STATE OF CALIFORNIA GRAY DAVIS, *Governor*

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

August 29, 2002 Agenda ID #1062

TO: PARTIES OF RECORD IN APPLICATION 01-10-020

This is the proposed decision of Administrative Law Judge (ALJ) Vieth, previously designated as the principal hearing officer in this proceeding. It will not appear on the Commission's agenda for at least 30 days after the date it is mailed. This matter was categorized as ratesetting and is subject to Pub. Util. Code § 1701.3(c). Pursuant to Resolution ALJ-180 a Ratesetting Deliberative Meeting to consider this matter may be held upon the request of any Commissioner. If that occurs, the Commission will prepare and mail an agenda for the Ratesetting Deliberative Meeting 10 days before hand, and will advise the parties of this fact, and of the related ex parte communications prohibition period.

When the Commission acts on the proposed decision, it may adopt all or part of it as written, amend or modify it, or set it aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties to the proceeding may file comments on the proposed decision as provided in Article 19 of the Commission's "Rules of Practice and Procedure." These rules are accessible on the Commission's website at http://www.cpuc.ca.gov. Pursuant to Rule 77.3 opening comments shall not exceed 15 pages. Finally, comments must be served separately on the ALJ and the assigned Commissioner, and for that purpose I suggest hand delivery, overnight mail, or other expeditious method of service.

/s/ CAROL BROWN
Carol Brown, Interim Chief
Administrative Law Judge

CAB:sid

Decision **PROPOSED DECISION OF ALJ VIETH** **(Mailed 8/29/2002)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of North Gualala Water Company For Authority to Implement a Water Rate Surcharge to Recover Costs Associated with the Extraordinary Events Memorandum Account (Source of Supply Study).	Application 01-10-020 (Filed October 19, 2001)

Stacie M. Castro, Attorney at Law, for the Water Division and Sara Steck Myers, Attorney at Law, for North Gualala Water Company, applicant.

OPINION AUTHORIZING SURCHARGE FOR RECOVERY OF SOURCE OF SUPPLY STUDY AND RESOLVING ACCOUNTING DISPUTE

1. Summary

We conclude that Applicant North Gualala Water Company (North Gualala) acted reasonably in undertaking a Source of Supply (Study) to defend, under challenge from another state agency, its right to pump water from certain wells located near the North Fork of the Gualala River. Accordingly, we authorize North Gualala to recover $323,274.67 from its customers through a surcharge on the monthly bill over the next five years. The average customer bill will increase by approximately 9.3%, or $5.66 per month. This five-year amortization period, rather than the three-year period that North Gualala requests, will help to minimize "rate shock" in a service territory that has

experienced other, significant rate increases since 1996. We also resolve a dispute over the appropriate ratemaking account for recording the Study costs.

2. Factual Background

North Gualala is a Class C water utility[1] and as of February 15, 2002, its customer base comprised 952 customers (840 residential customers and 112 commercial customers). North Gualala seeks authority to recover from its customers $323,274.67 in costs recorded in connection with the Study. The utility undertook the Study in an effort to establish before the State Water Resources Control Board (SWRCB) whether water pumped from its Well Nos. 4 and 5 is percolating ground water for which no water rights permit is needed or a subterranean stream, as SWRCB staff has contended.

This issue is important because it controls whether North Gualala can pump water from the wells when stream flows on the North Fork of the Gualala River at North Gualala's diversion point fall below the minimum bypass requirements of its water rights permit (Permit No. 14853). Were North Gualala unable to use the wells when stream flows decline below bypass minimums, North Gualala would be left with insufficient water supplies to serve its customers.

Litigation over the nature and source of the well water has moved from the SWRCB to the Superior Court of Mendocino County and back to the SWRCB, and no final resolution had been reached as of the date this proceeding was submitted for decision. However, as we discuss below, North Gualala's reasonableness in undertaking the Study is uncontested.

