[142]

In California Water Services, Inc., D.04-07-033, we found that the utility's offenses were "serious and have been repeated" because previous similar violations were the subject of an earlier agreement with DRA, which had been approved by a Commission decision. In light of these facts, and others, we assessed a fine of $15,000 for each of five violations.

Here, in contrast, Cal-Am is not a repeat offender in the sense that this is its first time before the Commission for this type of violation, although there are four related instances. Therefore, we find that the severity of Cal-Am's offense is less than the severity of the offense in D.04-07-033 and that an appropriate fine should be less than $15,000 per incident.

We find that the severity of the offense and the Cal-Am's conduct require a fine of $10,000 per incident for its failure to timely file its customer service reports. These reports were remedial in nature and necessary for the Commission to properly exercise its regulatory function. Cal-Am's total fine for

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[141] Hearing Exh. 19 at p. 11.

the four instances is $40,000, which shall be paid to the General Fund no later than 30 days after the effective date of this decision.

6.2.3. Tank Painting

In its application, Cal-Am proposed $544,325 to paint its water tanks in Test Year 2009. DRA used a five-year average of recorded tank painting costs from 2003 to 2007, $223,204, and escalated for inflation to determine a Test Year 2009 forecast of $237,007.

In its rebuttal testimony, Cal-Am stated that it "provided a tank painting schedule for the years 2007-2012 to DRA, [which] provided ample proof as to why use of a historical average is inappropriate."[143]

Cal-Am did not provide the schedule for the record, nor did Cal-Am offer any explanation for tank painting expense more than doubling in 2009 (a 130% increase) as compared to the recorded 2003 to 2007 average adjusted for inflation.

Cal-Am bears the burden of justifying its proposed expenditures by presenting evidence for the record. Here, the record only shows Cal-Am's assertion of a tank painting schedule but not the schedule itself and, more notably, no rationale whatsoever for the proposed 130% increase in this line item.

As discussed above, the scoping memo instructed Cal-Am that due to the severe water supply and financial burdens on ratepayers in this district, we would require a demonstration of necessity for its proposed increase:

> Cal-Am bears the burden of proving by a preponderance of the evidence that the proposed rates are just and reasonable. We will review Cal-Am's presentation in the context of the increasingly severe water supply limitations in Cal-Am's

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[142] *Id.*, at pp. 12-13.

[143] Hearing Exh. 86 at p. 10.

> Monterey District and the significant financial burdens imposed on residential and business customers by the substantial rate increases sought by Cal-Am in these consolidated applications. This context requires that proposed expenditures be demonstrably necessary for reliable service and provide value to customers. We understand that the cost of providing an efficient and safe water supply is rapidly increasing and we will, where necessary, recommend approval of substantial expenditures, but we intend to carefully scrutinize Cal-Am's justifications for such proposals.[144]

Cal-Am's presentation on this topic, approximately five lines of rebuttal testimony, with no supporting documentation, is not sufficient to demonstrate that tank painting expense for test year 2009 is reasonably forecast to be double the historical average. We, therefore, will accept DRA's forecast based on the escalated historical average.

6.2.4. Payroll

Cal-Am requested test year 2009 payroll for the Monterey District of $6,320,952, a 42% increase from authorized 2006. DRA has agreed to a 32% increase from authorized 2006, to $5,889,564 for test year 2009.[145]

The primary component of the difference is new employees. Cal-Am proposed 15 new employees, and DRA agreed to a payroll/teller and three Maintenance Technicians. The payroll/teller is exclusively devoted to the

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

[145] Hearing Exh. 21 at pp. 3-26; DRA Opening Brief at p. 14.

Monterey District, and three Maintenance Technicians are assigned to the Coastal Division and will apparently be shared with other Cal-Am districts.[146]

The largest contingent of proposed employees that DRA would reject is four additional utility workers for the Monterey district; this request, if granted, would bring the total utility workers to 17 for this district. Cal-Am stated that its Monterey system experiences an extraordinarily high frequency of leaks.[147] Repairing leaks is the highest priority for the utility worker crews, and crews must stop whatever project they are working on and address the leak.[148] Cal-Am stated that the existing utility crews are "spending all of their time addressing leaks and do not have time to address normal distribution work," such as maintaining fire hydrants, blow-off valves, and repairing and inspecting valves.[149] Cal-Am contended that the need to respond on an emergency basis to the high frequency of leaks, as well as accomplish other, non-emergency repairs, required an increase in its utility worker staff to 17.

DRA analyzed Cal-Am's leak repair history and showed that the overall percentage of utility worker time devoted to leak repair decreased from 43% in 2003 to 28% in 2006, with a low of 18% for 2005. DRA explained that the declining leak trend was likely to continue, particularly given Cal-Am's major capital improvement projects.[150] DRA's report showed that Cal-Am's

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[146] No party stated the factor for allocating costs from the Coastal Division to the Monterey District.

[147] Hearing Transcript at p. 427.

[148] *Id*.

[149] Hearing Exh. 33 at p. 19.

[150] DRA Opening Brief at p. 22.

Monterey district has had a steady staff of 13 utility workers since 2003.[151] DRA concluded that Cal-Am had not justified the need for four more utility workers.

Cal-Am's witness testified persuasively that addressing leaks caused significant work scheduling disruptions, and that the quantified analysis in the record may not accurately portray the share of utility worker time actually required to temporarily close down an on-going work site and redeploy to fix a leak.[152] Cal-Am did not, however, provide any analysis demonstrating that specific, necessary work is not being performed, or that four is right number of additional utility workers. Other than reducing the stress of unpredictable scheduling, Cal-Am did not identify any significant benefit to its operations or customers from the proposed additional four utility workers. The record shows that since 2003 Cal-Am's Monterey district has had 13 utility workers, with a variable number of hours annually devoted to repairing leaks, and no evidence has been presented that needed or scheduled utility work has not been performed. While we understand that additional utility workers could diminish scheduling stress and allow for additional preventive maintenance, the 32% payroll increase already agreed to by DRA and revenue requirement increases elsewhere in today's decision should improve current operations.

Again, Cal-Am bears the burden of justifying its request. Absent a well-documented unmet need, we are not willing to impose further financial burdens on the Monterey District ratepayers. We, therefore, deny Cal-Am's request for four more utility workers.

Valve Turner

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[151] Hearing Exh. 21 at pp. 3-21.

[152] Hearing Transcript at p. 426; Hearing Exh. 17 at p. 2.

Cal-Am proposed another utility worker to conduct more frequent inspection and maintenance of the 11,848 valves in the Monterey district. Cal-Am stated that valves should be exercised once every five years, and current staffing only allows for 200 to 300 valves to turn annually. Insufficient exercising of valves can cause valves to "freeze up, break or become inoperable," can "cause leaks and the inability to isolate leaks," and "may result in extensive damage to infrastructure and property loss, extended service interruptions to our customers and can lead to costly repairs or replacements."[153]

DRA opposed Cal-Am's request for another utility worker to turn valves. DRA took issue with Cal-Am's estimate that only 200 to 300 valves are exercised annually by pointing out that each leak repair should require at least one and most often two valves to be closed to enable the repair. Because Cal-Am has experienced nearly 500 leaks per year, up to 1,000 valves are turned just to fix the leaks. Cal-Am, however, does not track valve turnings and inspections as part of its leak repair reports, and DRA recommends that Cal-Am's leak repair reports contain this, and other, information.[154]

As with the other four utility workers, Cal-Am has not presented a quantified analysis of the specific need in the Monterey district for additional valve turning. Had Cal-Am shown, for example, that the district has a higher than average level of valve failures and that the cost of those failures exceeds the projected cost of the new utility worker, the record may have supported this additional worker. Improving preventive maintenance is certainly a worthy objective, but given the extreme financial burdens imposed on Cal-Am's

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[153] Hearing Exh. 33 at p. 20.

customers by this rate increase, Cal-Am must show that its "proposed expenditures are demonstrably necessary for reliable service and provide value to customers." Cal-Am has not met that standard with regard to its request for a valve turner.

Backhoe Operator

Cal-Am requested an second backhoe operator position to enable it to reduce outsourcing of backhoe services and improve response time to repair leaks. Cal-Am's presentation on this issue consisted of 10 lines of text discussing in general terms the benefits of an additional backhoe operator.

DRA generally supported Cal-Am's objective of quickly repairing leaks, but criticized Cal-Am for failing to provide any quantification of the time crews spend waiting for the backhoe contractor, the amount of water lost in the continuing leak, or the expected savings from replacing the outsourced work with an employee.[155]

Cal-Am bears the burden of justifying on a cost/benefit basis each element of its General Rate Case revenue requirement. Here, the cursory presentation, without a single numerical quantity, falls far short of that which is needed. This is particularly troublesome because the record hints that such information may be readily available. For example, the number of hours that the second backhoe was hired, the cost, the time crews spent waiting, the estimated cost of another

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[154] Hearing Exh. 22 at pp. 3-21 to 3-23.

[155] Hearing Exh. 22 at pp. 3-23,-24.

operator, should all be in Cal-Am's possession.[156] Such information, if presented, may have formed the basis for this Commission to conclude that a second backhoe operator was needed and justified in the record. Absent such a showing, however, we are not able to conclude that Cal-Am has met its burden of justifying this additional cost for Monterey district ratepayers, and we therefore deny this element of the application.

