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Decision 92-03-093 March 31, 1992

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's )  
own motion into the financial and )  
operational risks of Commission )  
regulated water utilities, and )  
whether current ratemaking )  
procedures and policies require )  
revision. )

And Related Matter. )

**ORIGINAL**

I.90-11-033

(Filed November 20, 1990)

I.89-03-005

(See Appendix A for appearances.)

I N D E X

<u>Subject</u>	<u>Page</u>
INTERIM OPINION . . . . .	2
1. Summary . . . . .	2
2. Background . . . . .	3
3. Procedural History . . . . .	5
4. Branch's Assessment of Risk . . . . .	6
4.1 Small and Declining Rate Base . . . . .	8
4.2 Infrequent Rate Increases . . . . .	9
4.3 Low Authorized Return . . . . .	9
4.4 Inadequate Recovery of Fixed Costs . . . . .	10
4.5 High Operating Expenses Per Customer . . . . .	10
5. Utilities' Assessment of Risk . . . . .	11
6. Impending Costs of Water Quality . . . . .	12
7. Proposed Solutions . . . . .	15
8. Defining the Issues . . . . .	17
8.1 Immediate Rate Relief . . . . .	18
8.2 Encouraging Regulatory Review . . . . .	19
8.3 Other Measures . . . . .	19
8.4 Proposals Not Adopted at This Time . . . . .	20
9. Automatic Rate Adjustments by Index . . . . .	20
10. Authorization for Memorandum Account . . . . .	24
11. Recommended Rate of Return . . . . .	27
12. Recovery of Fixed Costs . . . . .	30
13. 'Small Claims Court' Procedure . . . . .	31
14. Advice Letter Available to All Class B Companies . . . . .	35
15. Operating Ratio Method . . . . .	37

16.	Changes to Be Developed in Workshops . . . . .	38
16.1	Facilities Fee Procedure . . . . .	38
16.2	Guidelines for Payroll Expenses . . . . .	39
16.3	Loans for Mandated Improvements . . . . .	40
16.4	Advice Letter Data Request . . . . .	41
16.5	Pilot Project for Cost-of-Service Ratemaking . . . . .	41
16.6	Workshop and Hearing Dates . . . . .	42
17.	Proposals Not Adopted at This Time . . . . .	42
17.1	Cost-of-Service Ratemaking . . . . .	42
17.2	Encouraging Acquisition of Small Companies . . . . .	44
18.	Comments on ALJ's Proposed Decision . . . . .	45
	Findings of Fact . . . . .	46
	Conclusions of Law . . . . .	49
	INTERIM ORDER . . . . .	52

APPENDIX A

INTERIM OPINION

1. Summary

Following eight days of hearings, testimony by 21 witnesses and examination of surveys conducted by the California Water Association and the Water Utilities Branch of the Commission Advisory and Compliance Division, the Commission in this order finds that the approximately 200 investor-owned small water utilities in California face a growing economic crisis that threatens their ability to deliver clean, safe drinking water to their customers. The Commission also finds that traditional ratemaking policies that are satisfactory for large water utilities are only sporadically successful in coping with the problems of Class D water companies (serving fewer than 500 connections) and Class C water companies (serving 500 to 2,000 connections). Most of these companies, often one- or two-person operations serving a few dozen neighbors in remote areas, rarely file for regulatory review and rate adjustment because they regard the Commission's rate process as too complicated and too time-consuming. As a result, on average, Class D companies have a negative rate of return, and Class C companies are earning less than half the rate deemed necessary for them to stay in business in the long term. Many of these companies already require plant improvements such as wells and chlorinators. New federal and state water quality regulations will impose additional capital requirements within the next three to five years.

In order to respond to these problems, and in an effort to prevent operators of small water utilities from simply abandoning their service, the Commission today adopts a number of new policies. First, in order to provide at least minimal additional revenue to small utilities, the Commission offers a simplified rate filing based on the Consumer Price Index, along with a new method for small companies to recover unanticipated repair costs deemed critical to continued service. Second, in

order to encourage small utilities to seek Commission review of their operations as part of more substantial adjustments in rates, the Commission increases the range of rate of return for small utilities and offers a number of streamlined procedures (including a so-called "small claims court" appeal process) to simplify and speed regulatory review. All of these changes are designed to address unique problems of small water utilities while at the same time providing safeguards against unnecessary or unreasonable costs for ratepayers.