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[1] Class C companies have more than 500 service connections but fewer than 2001.

North Gualala recorded the costs of the Study in its Extraordinary Events Memorandum Account from January 16, 1996 to September 13, 1999. North Gualala established the Account in 1992, in reliance upon Decision (D.) 92-03-093. This decision authorized small water companies to establish the account as part of the package of regulatory relief approved in Phase I of Investigation (I.) 90-11-033, the *Risk OII*, a Commission investigation into the financial and operational risks faced by water companies. Phase I concerned Class B, C, and D companies.

Before filing this application, North Gualala sought recovery of these monies through an advice letter filing. The Water Division informed the utility that it would recommend that the Commission reject the advice letter and suggested that North Gualala file an application instead.

3. Procedural History

North Gualala filed this application on October 19, 2001. No protests were filed within the 30-day period required by Rule 44.1, but on December 4, 2001, the Water Division filed a Notice of Intent to Participate that indicated concerns about the application.[2] As directed at the January 16, 2002, prehearing conference (PHC), North Gualala filed an amendment to its application on February 15; thereafter, Water Division prepared a Staff Report. Evidentiary hearing was held on April 4, in San Francisco. The parties filed opening briefs on

[2] In the future, we expect Water Division to file and serve a notice of intent to participate within the 30-day period that applies to protests under Rule 44.1. Such timeliness is necessary to apprise the administrative law judge (ALJ) and Assigned Commissioner of whether or not the proceeding will go forward on an *ex parte* basis so that they can make appropriate case management decisions.

May 2 and reply briefs on May 31. The proceeding was submitted for decision on June 3, 2002.

The Assigned Commissioner attended the PHC. There were no closing arguments and the proceeding was submitted on a timely basis.

4. Discussion

North Gualala asserts it acted prudently in undertaking the Study in an effort to defend and preserve its right to pump water from Well Nos. 4 and 5 in the face of the SWRCB challenge. Without that water source, North Gualala would be unable to serve its customers because it would be unable to provide them with water "from a source reasonably adequate to provide a continuous supply of water" as the Commission's General Order (GO) 103 requires. (See GO 103, II.1.b(1).) A December 16, 1996, letter from the Department of Health Services' District Engineer, Drinking Water Field Operations Branch, Santa Rosa District Office agreed with North Gualala's undertaking and advised "it is the opinion of the Department that the Water Company must complete the study of the wells and their impacts on the river." (Exhibit 2 to the Application.) Though the costs of the Study are substantial, North Gualala has established that it had no other viable means of contesting the SWRCB challenge and, moreover, the costs are much less than the costs of alternative sources of water, estimated at $1.5 million to $10 million. Water Division concurs that North Gualala was reasonable to undertake the Study under these circumstances and states that the recorded costs, themselves, are reasonable. We agree and conclude that recovery should be authorized.

The only issues in dispute are (1) whether the recovery period should be three years or five years and (2) whether the Study costs should have been

recorded, not in the Extraordinary Events Memorandum Account, but in another ratemaking account. We discuss each issue below.

4.1 Amortization Period

North Gualala seeks authority to recover the $323,274.67 from its customers on an equal charge per customer basis over three years. On a customer base of 952, the monthly surcharge would be $9.43 per customer per month.[3] This is the same surcharge rate design the Commission has approved, by resolution, for recovery of costs in North Gualala's Catastrophic Event Memorandum Account and for recovery of the costs of a loan under the Safe Drinking Water Bond Act (SDWBA). Water Division proposes a longer amortization period, five years, which would reduce the amount of the monthly surcharge to approximately $5.66 per customer per month.

The choice of an amortization rate for this surcharge requires us to consider the impact of the various options on both customers and the utility. We want to keep customer bills as low as possible without undermining safe, reliable and financially stable utility operations.