Four Maintenance Technicians

Cal-Am's presentation for four maintenance technicians included many quantified amounts, but the quantities were internally inconsistent, confusing, and ultimately, unpersuasive.

Cal-Am stated that in 2001 it had five maintenance technicians but now it has only one.[157] Cal-Am tabulated the tasks and time necessary to maintain and repair existing controls and determined that 6.2 full-time equivalent maintenance technicians were needed to perform the needed tasks at the Monterey water and wastewater assets.[158]

The testimony is not clear what share of the tabulated time is for water operations only. The testimony at page 18 stated that the total included "hours associated with two wastewater workers" which were separately addressed in the wastewater application. The testimony exhibit, however, shows only 288 hours for "WW Treatment Plants" which we infer refers to wastewater

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[156] But see, Cal-Am reply brief at note 61, indicating that of the amount shown in application workpapers for Account 798, $265,039 is for legal expense, $42,603 for seasonal workers, and only $60,000 is for "all other outside contract expense."

[157] Hearing Exh. 33 at p. 18.

[158] *Id.*, at Exhibit B.

plants, but 288 hours is only about 17% of an FTE, not two full-time workers. If the data are correct, then the testimony exhibit supports the need for six technicians for water purposes, but if the text is reliable, then the two wastewater positions should be subtracted from the six, for a total of four technicians. Cal-Am's application, however, seeks funding for an additional four technicians for a total of five. So, either way, Cal-Am's request is not consistent with its own tabulation.

Further confusion arises with DRA's attempts to accept Cal-Am's proposal. DRA stated that "proper maintenance of equipment is an important function that increases reliability and reduces costs in the long term" and that DRA "does not object to any proposed positions that clearly show an offsetting cost, either in reduced overtime or in outsourced contracts."[159]

In Hearing Exhibit 33 at page 4, Cal-Am's witness stated:

> In the Monterey District there is an opportunity to reduce the amount of outsourced contracts by shifting duties that have been performed by outside contractors to California-American's in-house Maintenance Technicians. . . . [Table 1] shows that Contracted Services, the outsourced labor component of the work, is on average approximately $160,000 per year.

DRA went on to agree that based on the cost savings estimated in Cal-Am's testimony:[160] "it makes economic sense to fund three Maintenance Technician positions, with concomitant reduction in Contracted Services."[161]

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[159] DRA Opening Brief at p. 20.

[160] *See* Hearing Exh. 40 at p. 3 ("approximately $160,000 per year") and Exh. 33 at Exhibit B ("elimination of the generator contract ($52,000 annually + repair costs)).

[161] DRA Opening Brief at pp. 20–21.

Cal-Am, however, objected to DRA's agreement and contended that DRA had not justified the reduction in contracted services.[162] Cal-Am explained that the Contracted Services account is mostly legal expenses, $265,039 and seasonal employees, $42,603, with only $60,000 for all other outside contracted services. Cal-Am argued that its testimony only indicated that there was an "opportunity" to reduce outside expenses, not any specific reduction. Cal-Am renewed its call for four additional technicians, with no reduction in Contracted Services.

We conclude that Cal-Am has not demonstrated that the four additional Maintenance Technicians are justified based on cost reductions in Contracted Services because Cal-Am has not shown that any such cost reductions would occur.

We are more disturbed by Cal-Am's history with these positions. In 2001, Cal-Am had five Maintenance Technicians but now has only one. From test year 2000 to proposed test year 2009, Cal-Am's payroll has increased by 72%.[163] The reported decisions do not show any discussion of a request by Cal-Am to reduce its Maintenance staff, and Cal-Am's current application stated that it has "25 employees in the Distribution Department to provide all the maintenance to the system, in addition to the valve and hydrant crews, USA locating, vehicle maintenance and inspection of capital projects."[164] Cal-Am has not articulated a

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[162] Cal-Am Reply Brief at p. 20.

[163] *See* D.00-03-053 at Summary of Earnings and Hearing Exh. 21 at pp. 3-21.

[164] Application Exhibit A, Chapter 3, Section 1, p. 1. The application does not provide the total number of employees in the Monterey District in the section entitled "District Operations and Personnel" and we are unable to tabulate the total number of employees of the Monterey District because Cal-Am states, in addition to the 25 employees in the Distribution Department, it has 19 in the Commercial Department and 24 water treatment and pump operators, and the "balance of the staff is involved in

Footnote continued on next page

rationale for its decision, over time, to redeploy its authorized Maintenance Technicians to other tasks. Moreover, because previously authorized payroll is typically escalated to the current test year for General Rate Case revenue requirement purposes, the payroll for Cal-Am's previously authorized five Maintenance Technicians is embedded in its historic base payroll, which is escalated up to 2009 test year. To re-authorize (and fund) four additional Maintenance Technicians would have Cal-Am's revenue requirement for payroll include nine Maintenance Technicians.

Cal-Am has not met its burden of justifying any additional Maintenance Technicians and we deny the request.

We also direct Cal-Am to present a comprehensive position-by-position description of each budgeted employee in all future general rate case filings. Such descriptions shall include comparisons of the employee positions reflected in the last authorized general rate case to the proposed test year. All significant changes in personnel positions shall be explained.

Senior Operations Engineer and Engineer In Training

Cal-Am stated that it needs a Senior Operations Engineer to "manage local contracts, address process control issues, energy efficiency, and inspection oversight" and a trainee engineer to "grow into" the position.[165] DRA opposed both positions as insufficiently justified and possibly redundant with two engineering positions in Cal-Am's Coastal Division.

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administration, capital, administration, accounting, and budgeting procedures." The number of employees constituting "the balance of staff" is not provided.

[165] Hearing Exh. 33 at pp. 17-18.

Cal-Am's presentation for these two permanent positions consisted of one half a page of testimony with no numerical analysis whatsoever. Cal-Am has not shown that these positions are necessary and will provide value to ratepayers, and we deny the request.

Operation Specialist and System Operations Specialist

Cal-Am stated that the Operation Specialist will "be responsible for all our regulatory, financial and operational analysis," as well as "improve recordkeeping" and "generate reports and evaluate business performance."[166] DRA found this position to be insufficiently justified and pointed out that all accounting functions have been moved from the districts to the regional accounting office.[167]

Cal-Am stated that its proposed System Operations Specialist would "manage a newly established Computer Maintenance Management System for both water and wastewater operations" and that such a system had many benefits for maintenance planning and performance.[168] Cal-Am asserted that a computerized maintenance program is required for sewer systems.

DRA also found this position to be insufficiently justified and took issue with whether the new sewer regulations required it. DRA provided the actual text of the regulation, which required "standard procedures for immediate

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[166] Hearing Exh. 33 at p. 14.

[167] Hearing Exh. 22 at pp. 3–14,-15. But see Application Exhibit A, Chapter 3, Section 1 at p. 1 ("The balance of the staff is involved in administration, capital, administration, accounting, and budget procedures." (Emphasis added)).

[168] Hearing Exh. 33 at p. 15.

response" to a spill, but contained no reference to a computerized maintenance program.[169]

We conclude that Cal-Am has failed to show that these two new positions are necessary for reliable service and would provide value to ratepayers. We, therefore, deny Cal-Am's requests.

6.2.5. Seaside Basin Adjudication Costs

Cal-Am incurred costs of $2,755,960 to successfully litigate and secure Seaside Basin water rights. This amount is comprised of $1,503,949 for legal fees, $910,000 for initial funding of the Water Master and Monitoring Plan, and other one-time Water Master costs of $342,011.[170] Cal-Am proposed to include these costs in rate base as plant in service.

DRA agreed that the costs incurred were reasonable and prudent,[171] but recommended a 20-year amortization period of the costs, without interest, as a way of sharing the costs between ratepayers and shareholders.[172] DRA argued that Commission precedent does not support rate base treatment but rather a sharing of these costs and amortization of the ratepayer share.

The Hidden Hills Subunit Ratepayers Association contends that Cal-Am's shareholders benefited from the adjudication by establishing a Seaside Basin management structure that was more favorable to shareholders, and that this

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[169] Hearing Exh. 22 at pp. 3–16.

[170] Hearing Exh. 2, Tab 14 at p. 5.

[171] Hearing Exh. 21 at pp. 11-9.

[172] *Id.*, at pp. 11-12.

litigation had the "unfortunate" effect of determining that the Hidden Hills Subunit Ratepayers Association has zero water rights.[173]

In rebuttal, Cal-Am explained that DRA's recommended ratemaking treatment would deny Cal-Am recovery of approximately 41% of its incurred expenses. Cal-Am also explained that the ratepayers in Hidden Hills, like all Cal-Am ratepayers, benefit from Cal-Am having a settled source of supply.

We find that Cal-Am is entitled to recover all of its prudently incurred litigation and water master expenses.[174] When previously addressing litigation costs for water rights, we allowed the utility to recover the full amount of these capital costs by amortizing them, plus interest, over a reasonable period of time.[175] We will follow our precedent and adopt a similar result here. We find that DRA's recommended 20-year amortization period is excessive and instead adopt a 10-year amortization period. We will also adopt the interest rate used for memorandum accounts for the unamortized balance. Amounts recorded in a memorandum account are awaiting ratemaking treatment, much like these unamortized litigation and water master costs. Thus, the memorandum account interest rate is a reasonable rate to adopt for this purpose.