## 2. Background

This Order Instituting Investigation (also called the Risk OII) was issued on November 21, 1990, to consider whether financial and operational risks faced by small and large water utilities that are under Commission jurisdiction warrant changes in regulatory policies. The investigation was bifurcated, with Phase One to address issues important to smaller water utilities, defined as Class B, C and D companies.<sup>1</sup> Phase Two, devoted to issues pertaining to the larger Class A water utilities, is to commence after hearings end and briefs are submitted in Phase One.

The Risk OII was prompted in part by an April 1990 report on water utility risk prepared by the Commission Advisory and Compliance Division (CACD).<sup>2</sup> That report concludes that

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<sup>1</sup> In Decision 85-04-076, the Commission approved the following Uniform System of Accounts subdivisions for water utilities: Class A, more than 10,000 service connections; Class B, between 2,000 and 10,000 service connections; Class C, between 500 and 2,000 service connections; Class D, fewer than 500 service connections.

<sup>2</sup> The report was supplemented in October 1990 by a second CACD study, entitled "Status of Small, Privately Owned Water Utilities in the State of California." This report analyzed in detail 19 small water utilities. The report concludes, among other things, that "(t)he most striking result of this survey is the poor financial condition of small water utilities regulated by the Commission." We take official notice of these two CACD reports,  
(continued...)

most of the approximately 200 small investor-owned water utilities in California face problems of too few resources, stagnant or declining customer growth, little or no capital, and scant likelihood of earning an authorized rate of return on investment. Many of these companies have little contact with the Commission. Half of those surveyed need large plant improvements such as wells, water storage tanks, chlorinators and other capital equipment.

The Commission described the purpose of Phase One of this investigation as follows:

- Smaller water utilities account for almost all the service problems affecting customers. Often the problems are serious. We are concerned that the financial and operational problems that have tended to plague these companies are worsening. The greatest public benefit can result...from assessing alternatives and fresh approaches to ameliorate the problems facing smaller utilities. The Water Utilities Branch is developing a small water company assistance program and will be ready to advance it in Phase One....The California Water Association has offered to help develop options and solutions that will benefit smaller utilities, and we welcome its offer to participate."

The Commission also posed a number of questions that it asked parties to address in Phase One. Among the questions:

- o Should the Commission relax some aspects of regulation for small water utilities?
- o Should the Commission simplify the ratemaking process for small water utilities by using even more streamlined advice letter filings?
- o Should there be a defined appeal procedure so that small water utilities may bring disputes to a neutral party before resorting to formal application?

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<sup>2</sup>(...continued)

which were distributed or made available to all parties in this proceeding.

- o Should automatic rate adjustments such as indexes, price caps, or price ceilings be used as regulatory alternatives?
- o Should the Commission provide an incentive to encourage mergers or acquisitions of uneconomic small utilities?
- o Should higher compensation be allowed for managers of small water companies?
- o Should operating ratios be used in place of return on rate base for small water companies having low net plant balances?

### 3. Procedural History

The Commission consolidated into the Risk OII two companion proceedings, the Drought OII (I.89-03-005) and the Connection Charges OIR (Order Instituting Rulemaking 90-07-004). The Drought OII, addressing issues of primary concern to Class A utilities, is a continuing one, with additional hearings scheduled in April 1992. The Connection Charges OIR was closed on April 24, 1991, in Decision (D.) 91-04-068. Two of the determinations of D.91-04-068 have particular relevance to the small water company phase of this proceeding. Those determinations are:

- o Water companies serving 2,000 or fewer connections (that is, Class C and Class D water companies) are authorized to accept from customers amounts in contribution as connection fees covering actual cost of installing new connections. These fees, similar to those imposed by municipal water agencies, can provide additional revenue to small utilities in a growing service area. However, because the fees are contributions, they will not increase rate base.
- o Water companies serving 2,000 or fewer connections also are authorized to accept from customers amounts in contribution as "facilities fees," representing part of the cost of additional or replacement facilities required because of the new connections. The burden is placed on the utility to justify a facilities fee in an advice letter filing. Again, since the fees are contributions, they do not increase rate base. However, they can be a source of revenue to expand or replace plant for a small utility faced with serving a new development.