The Staff Report calculates the average customer bill at approximately $61.60 per month and the utility agrees with this assessment. The average represents a customer with a 5/8 by ¾ inch meter and monthly consumption of 7.05 hundred cubic feet of water. Nearly one third of the average bill is the $18.15 surcharge for repayment of North Gualala's SDWBA loan. Commission

[3] As of February 15, 2002, the date it filed the Amendment to the Application, North Gualala had 840 residential customers and 112 commercial customers. All customers are charged for water consumption at the same rate, $3.03 per 100 cubic feet. Differences in bills relate to the amount of the consumption and the size of the meter, with charges varying by meter size.

resolutions in 1996 and 1998 approved the current surcharge and it will continue for another 28 or 29 years.[4]

North Gualala's amortization proposal (approximately $9.43 per customer per month) would result in an average monthly bill of about $70.04, which represents an increase for most customers of approximately 13.5% in each of the next three years. The Water Division's proposal (approximately $5.66 per customer per month) would result in an average monthly bill of about $66.27, an increase of approximately 9.3% in each of the next five years. Neither amount is inconsequential, considering the substantial increases North Gualala's customers have experienced since 1996 for SDWBA loan repayments. Given that the underlying costs have been reasonably incurred, we must examine the whole record to determine what is most fair to both customers and the utility.

John Brower (Brower), the president and owner of North Gualala, testified that the utility has experienced a severe cash-flow problem as a result of the Study and other unforeseen expenses, causing it to borrow money to meet its current expenses. The utility has not been earning its authorized rate of return and, in fact, has not been earning any return at all for a number of years. We accept Brower's testimony. Therefore, we need not take official notice of the North Gualala's 2001 annual report, which was submitted to the Commission

[4] Resolution F-645 (January 24, 1996) originally authorized recovery from ratepayers of a SWDBA loan of $3,081,938. Resolution W-4108 (September 23, 1998) allowed North Gualala to increase the existing SDWBA to $4,442,521 and to recover that amount from its ratepayers.

(and attached to its brief) after the close of evidentiary hearings.[5] Regarding the financial impact on the utility of the amortization period for the Study, Brower testified as follows:

> Our current loan could be repaid in six months if we had a three-year payback; if it's a five-year payback, our current loan will be paid back in almost 12 months. (Tr. at 20.)

Water Division argues that North Gualala's failure to file for a general rate case since its last offset rate increase in July 1993 militates for the lower surcharge (and the longer amortization period). The Water Division witness, Peter T. Liu (Liu) testified:

> So it's our way of thinking, if the company doesn't bother to come in, that means that they're able to survive, because for a Class C water company and for Class D, they can come in for a GRC every three years, or even sooner if they have some extraordinary things going on.
>
> So since they have waited so long and we don't hear anything from them other than this [application], we believe about a 10 percent rate increase for this case over five years is more reasonable for the ratepayers, especially because -- we want to lessen the impact on the ratepayers because based on the average bill they are paying $60 a month, and as Mr. Bower indicates some other high-end even pay $200 and for that particular thing we think five years is reasonable.

[5] Accordingly, we deny North Gualala's request for official notice, which Water Division opposes. We do so because the proffered evidence is superfluous and thus have no need to address the merits of the parties' arguments.

> That's why we recommend a longer period of time instead of three years. (Tr. at 27-28.)

We conclude that the longer amortization period is preferable on this record, since it will minimize the monthly "rate shock" for all customers, even though the surcharge will continue for a longer period. Our decision will provide the utility with funds to pay off its current loan within the next year. In response to questioning from the ALJ, Bower testified that the choice of amortization period will not determine the financial survival of the utility. If the utility should find itself unable to meet its expenses in future, Bower testified it would obtain a loan to cover them.

We are concerned, however, by Bower's representation that North Gualala's unexpected, extraordinary expenses have left it unable to earn any return in recent years and we urge the utility to file a general rate case for review of its current rates.[6] While we recognize that such filings may be unpopular with customers as well as utility management, they are necessary to provide appropriate regulatory oversight and to ensure, among other things, the financial integrity of a small water company like North Gualala.