Therefore, we find that Cal-Am prudently incurred capital costs of $2,755,960 to successfully litigate and secure Seaside Basin water rights. Cal-Am is entitled to recover these costs from ratepayers over a 10-year amortization period. The unamortized balance shall accrue interest at the 90-day commercial paper rate. Cal-Am should file an advice letter establishing a Seaside Basin

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[173] Hidden Hills Subunit Opening Brief at p. 5.

[174] *See* Re Southern California Water Company, 44 CPUC2d 458, 463 (D.92-05-073).

[175] *Id.*, at p. 466.

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]

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[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

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[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

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[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

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[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

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[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.

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[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

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[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.

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[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

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[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

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[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]

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[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

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[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

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[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

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[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.

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[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

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[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

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[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

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[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

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[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.

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[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.

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

6.4.1. Background

In 1977, the Legislature created the Management District for the purposes of: "conserving and augmenting the supplies by integrated management of ground and surface water supplies, for control and conservation of storm and wastewater, and for the promotion of the reuse and reclamation of water." The Management District's specific functions are "management and regulation of the use, reuse, reclamation, conservation of water and bond financing of public works projects."[239] The Management District is authorized to issue bonds,[240] assess charges for groundwater enhancement facilities,[241] levy assessments on real property and improvements,[242] and "fix, revise, and collect rates and charges for the services, facilities, or water furnished by it."[243] For "general administrative costs and expenses," as well programs of general benefit, the Management District is authorized to levy a second property tax of up to $0.10 per $100 in assessed value.[244]

The Management District stated that it has "collected a user fee since 1983" and that the "revenues from the user fee are used to support [its] comprehensive

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[239] Stats. 1977, ch. 527, § 2, Deering's Water-Uncod. Acts (2008 Supp.) Act 5065, p. 98-9 ("District Law").

[240] District Law, §§ 601-684.

[241] District Law, §§ 343-6.

[242] District Law, §§ 435-7, such assessments are limited to $0.20 per $100 of property value. (*See* also § 702 providing for collection of "unpaid costs and expenses," subject to the same cap.)

[243] District Law, § 326(b).

[244] District Law, § 701.

Mitigation Program," which it adopted in 1990.[245] Quoting from the 1995 order of the State Water Control Board, the Management District has concluded that Cal-Am is responsible for implementing all measures in the Mitigation Program "not implemented by the [Management District]."[246] The Management District stated that it provides the Mitigation Program measures at a "cost below that of Cal-Am" and that these savings "accrue to the benefit of Cal-Am and its customers." [247]

The user fee is a percentage of each Cal-Am and Seaside Municipal Water System customer's total bill, and is currently set at 8.325% of all meter and water charges.[248] The Management District stated that the fee "generated approximately $1,860,000 in fiscal year 2006."[249] The revenues obtained from the user fee are currently split between the Management District's comprehensive Mitigation Program for the Carmel River, 7.125%, and the Aquifer Storage and Recovery project, 1.2%.[250]

The Management District stated that if Commission authorization is required and the Commission does not authorize Cal-Am to collect the user fee from customers and remit it to the Management District, then the Management District will proceed to assess the fee directly against Cal-Am.[251]

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[245] Management District Opening Brief at p. 11.

[246] Management District Opening Brief at p. 16.

[247] *Id.*

[248] Management District Opening Brief at p. 11.

[249] *Id*.

[250] Management District Opening Brief at pp. 15-16.

[251] Management District Opening Brief at p. 17.

In opposition, Cal-Am explained that there was "no legal or factual support for [The Management District's] request for the Commission to authorize California American Water to collect [the] user fee and remit it to the [Management District]."[252] Cal-Am pointed out that the Management District presented no testimony for the formal record sponsored by an expert witness, who would be "subject to cross examination."[253] By way of example, Cal-Am cited the Management District's claim in its brief that the Management District is providing mitigation measures at a cost below that of Cal-Am. This new factual assertion, Cal-Am argued, was procedurally improper and consequently, Cal-Am asked the Commission to reject the Management District's "request to authorize the user fee."[254]

6.4.2. Discussion

Throughout today's decision, we have restated and relied on our commitment early in this proceeding to review costs in the context of the increasingly severe water supply limitations in Cal-Am's Monterey District and the significant financial burdens imposed on residential and business customers by these substantial rate increases. In evaluating issues, we have required that proposed expenditures be demonstrably necessary for reliable service and provide value to customers. We have carefully scrutinized Cal-Am's justifications for such proposals and, as set forth above, rejected numerous proposals for failing to make the required demonstration on the record.

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[252] Cal-Am Reply Comments on Settlement Agreements, January 8, 2009, at p. 29.

[253] *Id.*

[254] *Id.*

As pointed out by Cal-Am, we have no evidentiary record to assess the necessity or the cost-effectiveness of the Management District's expenditures on Cal-Am's behalf and no expert witness has been subject to cross examination on the factual assertions offered by the Management District. Accordingly, we are concerned that Cal-Am's customers may be paying user fees to the Management District for projects that may not be necessary or cost effectively performed by the Management District.

The Management District has a variety of funding mechanisms at its disposal over which this Commission has no jurisdiction. If the expenditures are properly Cal-Am's responsibility, we must ensure that the projects undertaken by the Management District on Cal-Am's behalf are necessary and are being provided in the most cost-effective manner.

The Management District's choice of a percentage assessment, rather than a fixed amount, has the effect of substantially increasing the total amount collected by the Management District for the identified projects as Cal-Am's rates increase. The Management District stated that the fee generated $1,860,000 in revenue during fiscal year 2006. At its current level of 8.325%, the fee generated $2,560,000 from Cal-Am's customers at present rates in 2008, a 41% increase from 2006. At Cal-Am's proposed test year 2009 rates, the fee would generate $4,620,000, a 148% increase from 2006.[255] Even assuming a mid-range 2009 rate increase of 30% would result in the Management District collecting $3,331,490, a 79% increase over 2006.

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[255] Application Exhibit A, Chapter 1, Section 1, Table 1, at p. 1, shows Cal-Am's gross operating revenues at present and proposed rates.

We are also concerned that the Management District's explanation of the user fee was incomplete. The Management District stated that of the current 8.325% fee, 7.125% is used for mitigation measures, which it did discuss, and 1.2% is for the Aquifer Storage and Recovery project costs.[256] The Management District offered no discussion of its Aquifer Storage and Recovery costs. This is troubling because in Cal-Am's Partial Settlement Agreement with DRA, discussed below, the parties agree that Cal-Am will continue to record Aquifer Storage and Recovery costs in a memorandum account for reasonableness review by the Commission in Cal-Am's next general rate case and that costs are expected to be about $14 million.[257] We are concerned that having Cal-Am and the Management District expend funds for the same purpose may not be the most cost-effective means of undertaking the required measures.

We note that a prior joint project between Cal-Am and the Management District may serve as an appropriate model for ensuring cost-effective coordination here, both with regard to the Aquifer Storage and Recovery project and the Mitigation Program. We have previously approved a joint project between Cal-Am and the Management District for conservation programs, which included recovery of the Management District's costs from Cal-Am's customers by a surcharge placed on the customers' bills. In D.06-11-050, the Commission approved a settlement agreement between Cal-Am and DRA which provided for a conservation surcharge on Cal-Am's customers' bills, not to exceed $300,000 annually, to fund conservation programs to be undertaken by the Water

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[256] Management District Opening Brief at pp. 15-16.

[257] Partial Settlement Agreement at Section 13.13.

Management District.[258] Cal-Am incorporated this surcharge in its tariffs.[259] In that decision, we imposed additional documentation requirements on the joint project at the request of the Management District, specifically requiring that the joint project agreement include "a description of reimbursable activities, the rates at which services are reimbursed, the invoicing format, the categorization of services to reflect Commission authorization, the reporting format, the ownership of work product, and the term of the agreement."[260]

In light of the preceeding discussion, we agree with Cal-Am that the current record does not provide sufficient legal or factual support to determine the appropriate level of Cal-Am funding for the Mitigation and Aquifer Storage and Recovery projects. To the extent that Cal-Am and its ratepayers are legally responsible for these programs, we expect Cal-Am to discharge that responsibility in an efficient and effective manner either by its own actions or as a joint project with the Management District.

Therefore, we direct Cal-Am to meet and confer with the Management District to discuss funding for, and implementation of, both the Mitigation Program and, the Aquifer Storage and Recovery Project, including particularly the possibility of implementing them as joint projects like that described above. Any joint project agreement should address the issues included in the conservation project agreement as well as a detailed description of these

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[258] D.06-11-050, *mimeo*. at pp. 26-27. We emphasize that the surcharge was limited in amount to be recovered and was not an overall percentage.

[259] Schedule MO-1, Monterey District Tariff Areas, General Metered Service, Special Condition 13.

[260] D.06-11-050 at pp. 26-27. This program was recently reauthorized in D.09-05-029.

two programs, overall responsibility for the programs and each project and a demonstration that the proposed implementation is the most cost effective. The parties may also consider other cost effective and efficient methods for Cal-Am to fully meet any responsibility it may have for the Mitigation Program and the Aquifer Storage and Recovery project. Cal-Am shall then file, no later than 180 days after the effective date of today's decision, an application setting forth any new method of collecting funds to support program costs properly assignable to Cal-Am, whether performed by Cal-Am or the Management District. We will authorize Cal-Am to file an advice letter to set up a memorandum account to record any interim costs.