Hearings in the Risk OII began on July 22, 1991, in San Francisco, and continued for five days. Three additional days of hearings were conducted beginning July 29, 1991, in Sacramento, where a number of owners of small water companies testified. Parties to this proceeding include the California Water Association (the Association), representing some 57 investor-owned water utilities<sup>3</sup> in the state; the Water Utilities Branch (Branch) of the CACD; the Division of Ratepayer Advocates; and Toro Water Service, Inc. (Toro). The Commission heard from a total of 21 witnesses, including the owners or operators of 10 Class C and Class D water companies. Briefing was completed on October 25, 1991, at which time Phase One of this proceeding was deemed submitted to the Commission for decision.

#### 4. Branch's Assessment of Risk

Branch sought to identify and quantify risks faced by small water companies. It did this in a two-step process. First, it collected financial data for 58 randomly selected water utilities (3 Class A, 1 Class B, 15 Class C and 39 Class D) from annual report data in a mathematical model designed to measure risk against certain known variables. Branch used 10 such variables, including customer growth per year, operating expense per customer, net plant turnover ratio (i.e., gross operating revenue divided by net plant), average customer size, and return on investment. (Ex. 1, pp. 19-20.)

In a subsequent analysis, Branch grouped the 58 water companies by class (Class D, Class C and a combined Class B and A) to compare each class's degree of risk, operating expense per customer, customer growth per year, average number of years

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<sup>3</sup> All Class A water utilities and 44 Class B, C, and D water utilities are members of the Association.



between rate cases, and average profit margin.<sup>4</sup> The result of this risk analysis was:

<u>Class</u>	<u>Adjusted Risk Factor</u>	<u>Operating Expense per Customer</u>	<u>Customer Growth Ratio</u>	<u>Years Between Rate Cases</u>	<u>Profit Margin</u>
Class D	9.7	273	8.5	8	-1%
Class C	1.28	202	24.5	6	19%
Class A&B	1	163	146.5	4	31%

While the Association and Toro challenge elements of Branch's formulas,<sup>5</sup> there is little dispute about most of the conclusions reached by Branch in its analyses.<sup>6</sup> Among other things, Branch concludes:

- o Class D water companies are about 10 times more likely to fail than are larger companies. Class C water companies as a class are about 1.3 times riskier than larger utilities.

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<sup>4</sup> Profit margin is operating revenue less operating expense divided by operating revenue.

<sup>5</sup> Utilities argue that Branch shows little justification for equating Class B utilities with Class A utilities, and that smaller Class B utilities are more closely allied with Class C companies. Toro also showed numerous errors in the small utility annual reports relied upon by Branch. Branch maintains that these random errors tend to cancel each other out.

<sup>6</sup> One notable exception is a conclusion by Branch, based on its mathematical model, that the number of customers a utility serves has no bearing on risk. (Ex. 1, p. 25.) Utilities argue that the evidence, and common sense, suggest that size and risk are directly related. Rogina Water Company's owner testified that, in his experience, the difference in customer size begins to have an effect at 1,200 to 1,500 customers. "At that level, you begin to have enough assured cash flow from monthly service charges that you can cover the unexpected expenses...[and] you can build up an expected cash flow to take care of emergencies...[and] provide for replacement of equipment and improvements." (Ex. 15, pp. 10-11.) On cross-examination, Branch's witness acknowledged that economies of scale grow with customer size, and that utility size and risk--as a practical matter--are related.

- o On the average, Class D companies wait eight years and Class C companies wait five years before seeking general rate increases, as contrasted by an average four years for larger water companies. Under the Commission's rate guidelines, water companies are permitted to apply for general rate increases every three years.
- o Maintenance and operating costs per customer are substantially higher for Class C and D companies. That is, small water companies face similar operating costs but have fewer customers among whom to spread those costs.
- o The rate of customer growth of Class A water companies is 6 to 18 times greater than that of Class C and Class D companies.