4.2 The Correct Ratemaking Account

Though the Water Division did not raise the issue previously, the Staff Report asserts, as a secondary and seemingly ministerial matter, that the Study costs should have been recorded in Account 180 of the Uniform System of Accounts for Class B, C, and D Water Utilities rather than in the Extraordinary

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[6] D.92-03-093 authorizes Class B, C and D water utilities to file general rate cases by advice letter, rather than application.

Events Memorandum Account.[7] In response to questioning from the ALJ at evidentiary hearing, Liu clarified the Water Division's position, stating that while approval of the surcharge should not be delayed, the Commission should direct the utility to correct the alleged accounting error. North Gualala disagrees and the parties' briefs address, at length, which account is the correct ratemaking account for Study costs entries.

To provide context for this issue, we review each of these accounts more closely. The Extraordinary Events Memorandum Account resulted from Commission adoption of a Water Division proposal in Phase I of the *Risk OII*[8]. The Commission found that: "Unanticipated costs, primarily for repair of leaks and other equipment, are the major reason that small water companies are unable to earn their authorized rate of return." (*Id.*, Finding of Fact 19.) To address this problem, the Commission created the new memorandum account:

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[7] We regret that Water Division failed to register this concern with North Gualala earlier, at the time it recommended the filing of an application rather than an advice letter.

[8] D.92-03-093 describes the proposal as follows:

> Branch's proposal at hearing would permit small water companies (Class C and Class D) to establish by advice letter a similar memorandum account for unanticipated repair costs that are not already reflected in rates. It would be limited to costs that are (1) unanticipated, and (2) crucial to the operation of the utility. Costs to correct heavy damage due to an unusual freeze would be an example of likely recovery. Repair of a failed water pump, where the failure could not have been foreseen or prevented and the repair costs are not already included in rates, would be another example." (D.92-03-093, 43 CPUC2d 568, 581.)

The Commission adopted the proposal but declined to be more specific about the definition of unanticipated repair costs.

> A Class C or D water utility is authorized to establish a memorandum account to track *unanticipated costs of repairs necessary for a utility's service to its customers* and to notify the Water Utilities Branch (Branch) by letter when it has done so. A Class C or Class D water utility is authorized to file by advice letter, or as part of a general rate case, to recover costs recorded in the memorandum account for unanticipated repair costs when the total cost exceeds 2% of the utility's last adopted gross revenues. Costs already reflected in rates or recoverable through insurance or other means and costs that with reasonable diligence could have been avoided shall not be recoverable through the memorandum account. (*Id.*, Ordering Paragraph 2 [Emphasis added].)

Dicta in D.92-03-093 compare this new account to the Catastrophic Event Memorandum Account which the Commission had created previously to permit "capture for consideration for later recovery those costs caused by catastrophic events, such as the Loma Prieta earthquake." (*Id.*) Utilities may establish that account by advice letter filing also and like the Extraordinary Events Memorandum Account, may seek recovery by advice letter, which requires issuance of a Commission resolution after reasonableness review. A significant feature of a memorandum account is that it provides a mechanism for future recovery, on a dollar for dollar basis after reasonableness review, of costs incurred in the past without violating the prohibition on retroactive ratemaking inherent in Pub. Util. Code §§ 454 and 728 and case law.

Account 180, on the other hand, is a standard ratemaking account – not a memorandum account – but it likewise provides for some flexibility that avoids the prohibition on retroactive ratemaking. Account 180 is defined as follows:

> This account shall include such items as expenses of security issues, bond discount, *items in suspense*, and costs which the Commission has authorized the utility to amortize over future periods. (Emphasis added.)