7. Rate Design Settlement

On November 24, 2008, Cal-Am and DRA filed their Settlement Agreement as to Rate Design Issues, which is Attachment A to today's decision. Comments opposing certain components of the settlement were filed by the Water Management District, Independent Reclaimed Water Users Group, and Hidden Hills Subunit Ratepayers Association.

7.1. Summary of the Rate Design Settlement

The rate design settlement applies to the Monterey main system and the Ambler Park, Bishop, Hidden Hills, Ryan Ranch, Chualar, and Ralph Lane systems. Customers in the Monterey Main System, Ryan Ranch, Hidden Hills, and Bishop will be on the same rates and rate design, after a three-year transition period for Hidden Hills and a six-year transition period for Bishop. The settlement agreement provides that rates and rate design for customers in Ralph Lane will not change as a result of this proceeding, and the rate increase for Chualar shall be limited to an escalation of 9.17%. Ambler Park will have a separately calculated water sales adjustment mechanism.

The rate design changes are generally directed at creating financial incentives for customers to improve the efficiency of their water use by allowing customers an allotment of low-priced water, with prices steeply increasing for use above the Block 1 allotment. For residential customers, the Block 1 allotment is set based on the number of people residing at the service address as well as large animals. For non-residential customers, the Block 1 allotment is based on historical water use and best management practices.

Specifically, the number of people and large animals residing at the residential service address determine the amount of water in each of the five blocks of increasing price, as indicated in the table below. Each person is allocated 1.5 ccf or about 37.5 gallons/day and large animals get 0.5 ccf or 12.5 gallons/day in each block. In addition, during summer months, the higher blocks, three (200% of base rate), four (400% of base rate), and five (700% of base rate) include landscaping irrigation allowances based on lot size that range from 1 ccf or 25 gallons/day to 3 ccf or 75 gallons per day. The base rate will be calculated using the final adopted revenue requirement. For purposes of the Settlement Agreement, the parties assumed that the Commission granted Cal-Am one-half its requested increase.

Residential Block Rates

Block	Percent of Base Rate	Rate, assuming base=$4.04/Ccf
1	Retain Current Price	$2.7036
2	100%	$4.04
3	200%	$8.08
4	400%	$16.16
5	700%	$28.28

For non-residential customers,[261] the Settlement Agreement adopts a three-level increasing block rate structure. Each customer's monthly allotment, *i.e.*, service to be provided in the lowest-priced block, will be based on audits using best management practices for that type of business. To the extent the non-residential customer exceeds the total amount on an annual basis, the service will be billed at a higher block. All outdoor water use that is "not essential to the business function" will be billed at the higher block 2 or 3 rates.

Non-residential Block Rates

Block	Percent of Base Rate
1	100%
2	300%
3	700%

7.2. Comments on the Rate Design Settlement

The Hidden Hills Subunit Ratepayers Association generally supported the conservation encouraging rate design, but opposed being included in the same tariff as Ryan Ranch. Hidden Hills contended that its subunit was largely residential, while Ryan Ranch was commercial.[262]

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[261] Non-residential customers are commercial, industrial, public authority, golf courses (potable), golf courses (non-potable, Viscaino tank), and dedicated irrigation customers. *See* Settlement Agreement Section "V."

[262] Opening Brief of Hidden Hills Subunit Ratepayers Association at p. 2.

The Management District opposed the transition periods for Bishop and Hidden Hills, arguing that such periods diminish the effectiveness of conservation ratemaking. The Management District also advocated for periodic verification of claims of medical need for extra water allotment in Block 1.[263]

The Independent Reclaimed Water Users Group strongly supported Cal-Am's goal of using rate design to encourage water conservation, but contested the settlement agreement's continuance of the status quo for golf courses using potable water for irrigation. The Independent Reclaimed Water Users Group recommended that golf course use of potable water in Block 1 be set at 85% of historical usage to create a strong financial incentive to reduce such usage.[264] The Independent Reclaimed Water Users Group also sought below-base, lower rates for Block 1, to mimic residential rate blocks, and "revenue positive" upper Blocks to fund water supply alternatives.[265]

In reply, Cal-Am explained that combining the Hidden Hills and Ryan Ranch tariffs is done for administratively efficiency and has no substantive effect. Cal-Am also stated that the record offers no support for the Management District's contention that rate design changes should be implemented simultaneously for all subsystems, or that customers abuse the medical needs adjustment.

Cal-Am's reply to the Independent Reclaimed Water Users Group first argues that neither it nor this "Commission have an obligation to provide an incentive to transition golf courses from the use of potable water to reclaimed

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[263] Comments of the Water Management District at p. 7.

[264] Comments of the Independent Reclaimed Water Users Group at p. 20.

[265] *Id.*, at p. 22.

water for irrigation purposes."[266] Similarly, Cal-Am states that it "makes absolutely no sense" to set a customer's Block 1 allotment below what is required to meet its business needs and that the Commission should recognize a "higher principle that rate design should not penalize customers who are using water in compliance with best management practices."[267]

7.3. Evaluating and Approving the Rate Design Settlement Agreement

Rule 12.1(d) requires that in order for a settlement to be approved by the Commission, the settlement must be: (1) reasonable in light of the whole record, (2) consistent with the law, and (3) in the public interest. We find that each element is present here.

The parties contend the Settlement Agreement is reasonable in light of the whole record because it takes into account the principles of conservation rate design and the unique features of the Monterey district. The parties have compromised their differences over the specific ratemaking approaches to achieve the conservation goal.

We agree that the settlement is reasonable in light of the record.

The proposed settlement is consistent with the law. The parties explain that the proposed rate design is just and reasonable as required by Pub. Util. Code § 451. We find that the settlement is consistent with the law.

Finally, we find that the settlement is in the public interest. The proposed settlement agreement provides for more aggressive conservation rate design, while allowing for sufficient lower-priced water for essential usage. The public

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[266] Cal-Am Reply Comments to Settlement Agreement Comments at p. 22.

[267] *Id.*, at p. 23.

interest would also be served by approval of the settlement agreement as an efficient means to resolve this application.

For the foregoing reasons, the Commission finds that the rate design settlement is reasonable in light of the whole record, is consistent with the law, and is in the public interest.

8. Water General Rate Case Partial Settlement

On November 24, 2008, Cal-Am and DRA filed their partial settlement agreement on Monterey water and wastewater issues. The agreement would fully resolve all outstanding issues in the wastewater docket, A.08-01-023, and the components of the settlement agreement relating to wastewater are reviewed in a separate decision in that docket, which is a companion decision to today's decision. The entire settlement agreement is attached to the decision in A.08-01-023 as Attachment A, which we incorporate by reference in today's decision.[268] At issue here are the remaining portions of that settlement agreement which pertain to the Monterey district water general rate case.

8.1. Description of the Settlement Agreement Provisions that Apply to the Water General Rate Case

The settlement agreement resolved many plant in service issues raised in DRA's report. In terms of cost, the Aquifer Storage and Recovery project at $14,380,000 is the most significant. The parties agree to place up to this amount in a memorandum account for Commission review in the upcoming state-wide Cal-Am general rate case to be filed in early 2010. Other significant plant

[268] The entire settlement agreement and motion addresses issues in both the wastewater and Monterey District water general rate cases. A complete copy may be viewed at http://docs.cpuc.ca.gov/efile/MOTION/94575.pdf <http://docs.cpuc.ca.gov/efile/MOTION/94575.pdf>.

investment projects include the New Segunda tank at $2.9 million to be accepted via advice letter, the Withers pump station at $491,000, and the CRV production and distribution system for $1.5 million. The last two projects are completed and in service.

The settlement agreement also addressed several of Cal-Am's special requests in its general rate case application. DRA agreed with Cal-Am's request to track Endangered Species Act compliance costs in a memorandum account, to continue to record payments to the National Oceanic and Atmospheric Administration pursuant to its 2006 Settlement Agreement in a memorandum account, and to amortize certain account balances through a 12-month surcharge. Cal-Am subsequently withdrew its only remaining disputed special request, which sought Commission authorization for an Infrastructure System Replacement Surcharge.[269]

Finally, the settlement agreement would resolve capital projects for the Toro service area. Cal-Am is in the process of planning and permitting needed upgrades to the arsenic treatment facility in the Toro system. The expected costs for the upgrade have increased to $685,000 from the preliminary $650,000 agreed to in the 2007 settlement. The settlement agreement provides that Cal-Am may submit an advice letter when this project is completed and operational consistent with is permit from the California Department of Public Health, but that any amount above $685,000 will be subject to reasonableness review. Additional capital projects for the Toro system, and a description of the condition of the

[269] Cal-Am Reply Brief at p. 117.

system are found in Attachment 1 to the settlement agreement. The projects set out there total $139,620 for 2008, $616,620 for 2009, and $99,620 for 2010.

8.2. Evaluating and Approving the Water General Rate Case Settlement Agreement Provisions

Rule 12.1(d) requires that in order for a settlement to be approved by the Commission, the settlement must be: (1) reasonable in light of the whole record, (2) consistent with the law, and (3) in the public interest. As regards the provisions of the settlement agreement between DRA and Cal-Am that pertain to the Monterey water district, we find that each element is present here. The partial settlement agreement is Attachment A to the companion decision in A.08-01-023.