In summary, Branch's analyses identified five major problems shared by a majority of small water companies. These are:

#### 4.1 Small and Declining Rate Base

In traditional ratemaking, rates are based on the sum of a utility's expenses, taxes and depreciation, plus a return on net investment (or rate base). For a utility with a small rate base (for example, with plant financed by developer contributions rather than owner investment), the return on rate base can be equally small. Rates designed for, say, a 10% return on a \$6,000 rate base will yield only \$600 in income. A minor error in forecast can leave a utility with expenses that exceed revenue. Branch states:

- [While] traditional rate base regulation is appropriate for utilities with substantial capital investment, for Class D utilities with low profit margin, the risk to the company resides not in cost of capital but in operating expense. The return on a small net investment will not adequately compensate the utility owner for risk associated with high operating costs. For these small utilities, rate base regulation falls short of providing the necessary compensation for risk.\* (Ex. 1, p. 30.)

#### 4.2 Infrequent Rate Increases

Branch's survey shows that Class D water companies on the average seek rate increases once every eight years. Branch contends that this hurts both investors and ratepayers. Owners lose that portion of plant investment that is depreciating without recovery through depreciation expense. Customers lose because the capital drain impairs a company's ability to attract capital for plant repair and replacement. Instead of relatively small increases over time, ratepayers face a substantial increase when application finally is made or when the utility fails and is taken over by another water purveyor.

Branch states that the reasons given by owners of small water companies for failing to seek more frequent rate adjustments are (1) the rate case process takes too long; (2) the process is too complex for owners to do themselves; (3) Commission staff is intimidating and adversarial. Branch adds that, in its judgment, a fourth reason is indifference by or incompetence of some small utilities.

#### 4.3 Low Authorized Return

Branch concludes that traditional methods of setting authorized rate of return simply do not work for many small water companies. Generally, financial risk is measured by the capital intensiveness of a utility, or by the utility's cost of capital (interest on debt and return on owner investment). However, many small water companies have low plant investment, or the plant is old and depreciated. Similarly, most small water companies show little debt because no one will lend them money on the basis of utility assets alone. In seeking to fit these small companies into traditional ratemaking, Branch states:

- [t]he general rule of thumb has been that the authorized rate of return for small water utilities should be less than or at most equal to that granted for large water utilities...implying that small water

utilities are less risky than large ones. (This) cost of capital approach ignores the risk for small water utilities in (1) variability of expenses and revenues; (2) inadequate rate base, and (3) a regulatory environment that has for the most part overlooked their unique circumstances. [T]his traditional method of ratemaking...may have exacerbated the financial risks of small water utilities." (Ex. 1, pp. 38-39.)

#### 4.4 Inadequate Recovery of Fixed Costs

A consumer's water bill includes a service charge that covers some fixed costs and a use charge that covers costs of water delivered. The Commission permits all water companies to set service charges to recover up to 50% of fixed costs. Branch states that its analyses confirm that one method of reducing risk for small utilities is to permit a higher recovery of fixed costs in the service charge, which does not change because of rain or other weather conditions.

#### 4.5 High Operating Expenses Per Customer

Class D utilities are characterized by high operating expenses per customer, in contrast to larger companies, because of lack of economies of scale. An unanticipated \$2,000 pipe repair may have negligible per-customer impact on a Class A utility with more than 10,000 connections, but the same repair has significant per-customer impact on a Class D company with 200 connections. One result of this, in practical terms, is that when Branch estimates future revenues and expenses in a rate case, any miscalculation based on poor records, poor estimates or simple error will always have a disproportionate impact on the small utility.

5. Utilities' Assessment of Risk

The Association, representing 44 small water companies, presented results of its own study, along with the testimony of 10 owners. The Association argues that small water companies are unique public utilities for which non-traditional regulatory methods are required. Witness Phil Guidotti, owner of two companies and chairman of the Association's Small Water Company Committee, testified:

" [S]mall companies face unique problems due to their size and the often isolated rural areas which they serve. In rural areas, the small company owners usually know everyone in the community. They are neighbors serving water to neighbors who want to, and usually do, provide good service." (Ex. 17, p. 4.)