North Gualala advances the somewhat novel theory that because the Study costs were incurred to prevent failure of a source of supply – not through mechanical failure but by legal directive of the SWRCB -- they qualify as *unanticipated costs of repairs necessary for a utility's service to its customers.* While we agree that undertaking the Study was reasonable and that recovery by surcharge is appropriate, we conclude that North Gualala's interpretation does not comport with a plain reading of Ordering Paragraph 2 of D.92-03-093 and moreover, no finding of fact, conclusion of law, or discussion in the decision militates for a different interpretation. Though the name, Extraordinary Events Memorandum Account, arguably suggests a broader inventory than unanticipated repair costs, the controlling authority, D.92-03-093, is more limiting.

Water Division asserts that the Study costs should be booked as incurred, but unrecovered, *items in suspense.* Such a use of Account 180 would recognize that the Study costs are unique costs that do not meet the definitional criteria of any established memorandum account but which do not clearly belong in any standard capital or expense account. Upon review for reasonableness, the amounts listed as *items in suspense* may be recovered from ratepayers by a Commission-approved means, such as a surcharge. We adopt this reading of Account 180. We caution, however, that because Account 180 is not an identified, special purpose memorandum account, a utility which chooses to list unique cost items as *items in suspense* in Account 180 may wish to seek, in advance by advice letter, Commission authority to do so. Such "pre-approval" will remove the risk of the Commission subsequently determining that the broad category or class of costs should have been accounted for differently. North

Gualala should remove the Study Costs from the Extraordinary Events Memorandum Account and list them as *items in suspense* in Account 180.

5. Comments on Proposed Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure.

Findings of Fact

1. North Gualala had no viable means of contesting the SWRCB challenge other than the Study, and the costs associated with the Study are much less than the costs of alternative sources of water, estimated at $1.5 million to $10 million.

2. North Gualala acted prudently in undertaking the Study in an effort to defend and preserve its right to pump water from Well Nos. 4 and 5 in the face of the SWRCB challenge.

3. The surcharge rate design North Gualala proposes is the same surcharge rate design the Commission has approved, by resolution, for recovery of costs in North Gualala's Catastrophic Event Memorandum Account and for recovery of the costs of a loan under the SDWBA.

4. A five-year amortization period will minimize the monthly "rate shock" for all customers and will provide the utility with funds to pay off its current loan within the next year.

5. The choice of amortization period will not determine the financial survival of the utility; if the utility should find itself unable to meet its expenses in future, it will obtain a loan to cover them.

6. The Study costs are unique costs that do not meet the definitional criteria of any established memorandum account but which do not clearly belong in any standard capital or expense account.

7. The Study costs should be booked as incurred, but unrecovered, *items in suspense* under Account 180.

Conclusions of Law

1. North Gualala was reasonable to undertake the Study under the facts presented, and the associated, recorded costs are reasonable and should be recovered from ratepayers by surcharge.

2. A five-year amortization period should be adopted.

3. Account 180, a standard ratemaking account, provides for some flexibility that avoids the prohibition on retroactive ratemaking.

4. Upon review for reasonableness, the amounts listed as *items in suspense* under Account 180 may be recovered from ratepayers by a Commission-approved means, such as a surcharge.

5. In order to permit the utility to implement the surcharge and commence cost recovery as soon as practicable, this decision should be effective immediately.

O R D E R

IT IS ORDERED that:

1. The application of North Gualala Water Company (North Gualala) for recovery of $323,274.67 in costs incurred in connection with a Source of Supply Study (Study) is approved, as provided in Ordering Paragraph 2.

2. North Gualala shall establish a surcharge on customer bills to recover the $323,274.67 on an equal charge per customer basis over five years and shall levy the surcharge beginning in the next billing cycle practicable following the effective date of this order.

3. North Gualala shall remove the Study costs from the Extraordinary Events Memorandum Account and list them as *items in suspense* in Account 180 of the Uniform System of Accounts for Class B, C, and D Water Utilities, as soon as practicable.

4. Application 01-10-020 is closed.

This order is effective today.

Dated _____, at San Francisco, California.