The parties contend the settlement agreement is reasonable in light of the whole record because the parties engaged in extensive and duly noticed settlement negotiations over several weeks to reach reasonable compromises on the ratemaking issues. They submit that the resulting settlement agreement as to the water issues resolves several issues in this proceeding consistent with sound ratemaking practices and allows needed system investment to go forward. We agree that the partial settlement addressing Monterey district water general rate case issues is reasonable in light of the record. The parties explain that the proposed resolutions of the water general rate case issues result in just and reasonable rates as required by Pub. Util. Code § 451. We find that this portion of the settlement is consistent with the law.

Finally, we find that this partial settlement agreement is in the public interest. The proposed settlement agreement efficiently resolves a significant portion of the outstanding issues in this proceeding, thereby conserving the

parties' and the Commission's resources for vital policy and ratemaking issues in this proceeding.

For the foregoing reasons, the Commission finds that the resolution of the Monterey district water general rate issues in the settlement agreement attached to the companion decision in A.08-01-023 are reasonable in light of the whole record, consistent with the law, and in the public interest.

9. Reducing Use of Potable Water for Landscape Irrigation

As Cal-Am has repeatedly stated and demonstrated throughout this proceeding, the Monterey district is confronting severe supply limitations. The continued use of potable water for landscape irrigation is unreasonable and fundamentally at odds with resource limitations confronting Cal-Am in the Monterey district.

Transitioning users of potable water for landscape irrigation to non-potable alternatives is an urgent obligation of Cal-Am. While rate design can and must provide financial incentives for customers to make this change, Cal-Am has an important role in providing alternative supply options. As pointed out by the Independent Reclaimed Water Users Group, such alternative projects could have lasting benefits to the district's customers.

Demonstration projects, feasibility studies, and other means to develop, evaluate, and implement the innovative solutions called for by the American Water directives require leadership from Cal-Am. We find that these types of projects are a necessary companion effort to adopting a rate design that provides financial incentives to transition from potable to non-potable water use for irrigation. Cal-Am did not anticipate this outcome and has not sought such funding in this proceeding. We will, therefore, authorize Cal-Am to file an application for alternative supply projects for landscape irrigation.

As discussed above, American Water's corporate directives, with which we agree, state that "innovative solutions" particularly for large irrigation users are appropriate where, as here, existing water supply capacity is limited. The record shows that the City of Pacific Grove is analyzing, apparently without Cal-Am's support, a stormwater recovery project to serve the Pacific Grove golf courses.[270] The record suggests that other options may be available as well.[271] Cal-Am should assign a high priority to developing and implementing alternative options for large-scale potable water irrigation users.

10. Comments on Proposed Decision

The proposed decision of the Administrative Law Judge in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were filed on May 27, 2009, by the Cal-Am, DRA, the Independent Reclaimed Water Users, and the Hidden Hills Subunit Ratepayers Association. Reply comments were filed on June 1, 2009, by Cal-Am and DRA.

Cal-Am contended that plant additions should include three of the four Lower Carmel River Valley replacement wells it requested as these wells are necessary to provide reliable service and have been completed. As set forth elsewhere in today's decision, we have revised the proposed decision to include two of these three wells at the updated cost of $833,000.

Cal-Am explained that the delay in placing its Lower Rancho Fiesta tank into service will result in $200,000 of capital cost being written off. We will allow

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[270] Hearing Exh. 77 at p. 8.

[271] *See* generally Hearing Exh. 77.

these costs to remain in construction work in progress during this rate cycle, pending completion of this project.

Cal-Am disputed the 30/70 split between capital and expense for the amount allowed for well rehabilitations. We adopted this split for prospective ratemaking purposes only. The actual accounting treatment of the costs of each well rehabilitation should be based on actual activities performed, consistent with our accounting rules, and will therefore vary based on the actual work performed.

Cal-Am requested that the number of advice letters for capital projects be reduced or that that amount allowed to be recovered include an allowance for funds used during construction. Advice letters for rate base additions provide a convenient means to synchronize rate increases with actual in service dates for significant plant additions. To the extent such projects exceed one year in construction, we will allow Cal-Am to include an allowance for funds used during construction in the total costs.

Cal-Am sought permission to include new updated information about the Sand City Desalinization Plant lease in a subsequent application. Accordingly, we will deny the current request for ratemaking approval without prejudice so that Cal-Am can make a comprehensive presentation justifying the San City costs.

Cal-Am reiterated its arguments on regulatory expense and tank painting.

On general office issues, Cal-Am focused on the proxy used in the Proposed Decision to allocate costs to non-regulated operations. Cal-Am contended that its multiple tier allocation methodology, used for its non-regulated subsidiary, American Water Enterprises, Inc., was a superior approach. Cal-Am, however, continues to ignore the point made first by DRA

and then in the Proposed Decision: all non-regulated operations are not included in the allocation methodology because certain non-regulated operations are conducted by corporate affiliates other than American Water Enterprises, Inc. These omitted non-regulated operations are not subject to the multiple tier allocation methodology and are effectively allocated no costs in Cal-Am's General Office application. Consequently, these costs are allocated instead to regulated operations. In its rebuttal testimony, Cal-Am did not comprehensively disclose all non-regulated operations that are in any way served by employees or assets included in revenue requirement and show that all such operations are carefully subjected to the multiple tier cost allocation methodology. Absent such a demonstration, we are left with only the Securities and Exchange Commission data on which to allocate costs to the undisclosed non-regulated operations.

1. We will, however, allow Cal-Am another opportunity to demonstrate the cost allocation that would occur if the multiple tier allocation methodology were applied comprehensively to all non-regulated operations. No later than 90 days after the effective date of this order. Cal-Am is authorized to file a petition for modification of today's decision that fully discloses all non-regulated operations which use any assets or employees included in revenue requirement, specifying the following:

    1. Identification of all such goods and services provided to non-regulated operations,
    2. Identification of all personnel positions and assets included in revenue requirement and used to provide the non-regulated goods and services,
    3. Statement of revenue received for such goods and services,
    4. Demonstration that all identifiable costs are direct billed to non-regulated accounts and that all indirect costs are allocated consistent with the multiple tier methodology.

Cal-Am next disputes the Proposed Decision's adjustment to call center costs to remove 5.8% of excess costs associated with the nation-wide consolidated call center. Cal-Am claims that increased call volume and services justify the additional costs, but offers no explanation for cost reductions that should have occurred due to economies of scale, new technology, and productivity improvements. Similarly, Cal-Am objects to escalating general office labor from May 31, 2008, actual employee levels.

Finally, Cal-Am declined to accept the modification to the rate design settlement.

In its comments on the Proposed Decision, DRA argued that the Santa Margarita Aquifer Storage and Recovery well should be added to the summer supply capacity. In reply, Cal-Am disputed this assertion so we have not included this well.

DRA recommended that the Proposed Decision specifically require Cal-Am to improve its pipeline break data collection to comply with industry best practices and to include break type and cause of pipe failure. We will adopt these requirements.

DRA reiterated its support for an unaccounted for water target of 8.5% in the current case, and adopting the Monterey Peninsula Water Management District's 7% as the target for the next rate case cycle. Due to the critical importance of decreasing unaccounted for water, we have adjusted the Proposed Decision to adopt a 9% standard for the Monterey system.

DRA opposed including the Sand City Desalinization Plant in revenue requirement because alternative projects would produce more water savings at a lower cost. As mentioned above, we are deferring resolution of this issue.

DRA also opposed the proposed modifications to the Rate Design Settlement. As both parties to the Rate Design Settlement Agreement declined to accept the proposed modifications, we have considered the Agreement as filed by the parties and approved it. We have, however, adopted other measures to decrease the use of potable water for irrigation.

The Hidden Hills Subunit Ratepayers Association proposed that pipeline be replaced in its subsystem rather than constructing an interconnection to the main system. Cal-Am agreed and today's decision has been modified to include this alternative. The Hidden Hills Subunit Ratepayers Association also reiterated its position that customers of this subsystem should not bear costs of the Seaside Basin adjudication.

The Independent Reclaimed Water User Group recommended modifications to rates charged for potable water use by golf courses. Cal-Am opposed these recommendations as unnecessary and unwarranted, and we have not adopted the recommendations.

11. Assignment of Proceedings

John A. Bohn is the assigned Commissioner and Maribeth Bushey is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. Cal-Am's strategy for asset investment in capacity projects considers customer demand management an acceptable alternative in appropriate circumstances to additional supply projects. The strategy directs subsidiaries to reduce nonrevenue water especially in instances where limited or no customer growth is forecasted, and supports innovative solutions to meet customer needs.

Water Supply Projects

2. A seasonal operating permit for the San Carlos Well will increase Cal-Am's summer supply capacity by 1.5 MGD or 9.5%.

3. The Scarlett Well No. 8, when repaired with a sanitary seal and returned to service, will add about 1.76 MGD in supply capacity during winter, a 14.4% increase in winter capacity.