The Association reported on the results of a questionnaire it had sent to members. It said that these results show that, since 1981, Class D companies it surveyed failed to earn their authorized rates of return 89% of the time, and that Class C companies as a group failed to earn authorized rate of return 95% of the time. Average rates of return for 1990 for Class D companies surveyed was -1.6%; for Class C companies with fewer than 1,000 customers, 1.53%, and for Class C companies with more than 1,000 customers, 4.28%. Witness John S. Tootle said that small water companies failed to earn up to the current borrowing rate more than 90% of the time and failed to earn the equivalent of risk-free investments (Treasury note interest) more than 85% of the time.

Ten owners of small water companies testified in support of the Association's recommendations. The owners testified that the current regulatory system is too complex and requires unnecessary and time-consuming compilation of data; that the advice letter process of obtaining rate increases takes too long (seven to nine months); and that regulation operates in a manner that does not allow recovery of the true costs of running a small water company. Owners testified that the salary and

payroll levels permitted in a rate filing are inadequate, and they criticized what they called a "take-it-or-leave-it" approach by some staff members in estimating expenses. Owners said that their poor financial performance prevents them from obtaining bank loans without pledging personal assets.

Many of these problems also were cited by three former Commission staff members questioned by the Association.<sup>7</sup>

Witness Martin Abramson, criticizing Branch's recommendations, summarized much of the testimony as follows:

" I am really concerned that the staff's proposals do not address what I consider to be the three most important problems that we face with small water companies. The first is the ratemaking process takes too long. The second is that it's too complicated. The third is that the staff is not fair in its estimates of expenses and rate base in advice letter proceedings." (Tr., p. 839.)

In other testimony, owners of the small water companies claimed that unexpected costs, primarily for leaks and repairs, often exceed their allowed maintenance budget, and that this constitutes the major reason that utilities are unable to earn their authorized rate of return. Owners criticized the length of the advice letter filing process and unnecessary detail required in a 21-page data package that is part of the advice letter process.

#### 6. Impending Costs of Water Quality

In its April 1990 assessment of water utility risk, Branch termed the subject of water quality the most important and potentially the most costly issue facing the industry. Branch and the Association at hearing presented evidence showing that small water companies face increased operating costs and

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<sup>7</sup> The Association called as witnesses Martin Abramson, a consultant and veteran of 33 years with the Commission, and Stephen Kachur, a former assistant utilities engineer with the Commission. Also testifying was John Gibbons, a 30-year veteran of the Commission representing Toro as a consultant.

significantly increased capital costs to comply with new federal and state regulations on water quality. John M. Gaston, a consulting engineer and former chief of the Sanitary Engineering Branch of the California Department of Health Services (DHS), testified that these increased costs will occur in four areas.

Service Fees. Under the California Safe Drinking Water Act of 1989,<sup>8</sup> water utilities with more than 500 service connections will pay a one-time fee to cover the cost of a state-wide Water Quality Control Plan. The plan itself is likely to increase operating costs because it will establish standards for levels of contaminants in drinking water.<sup>9</sup> A 1990 state statute (Assembly Bill 2158-Costa 1990) will require all water companies to pay annual fees-for-service to fund the DHS and county regulatory programs.<sup>10</sup> Generally, draft fee language would require an annual cost of \$1,275 for a system of between 200-500 connections; \$2,550 for a system with 500 to 1,000 connections, and \$6,375 for a system with 1,001 to 3,000 connections. Fees for systems of fewer than 200 connections are likely to be higher on a per-capita basis.<sup>11</sup>

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<sup>8</sup> California Health and Safety Code §§ 4010 et seq.

<sup>9</sup> Initially, requirements for reducing contaminants in drinking water will be limited to systems with more than 10,000 service connections. The practical impact of the contaminants level is to require water utilities to meet a standard more stringent than that of federal drinking water standards. The greatest impact will be in the control of contaminants thought to be carcinogenic, such as trihalomethanes. These organic compounds are formed when water containing organic material such as leaves and grass is chlorinated in an attempt to control harmful bacteria.

<sup>10</sup> The goal of the statute is to replace the General Fund as the source for funding the DHS and to supplement county funding. County regulators are responsible for systems between 5 and 199 service connections.

<sup>11</sup> Draft language on fees for these very small utilities was not available at the time of hearing.

Testing Costs. The Federal Safe Drinking Water Act amendments of 1986 (Public Law 99-339, June 19, 1986) require increased testing and increased costs of testing for large and small water utilities. Sampling and analytical costs for required lead and copper testing will range between \$10 and \$20 per sample.<sup>12</sup> The Environmental Protection Agency (EPA) has tightened compliance for current testing of coliform bacteria to determine microbiological safety of water. Costs per sample range from \$15 to \$25, and costs for re-sampling range as high as \$60. Utilities with up to 199 connections are required to do one sample per month; those with 200 to 600 connections, one sample every other week; 600-2,000 connections, one to two samples per week; and 2,000-10,000 connections (all Class B systems), from two to 10 samples weekly. Far more costly sampling (from \$100 to \$250) is forecast for testing organic chemical contamination of groundwater where systems utilize wells as a source.<sup>13</sup>

Capital Costs. Capital costs required to remedy contaminants disclosed in testing can be substantial. Witness Gaston testified that a new chemical feed pump to correct lead corrosion would cost \$12,400, with costs of chemicals and maintenance of about \$4,000 annually. Chlorination equipment to correct coliform bacteria is about \$7,900 per well, plus maintenance and chemical costs of \$8,000 annually. The EPA's new

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<sup>12</sup> The National Primary Drinking Water Regulations for Lead and Copper are set forth at 56 Federal Register 26460-564 (June 7, 1991). Sampling is required by July 1, 1992, for systems between 3,301 and 9,999 connections, and by July 1, 1993, for systems with fewer than 3,301 connections. If tap sampling shows that the utility exceeds an action level for lead (15 parts per billion) or copper (1,300 ppb), the utility must recommend corrosion control technology to the state within six months.

<sup>13</sup> These regulations (40 CFR Part 141.40) require monitoring for 36 organic compounds. Systems with fewer than 150 connections may be excluded from sampling requirements. In California, the greatest impact is likely to come with treatment for DBCP, an agricultural chemical widely used at one time in the San Joaquin Valley, and trichloroethylene (TCE).



"surface water treatment rule," effective in 1993, may have the greatest cost impact on small water utilities. It would require a utility to construct and operate a water treatment filtration facility (at a cost of more than \$250,000 for a 500-connection system) if it uses non-filtered surface water.<sup>14</sup> Similar high capital costs (approximately \$172,000) are anticipated for well-head treatment for organic chemicals like DBCP and TCE.

(Ex. 14.)

Personnel Costs. The Association's witnesses testified that, as skill and license requirements rise in the water industry, personnel costs also increase. Utilities will have to spend more time dealing with county and state health departments. Additional training and licensing will be required for an operator of untreated wells, who now may be in charge of wells requiring air stripping towers, granular activated carbon beds or other treatment units.

Based on its assessment of legislative reports, Branch states that total costs of these new water quality regulations in California will be \$51 million in capital expenses and \$3 million annually in operating and maintenance costs to meet the maximum contaminant levels promulgated by DHS. Branch estimates an additional \$449 million in capital costs and \$47 million in maintenance costs annually to meet State Surface Water Treatment regulations. (Ex. 1, p. 44.)

#### 7. Proposed Solutions

The parties have put forth many proposals intended to help meet the challenges faced by small water companies. Toro proposes that "little" Class D utilities (fewer than 250 connections) be lightly regulated based on quality of service

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<sup>14</sup> Systems which rely on groundwater will not be affected by this rule so long as the water is independent of surface water. However, older wells drilled at or near the banks of rivers or lakes may fall under the rule if testing reveals that the surface water has contaminated the groundwater.

instead of cost, with automatic annual rate increases to a predetermined cap. Toro also proposes generic rates of return based on a premium above the rates authorized for Class A water companies (5 percentage points for Class D, 3 for Class C and 1.5 for Class B). Toro also urges a simple data package to replace the 21-page document now in use, along with a streamlined procedure for processing advice letter rate requests. (Ex. 28.)