4. In winter, Cal-Am has sufficient current supply to meet the Maximum Daily Demand of its customers.

5. Interrupting service in an emergency to the Aquifer Storage and Recovery Project will impose less public inconvenience and health and safety threats than interrupting service to a typical residential or business customer.

6. With a seasonal permit for the San Carlos Well, Cal-Am's summer available supply will be increased from 15.7 MGD to 17.20 MGD but will not meet Cal-Am's forecasted Maximum Daily Demand of 19.5 MGD.

7. Cal-Am identified the risk of imposing mandatory water conservation measures as a consequence of failing to meet Maximum Daily Demand.

8. The risk of imposing mandatory water conservation measures does not justify spending $7 million on five wells and associated treatment plant upgrade.

9. Cal-Am presented no evidence that the Comprehensive Planning Study methodology accurately predicts Maximum Daily Demand in systems with declining consumption and aggressive conservation programs.

10. The Comprehensive Planning Study forecasted an extreme increase in Maximum Daily Demand that was inconsistent with historical patterns.

11. Cal-Am's study identified a low-cost means to assess the potential for altering the Playa Well No. 4 to decrease treatment requirements.

12. Well rehabilitations vary in significantly in cost; Cal-Am justified a 20% contingency factor.

13. DRA presented historical cost data for well rehabilitations and recommended an average of forecasted cost $41,337, without contingency allowance.

14. Cal-Am did not present sufficient record evidence to support 10 well rehabilitations per year at a total cost of $1.3 million.

15. Cal-Am proposed and justified prioritizing well rehabilitations in the Lower Carmel River Valley.

16. Cal-Am proposed $8.7 million for 10 new or replacement storage tanks and DRA agreed to nine.

17. Cal-Am did not justify the Lower Rancho Fiesta 150,000 gallon tank to replace a 10,000 gallon tank.

18. Cal-Am failed to justify $10,000 in cost wasted on an infeasible site for the Ambler Park Oaks tanks.

19. Local fire officials have useful information for prioritizing fire flow projects.

20. Cal-Am has justified spending up to $150,000 during this rate case cycle on fire flow projects as supported by the fire flow task force.

Pipeline Projects

21. The Seaside North and South areas have main break rates of 3.5 breaks/mile/year; the Monterey district's average is 0.28 breaks/mile/year and the nationwide average is 0.25 breaks/mile/year.

22. Cal-Am for the first time proposes a proactive pipeline replacement program in the Monterey district.

23. Polybutylene service connections account for 52% of the service connection breaks but comprise only eight percent of the service connections in the Monterey system.

24. Cal-Am historically replaces about 150 polybutylene connections per year but 3,500 remain in the Monterey system. An additional 200 connections must be replaced each year to completely replace all such connections over the next 10 years, and the average cost of replacement is $1,851.

Interconnection Projects

25. Cal-Am proposes and DRA does not oppose interconnections between the Ryan Ranch and Hidden Hills systems, and between Hidden Hills and the main system, but DRA recommends allowing the projects in rate base only upon completion as both require but have not yet received approval by the Monterey Peninsula Water Management District.

Meter Replacement

26. Cal-Am is out of compliance with General Order 103 standards for meter testing or replacement.

27. Cal-Am needs to replace or test 2,630 meters/year to remain current with GO 103 standards.

28. Cal-Am has justified a cost of $191.67 per replaced meter, and a temporary supplemental replacement program rate of 1,885 per year will alleviate the backlog.

Unaccounted for Water

29. Cal-Am's 2003 to 2007 average amount of unaccounted for water was 11.59%, the industry standard is 10%, DRA recommends 8.5% and the Monterey Peninsula Water Management District's standard is 7%.

30. Over the period 2003 to 2007, Cal-Am's percentage and volume of unaccounted for water increased.

31. Cal-Am's consultant recommended pressure management measures and customer meter error reductions to reduce unaccounted for water by up to 650 acre-foot/year.

32. Cal-Am's consultant found that a "significant number of meters tested do not appear to be in the user account database and are apparently not generating revenue."

33. Supply constraints and conservation rate design in the Monterey system require the highest quality program to reduce unaccounted for water in the Monterey district.

34. Cal-Am needs a financial incentive to improve its performance in reducing unaccounted for water.

Purchased Water

35. The parties have agreed that should the Seaside Basin Watermaster deny Cal-Am's request to offset replenishment fees with Coastal Water Project costs, then Cal-Am may file an advice letter to include the replenishment fees in revenue requirement.

36. Purchased water includes $794,073 for Seaside Basin Non-replenishment fees.

37. The Sand City Desalinization plant will produce up to 300 acre-foot/year.

38. Cal-Am's lease of the Sand City Desalinization plant allows Sand City to allocate all 300 acre-foot/year to new development in Sand City, but regulatory approvals retained 94 acre-foot/year for Cal-Am's existing customers in Sand City.

39. The annual lease payments are currently expected to be $850,000, and annual operations and maintenance expenses are projected to be $203,000.

40. Cal-Am is under court or agency order or proposed order to reduce its draw from the Carmel River and the Seaside Basin by 2,361 acre-foot/year in 2009.

41. The initial term of the Sand City Desalinization plant lease is 15 years; pursuant to the lease terms, Cal-Am is obligated to produce 300 acre-foot/year of potable water and to incur all costs required to do so.

42. Cal-Am presented no contemporaneous cost analysis of the Sand City Desalinization Plant lease compared to alternatives.

43. Cal-Am presented no evidence of evaluating or negotiating the terms of the Sand City Desalinization Plant lease.

Regulatory Expense

44. Cal-Am's presentation on regulatory expense focused on expected costs for these proceedings, A.07-12-010, and the cost of capital proceedings.

45. Increased levels of Cal-Am and service company personnel dedicated to supporting rate case and other regulatory matters are included in Cal-Am's requested revenue requirement.

46. DRA calculated reasonable rate case expense of between $500,000 and $1,000,000; Cal-Am's actual outside services for its recent rate cases have been about $1,000,000.

Fine for Failure to File Required Customer Complaint Reports

47. Cal-Am does not dispute that it failed to timely file four customer complaint reports required by D.06-11-050.

48. Cal-Am is not a repeat offender.

49. Failing to file timely customer complaint reports is a serious violation and Cal-Am did not detect the violation.

Tank Painting

50. Cal-Am asserted that it provided DRA a schedule for tank painting but did not provide the schedule for the record; Cal-Am did not explain why its forecasted tank painting costs for test year 2009 were 130% higher than historical costs adjusted for inflation.

51. DRA calculated a five-year average of tank painting costs using recorded amounts, and adjusted for inflation, to determine a forecast of tank painting cost for test year 2009.

52. Cal-Am requested a 42% increase in district payroll over authorized 2006 and DRA agreed to a 32% increase.

53. Cal-Am has had 13 utility workers in the Monterey district since 2003 and did not identify specific required tasks that are not being performed due to insufficient staff.

54. Cal-Am did not present a quantified analysis of the need for and benefits of additional valve turning in the Monterey district.

55. Cal-Am's presentation seeking a permanent backhoe operator consisted of 10 lines of text and no quantification of costs and benefits.

56. Cal-Am reduced its maintenance technicians from five in 2001 to its current one without any payroll reductions or explanation for this change.

57. Cal-Am's presentation in support of its request for a Senior Operations Engineer and an Engineer in Training consisted of one-half a page of text with no numerical analysis.

Seaside Basin Adjudication Costs

58. Cal-Am incurred costs of $2,755,960 to litigate and secure Seaside Basin water rights, and DRA agreed the costs were reasonable and prudent.

59. Seaside Basin costs awaiting amortization should accrue interest at the 90-day commercial paper rate, as with balancing and memorandum accounts, which similarly record amounts awaiting ratemaking recovery.

General Office

60. In D.06-11-050, we adopted an audit requirement for this Cal-Am General Office application, required that Cal-Am make a comprehensive factual showing on each expense category, and stated that Cal-Am would need to overcome a heavy evidentiary burden to justify increases in excess of inflation plus customer growth.

61. Cal-Am proposed to increase its service company employee count by 38% as compared to authorized 2006 and DRA agreed to 25% by adopting actual employees hired as of May 31, 2008; DRA used this employee count to determine 2008 labor costs, which it escalated by 4% to forecast 2009 labor costs.

62. The 2007 actual incentive compensation payout rate for the service companies, including corrected data for the National Service Company, is a reasonable forecast for the 2009 incentive compensation payout rate.

63. Cal-Am demonstrated no quantified benefits to customers from business development operations.

64. Cal-Am presentation on General Office legislative influence expenses suffered from the same inconsistencies as Cal-Am's 2003 presentation on this issue.

65. The National Service Company provides service to over 100 non-regulated contracts but Cal-Am allocated no National Service Company costs to these non-regulated contracts.

66. Using information provided by American Water to the United States Securities and Exchange Commission, DRA calculated that 12% of National Service Company costs should be allocated to non-regulated operations.

67. Accurate cost allocation to non-regulated operations is essential to prevent cross-subsidization and unfair competition.

68. Cal-Am's testimony showed that rather than producing economies of scale, the nationwide consolidated call center model is resulting in costs 5.8% higher than under the stand-alone model.

Settlement Agreements

69. Cal-Am and DRA have negotiated and entered into settlement agreements addressing rate design and certain issues in water district revenue requirement. The rate design settlement is Attachment A to today's decision and the Partial Settlement of Water and Wastewater Issues is Attachment A to the companion decision in A.08-01-023.