Branch proposes 15 specific measures, including one (a memorandum account for unanticipated expenses) developed at hearing in response to testimony by the Association and small water companies. Branch also proposes a generic rate of return for small water companies using a modified Capital Asset Pricing Model, or CAPM.<sup>15</sup> Asserting that small rate base is a major cause of Class D company risk, Branch proposes using an operating ratio method of rate-setting (which benefits companies with high costs and low rate base), as an alternative to rate base method. Branch also proposes annual step increases for Class D and some Class C companies; revamping Branch's current outreach program for small water companies; simplifying the advice letter procedure; extending payback provisions of Safe Drinking Water Bond Act loans to commercial loans; and promoting legislation to provide low-interest loans to small water utilities. (Ex. 1, pp. 71-72.)

The Association's major proposal calls for adoption of a cost-of-service method of regulation that would permit small operators every three years to recover through rates all of their reasonable actual expenses based on the past three years, plus an authorized rate of return. The Association also urges creation of a "small claims court" procedure in which administrative law judges would informally hear and resolve disputes that arise between small companies and Commission staff. Another

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<sup>15</sup> A CAPM rate of return would be based on a 30-year Treasury note return, plus an amount derived from adjusted betas (or risk estimates) developed from Branch's multiple regression analysis.

Association proposal would provide a financial incentive for larger water companies to acquire small water companies.

## DISCUSSION

### 8. Defining the Issues

The record before us demonstrates that privately owned small water companies, as a group, face a financial crisis that will grow more severe as new federal and state water quality requirements take effect. Branch's study finds that Class D companies as a group have a negative rate of return. Class C companies are earning less than half the rate of return deemed necessary to assure their viability. The California Water Association reaches virtually identical results in its survey of member utilities. The Association's study shows that, since 1981, Class D water companies have earned authorized rate of return less than 5% of the time. Class C companies have earned authorized rate of return only 10% of the time. The poor financial condition and troubled outlook of small water companies threaten their ability to continue to provide adequate service and to deliver clean, safe drinking water to customers. The evidence is overwhelming that Class C and D water companies are not earning a return sufficient to meet their costs today, much less the higher costs forecast because of water quality regulations.<sup>16</sup> It seems clear that some of these small water systems will simply be abandoned by their owners if relief is not forthcoming.

The dilemma for the industry and for the Commission is that many operators of small water companies are unable or unwilling to file requests for regulatory review and rate

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<sup>16</sup> The EPA estimates that there will be an aggregate cost nationally of \$15 billion to comply with new Safe Drinking Water Act amendments. (Ex. 22A, p. 14.)

adjustments on a timely basis. To do so takes time and trouble. It subjects an operation to scrutiny by Commission engineers. Many of the owners who have appeared before us are highly independent. They are, as the owner of Toro puts it, "Don Quixotes...who will fight for the right to survive and serve the public." While small water companies recognize the necessity of regulation, it is not something that the owners are ever likely to embrace with enthusiasm.

We believe that three broad questions have emerged from the substantial research and testimony presented by the parties in this investigation:

1. What measures can be adopted to permit Class D and Class C water companies now earning less than their authorized rate of return to obtain rate adjustments with minimal regulatory requirements?
2. What measures can be adopted to encourage Class D and Class C water companies to file with the Commission for periodic regulatory review?
3. What other measures can the Commission take to enhance the ability of Class B, Class C and Class D water companies to maintain financial stability in order to continue to serve their customers?

Our conclusions, discussed in more detail below, are as follows:

#### 8.1 Immediate Rate Relief

1. All Class C and Class D water companies that are not now earning authorized rate of return and are not now subject to test year or attrition year increases may file by advice letter for a step increase based on the most recent Consumer Price Index. Such increases will be permitted annually so long as projected revenue does not exceed the last authorized rate of return.

2. All Class C and Class D water companies are authorized to establish memorandum accounts to track unanticipated costs of repairs necessary for a utility's service to customers, and to file from time to time for recovery of such

costs (following reasonableness review) in rates or through a one-year surcharge.