70. The continuing use of potable water for outdoor irrigation is not reasonable.

71. It is reasonable for Cal-Am to provide rate making financial incentives and innovative non-potable water solutions to diminish the use of potable water for landscape irrigation.

Conclusions of Law

1. Cal-Am bears the burden of proving by a preponderance of the evidence that the proposed rate increases are just and reasonable.

2. On a forecasted basis, Cal-Am can meet its customers needs on winter Maximum Day Demand adequately, dependably, and safely and can reasonably meet the needs of the Aquifer Storage and Recovery Project.

3. Reducing or prohibiting the use of potable water for outdoor irrigation during peak demand periods is a reasonable means of addressing short-term supply limitations; such use is not entitled to the high standard of reliability accorded to residential and commercial consumption and sanitary uses.

4. In consultation with its customers and landscaping professionals, Cal-Am should develop and implement a program to reduce or prohibit the use of potable water for landscape irrigation during Maximum Demand Periods.

5. Cal-Am has not met its burden of presenting persuasive evidence justifying four replacement wells, one new well, and associated treatment upgrade in the Lower Carmel River Valley. Two replacement wells costing $833,000 each have been justified.

6. Cal-Am should implement the proposed sealing testing for Playa Well No. 4.

7. Cal-Am has justified rehabilitating two wells per year in the Lower Carmel River Valley and two other wells per year in its system.

8. Using DRA's forecasted cost per well rehabilitation and Cal-Am's contingency factor result in a forecasted cost per well rehabilitation of $49,604, which is reasonable.

9. Allowing tank additions to be included in rate base upon completion and filing an advice letter, some with a showing of support by the fire flow task force established in today's decision, is reasonable.

10. The following tanks, along with specific approval requirements, should be authorized:

Tank	Size (gallons)	Cost	New or Replacement?	Resolution
Segunda		$2,905,598	New	Advice Letter
Hidden Hills	2 x 30,000	$322,000	Replace 16,000 gallon tank	Allow
Upper Rimrock		$479,000	Replacement	Advice Letter/Fire Flow
Chualar	150,000	$832,000	New	Advice Letter/Fire Flow
Withers	100,000	$200,044	Replacement	Allow
Carmel Woods 1, 2, and 3	100,000 replaced	$750,000	Repair and Replacement	Allow
Oaks (Ambler Park)	2 x 200,000	$1,962,971	Replace 2 x 20,000 gallon tanks	Allow tanks, but disallow $10,000

11. Cal-Am should convene and provide logistical and staff support for a fire official task force to prioritize fire protection upgrade projects, with consensus recommendations reduced to writing.

12. Cal-Am has justified proactively replacing pipeline in Seaside North, South, and Pacific Grove Country Club Heights over the three year rate case period at a rate of up to $2.4 million per year.

13. Cal-Am should be authorized to replace an additional 200 polybutylene service connections per year for the next 10 years at an annual cost not to exceed $370,742.

14. Cal-Am should be authorized to combine its pipeline and polybutylene service connection replacement projects to maximize efficiency.

15. Cal-Am should be authorized to file advice letters for inclusion in plant in service upon completion of each of its two interconnection projects.

16. Cal-Am should be authorized to choose between its Hidden Hills interconnection or replacing pipeline in the Hidden Hills subsystem.

17. Cal-Am should implement a permanent annual program of meter replacement at a rate of 2,630 meters/year to remain current with GO 103 and should implement a temporary supplemental program to replace 1,885 meters/year to eliminate its current backlog over four years.

18. The following unaccounted for water standards should be adopted for the Monterey district:

System	Cal-Am Proposed	Adopted
Bishop	10%	9%
Hidden Hills	16.16%	13.8%
Monterey	11.59%	9%
Ambler	17.04	13.5%
Ralph Lane	21%	15.5%
Chular	10%	9%

19. Cal-Am should include in its annual WRAM filing the following:

1. For the Bishop, Hidden Hills, Monterey, and Ambler systems,

    a. Provide the total water production for each system for the preceding calendar year.

    b. Calculate each system's adopted unaccounted for water quantity by multiplying the adopted percentage from the table in the preceding Conclusion of Law by the actual production quantity for period in item a. above.

    c. Calculate the actual unaccounted for water for the period by determining the difference between each system's production meters and the sum of all the system's customer meters.

    d. Subtract the actual volume of unaccounted for water from the adopted volumes calculated in item b. above for each system.

e. Multiply the difference calculated in item d. above by $2,018.79/acre-foot based on the adopted standard rate of $4.5345/Ccf.

f. If the result of item e. is positive, i.e., actual unaccounted for water is less than the standard, then this is a reward amount that will be added to the balance to be included in rates via WRAM Balancing Account amortization.

g. IIf the result of item e. is negative, i.e., actual unaccounted for water is greater than the standard, then this is a penalty amount that would be entered as a debit to the amount to be recovered from ratepayers through the WRAM Balancing Account.

2. For the Ralph Lane and Chualar systems, which are not included in the WRAM, the penalty/reward amounts will be calculated as above but will be assessed to customers by a separate one-time surcredit/surcharge.

20. Cal-Am should be authorized to file an advice letter to include Seaside Basin Replenishment Fees in revenue requirement, should the Seaside Basin Watermaster deny Cal-Am's request to off-set replenishment fees with Coastal Water Project costs.

21. To obtain cost recovery, Cal-Am must present clear and convincing evidence demonstrating that the costs and terms of the Sand City Desalinization Plant lease are reasonable and prudent; that is, the action would logically be expected to accomplish the desired result at the lowest reasonable cost consistent with good utility practices.

22. In the record for this proceeding, Cal-Am has not demonstrated that the costs and terms of the Sand City Desalinization Plant lease are reasonable and prudent.

23. Cal-Am's request to include the costs of the Sand City Desalinization Plant in revenue requirement should be denied without prejudice to re-filing.

24. Regulatory expense is included in revenue requirement on a forecasted basis.

25. Incremental rate case expense should be included at a forecasted amount of $350,000 per year of the three-year rate case cycle.

26. The severity of Cal-Am's offense in failing to file timely customer complaint reports and Cal-Am's conduct require a fine of $10,000 per violation, for a total fine of $40,000.

27. Cal-Am should be ordered to pay a fine of $40,000 for failing to timely file four customer complaint reports.

28. DRA's five-year average of tank painting costs, adjusted for inflation, is a reasonable forecast of test year 2009 tank painting costs.

29. Cal-Am did not justify four new utility workers, a valve turner, a backhoe operator, four new maintenance technicians, an operations specialist, senior operations engineer, engineer in training, or a system operation specialist positions.

30. Cal-Am should be required to present a comprehensive position-by-position description of each budgeted employee in all future general rate case filings, including comparisons of last authorized to proposed.

31. Cal-Am reasonably and prudently incurred $2,755,960 in costs for the Seaside Basin Adjudication.

32. Commission precedent supports including water rights litigation costs in revenue requirement by amortizing the capital costs, plus interest, over a reasonable period of time.

33. A ten-year amortization period, with interest at the 90-day commercial paper rate, is reasonable for the Seaside Basin adjudication costs.

34. Cal-Am should file an advice letter creating a Seaside Basin Adjudication Balancing Account to track the amortization of the costs and interest on the unamortized balance.

35. Cal-Am's forecast of 2009 General Office labor costs should be adjusted to conform to employees actually hired by May 31, 2008.

36. Cal-Am's General Office incentive compensation payout rate for test year 2009 should be forecasted by using the actual 2007 payout rate for each service company.

37. Cal-Am has not justified including business development expense in General Office revenue requirement for California customers.

38. Charitable contributions and sales and marketing expenses should not be included in regulated utility revenue requirement.

39. Cal-Am failed to justify its request for legislative influence expenses in General Office; the request should be denied.

40. DRA's adjustments for unsupported National Service Company costs and corrections for non-departmental interest income and income tax and Operating Risk Department salaries should be adopted.

41. Cal-Am's position-by-position analysis justified the reassignment of 12 employees from the Local Service Company to the California service company.

42. DRA's calculation, based on American Water Company's Securities and Exchange Commission filing, that 12% of the National Service Company costs should be allocated to non-regulated operations, is the best evidence before us of the proper allocation of costs to non-regulated operations.

43. Cal-Am should be allocated 4.56% of the following National Service Company rate filing categories: Belleville Lab, Customer Service Center,

Finance, Information Technology, NSC Functions, Operations/Network, and Shared Services.

44. Local Service Company allocations should be based on up-to-date customer counts.

45. The Customer Service Center costs should be adjusted to remove the 5.8% of excess costs over the stand alone model.

46. CalCorp rate case expense should be reduced by $34,664 to reverse double counting of rate case expense.

47. General Office costs should be allocated among the California districts based on number of customers.

48. Cal-Am should meet and confer with the Monterey Peninsula Water Management District regarding District costs properly Cal-Am's responsibility.

49. Cal-Am should be allowed 180 days to develop and file for Commission approval for a program to fund the projects currently performed by the District that are properly Cal-Am's responsibility.

50. The rate design settlement is reasonable.

51. Cal-Am should be authorized to submit an application for non-potable water irrigation demonstration projects, feasibility studies, and other means to develop and implement innovative replacements for potable water use in landscape irrigation.

52. The Settlement Agreement as to Rate Design issues is reasonable in light of the whole record, consistent with the law, and in the public interest. The Settlement Agreement should be approved.

53. Regarding the Partial Settlement Agreement between the Division of Ratepayer Advocates and the California-American Water Company on Monterey Water and Wastewater Issues, filed November 24, 2008, and attached

to the decision in A.08-01-023, the portion addressing Monterey district water general rate case issues is reasonable in light of the whole record, is consistent with the law, is in the public interest, and should be approved in this decision.

FINAL ORDER

IT IS ORDERED that:

2. The California American Water Company is authorized to file in accordance with General Order 96, and to make effective on not less than five days' notice, the revised tariff schedules for Monterey that are attached as appendices to this order. The revised tariff schedules shall apply to service rendered on and after their effective date.

3. California American Water Company is authorized to file advice letters seeking Commission authorization for rate base offsets in the Monterey district for the following capital projects when each has been completed and is used and useful, at costs not to exceed those indicated plus an allowance for funds used during construction to the extent the project exceeds one year in construction:

a. Two Lower Carmel River Valley replacement wells, not to exceed $833,000 each.

b. Segunda Tank, $2,905,598; Withers, $200,044; Carmel Woods 1, 2, and 3, $750,000.

c. Upper Rimrack Tank, $479,000, with fire flow task force support.

d. Chualar Tank, $832,000, with fire flow task force support.

e. Interconnection between Ryan Ranch and Bishop, $277,000.

f. Interconnection between Hidden Hills and Monterey Main System, or, as an alternative, replace pipeline in the Hidden Hills subsystem, $546,000.

4. The rate tables and tariff sheets attached to today's decision are adopted.

5. California-American Water Company is authorized to file on or after November 15, 2009, in accordance with General Order 96-B, an advice letter, with appropriate supporting workpapers, requesting an escalation adjustment for Monterey district water rates to be calculated in conformance with the rate case plan adopted by the Commission in Decision 07-05-062.

6. California-American Water Company is authorized to file on or after November 15, 2010, in accordance with General Order 96-B, an advice letter, with appropriate supporting workpapers, requesting an escalation adjustment for Monterey district water rates to be calculated in conformance with the rate case plan adopted by the Commission in Decision 07-05-062.

7. On May 11, 2009, California-American Water Company submitted a Tier 1 Advice Letter seeking interim rates from that date to the effective date of the rate increase adopted in today's decision. The surcharge to true-up the interim rates shall be based on the methodology set forth in Decision 07-12-055 and be collected over the remainder of this three-year rate case cycle. The tariff implementing the surcharge may be included in the filing authorized in Ordering Paragraph 1 or filed by advice letter within 60 days of the effective date of the rate increase authorized by this decision.

8. California-American Water Company is authorized to file Tier 1 advice letters to request amortization of the balancing and memorandum accounts adopted in Paragraph 4.4 of the Water Settlement and to continue the accruals adopted in Paragraphs 4.1 and 4.3 of the Water Settlement Agreement.

9. California-American Water Company is authorized to file an advice letter creating a Seaside Basin Adjudication Balancing Account to track the amortization of the costs and interest on the unamortized balance.

10. If the Seaside Water Master does not offset Replenishment fees with the costs of the Coastal Water Project, California-American Water Company is authorized to file an advice letter to amend its purchased water account by the amount not offset.

11. California-American Water Company shall improve its pipeline break data collection to comply with industry best practices and shall include break type and cause.

12. California-American Water Company is authorized to file an advice letter creating an Aquifer Storage and Recovery project memorandum account to record up to $14,380,000 in costs for the Aquifer Storage and Recovery project for later ratemaking consideration by the Commission, expected to occur in 2012-2014 Monterey district general rate case.

13. The requirement established in Decision 01-09-057 that California-American Water Company demonstrate synergy savings from the Citizen Water Company asset purchase is terminated.

14. California-American Water Company shall implement a permanent annual program of meter replacement at a rate not to exceed 2,630 meters/year to remain current with General Order 103.

15. California American Water Company shall implement a temporary supplemental program to replace 1,885 meters/year, after the 2,630 meters for the annual permanent program, to eliminate its current backlog over four years and is authorized to file an annual advice letter to include the costs of the actual

meters installed under its temporary supplemental program, up to a maximum cost of $191.67, when the meters are installed and operational.

16. California American Water Company shall pay a fine of $40,000 payable to the California Public Utilities Commission for deposit to the General Fund, and shall remit said amount to the Commission's Fiscal Office at 505 Van Ness Avenue, Room 3000, San Francisco, CA 94102, within 30 days of the effective date of this order. The number of this decision shall be included on the face of the check.

17. California-American Water Company, in consultation with its customers and landscaping professionals, shall develop and implement a program to reduce or prohibit the use of potable water for landscape irrigation during periods of Maximum System Demand. No later than 180 days after the effective date of this order, California-American Water Company shall file and serve a compliance filing setting forth such a program.

18. California-American Water Company shall conduct the test for Playa Well No. 4 and take appropriate actions based on outcome of the test.

19. California-American Water Company shall convene and provide logistical and staff support for a Monterey District fire official task force to prioritize Monterey District fire protection upgrade projects, with consensus recommendations of the task force reduced to writing. California-American Water Company shall consider the task force's prioritization and may fund fire flow projects up to $150,000 in this three-year rate case cycle and shall include in revenue requirement $10,000 for task force support and expenses.

20. California-American Water Company shall develop and implement a program consistent with the highest engineering standards for reducing unaccounted for water in its Monterey Main District and associated subsystems,

and shall include a comprehensive report on its efforts in its next general rate case filing.

21. California-American Water Company shall present a comprehensive, position-by-position description of all district personnel in its future general rate cases, including comparisons of authorized versus actual positions and all proposed changes.

22. In all future general office rate increase applications, any increase beyond inflation and customer growth shall be denied absent a specific demonstration that each element of the proposed increase is necessary to serve California customers. All proposed personnel increases must be justified on a position-by-position basis.

23. Cal-Am is authorized to file a petition for modification of today's decision that fully discloses all non-regulated operations which use any assets or employees included in revenue requirement, specifying the following:

1. Identification of all such goods and services provided to non-regulated operations,
2. Identification of all personnel positions and assets included in revenue requirement and used to provide the non-regulated goods and services,
3. Statement of revenue received for such goods and services,
4. Demonstration that all identifiable costs are direct billed to non-regulated accounts and that all indirect costs are allocated consistent with the multiple tier methodology.

24. California-American Water Company shall meet and confer with the Monterey Peninsula Water Management District regarding costs properly the responsibility of California-American Water Company and its ratepayers.

25. No later than 180 days after the effective date of this order, California-American Water Company shall develop and submit for Commission

approval a program to fund the projects currently performed by the Monterey Peninsula Water Management District that are properly California-American Water Company's responsibility, and is authorized to file an advice letter to create a memorandum account for interim costs.

26. California-American Water Company is authorized to submit an application for non-potable water irrigation demonstration projects, feasibility studies, and other means to develop and implement innovative replacements for potable water use in landscape irrigation.

27. California-American Water Company shall present a comprehensive comparison of all authorized capital projects to actual expenditures for the preceding three-year rate case period in all future general rate cases. Deviations from authorized shall be identified and explained.

28. The Settlement Agreement as to Rate Design issues is approved. The parties shall comply with the Agreement.

29. California American Water Company is authorized to file an Advice Letter creating a Water Revenue Adjustment Mechanism and Modified Cost Balancing Account as provided in the Rate Design Settlement Agreement.

30. California American Water Company shall incorporate within its Water Revenue Adjustment Mechanism and Modified Cost Balancing Account the following Unaccounted for Water Incentive Program:

1. For the Bishop, Hidden Hills, Monterey, and Ambler systems,
    a. Provide the total water production for each system for the preceding calendar year.
    b. Calculate each system's adopted unaccounted for water quantity by multiplying the adopted percentage from the table in Section 6.1.11 in the Decision by the actual production quantity for period in item a. above.

c. Calculate the actual unaccounted for water for the period by determining the difference between each system's production meters and the sum of all the system's customer meters.

d. Subtract the actual volume of unaccounted for water from the adopted volumes calculated in item b. above for each system.

e. Multiply the difference calculated in item d. above by $2,018.79/acre-foot based on the adopted standard rate of $4.5345/Ccf.

f. If the result of item e. is positive, i.e., actual unaccounted for water is less than the standard, then this is a reward amount that will be added to the balance to be included in rates via WRAM Balancing Account amortization.

g. IIf the result of item e. is negative, i.e., actual unaccounted for water is greater than the standard, then this is a penalty amount that would be entered as a debit to the amount to be recovered from ratepayers through the WRAM Balancing Account.

2. For the Ralph Lane and Chualar systems, which are not included in the WRAM, the penalty/reward amounts will be calculated as above but will be assessed to customers by a separate one-time surcredit/surcharge.

31. Consolidation of A.08-01-023 with A.08-01-027, and A.08-01-024 is set aside.

32. A.08-01-027 and A.08-01-024 are closed.

This order is effective today.

Dated July 9, 2009, at San Francisco, California.

MICHAEL R. PEEVEY
President
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG

TIMOTHY ALAN SIMON
Commissioners