3. A generic rate of return range of between 13.9% and 14.4% is established for Class D water companies. A generic rate of return range of between 11.6% and 12.1% is established for Class C water companies.

4. Class D water companies may file to recover up to 100% of fixed costs in the service charge portion of their rate design. Class C water companies may file to recover up to 65% of fixed costs in the service charge.

### 8.2 Encouraging Regulatory Review

1. As part of the advice letter filing procedure, we will authorize an appeal procedure by which Class B, Class C and Class D water companies may appear before an administrative law judge to review disputes with the Commission's staff.

2. In calculating rates for Class C and Class D water utilities, Branch will apply an operating ratio method as well as return-on-ratebase method and select the one producing the higher result. This change is intended to prevent artificially low rates that otherwise result when a utility has a small rate base.

3. As part of an industry workshop, we direct Branch to develop standard guidelines for determining salary and payroll costs for Class C and Class D water companies, and to report back to the Commission with results of the workshop within 90 days of the date of this order.

4. As part of an industry workshop, we direct Branch to develop a simplified information request form for Class C and Class D water companies for advice letter rate filings, and to report back to the Commission with results of the workshop within 90 days of the date of this order.

### 8.3 Other Measures

1. We amend General Order 96-A to permit advice letter rate filings by all Class B water companies, as well as Class C and D water companies, regardless of projected annual earnings.

2. As part of an industry workshop, we direct Branch to develop a simple procedure and form to be utilized by small water companies to assess a facilities fee for new connections, where warranted, and to report back to the Commission with results of the workshop within 90 days of the date of this order.

3. As part of an industry workshop, we direct Branch to develop recommendations to encourage availability of low-interest long-term loans for small water utilities, and to report back to the Commission with results of the workshop within 90 days of the date of this order.

4. We direct the assigned administrative law judge to schedule a second round of evidentiary hearings, if necessary, to take evidence on any disputed matters growing out of the industry workshop ordered in this decision.

#### 8.4 Proposals Not Adopted at This Time

1. For the reasons discussed below, we decline at this time to adopt the Association's cost-of-service ratemaking proposal.

2. For the reasons discussed below, we decline at this time to adopt the proposal by the Association and by Toro to establish additional incentives for the acquisition of small water companies.

#### 9. Automatic Rate Adjustments by Index

For whatever reason, small water companies do not come to the Commission to seek rate increases when they are entitled to do so. The Commission has sought to address this problem in the past by permitting small water companies with less than \$750,000 in annual revenue to file rate cases using the simpler advice letter filing, rather than an application and formal hearing. Additionally, we have authorized water companies to establish balancing accounts to record and collect increased expenses in purchased power, purchased water, taxes and postage. (See PU Code § 792.5.) As this record shows, however, small water companies make use of advice letter rate filings on an average of only once every six to eight years. Few establish

balancing accounts. Clearly, we can lead small utilities to sources of revenue, but we cannot make them act.

Because of this, both Branch and Toro urge forms of automatic annual rate increases for small utilities, based on a generally recognized index, with appropriate safeguards to protect ratepayers. Similarly, the chairman of the Association's Small Water Company Committee endorsed the concept of an index and testified as to its general effect. We are persuaded that the time has come to adopt a form of automatic rate increase based on an index, available to Class C and Class D water companies, up to the rate of return authorized for the utility in its last rate case filing.

Toro proposes a somewhat complex form of automatic increase in which owners would send a quality-of-service questionnaire to customers and, depending on the response, would then be entitled to an arbitrary \$1 a month rate increase up to a ceiling of \$25 or \$35 per month.<sup>17</sup> While the concept of tying annual rate increases to quality of service is commendable, Toro has not persuaded us that the questionnaire would accurately reflect service, nor has it presented evidence that operators are any more likely to perform this additional layer of paperwork before filing for an advice letter adjustment.

Branch's proposal would apply to all Class C and Class D water companies (that is, all water companies with fewer than 2,000 service connections) and would use the Consumer Price Index. The CPI is easily ascertainable, measures average change in prices for basic consumer goods and services, and does not

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<sup>17</sup> Toro would apply its proposal to the approximately 145 "little D" water companies with fewer than 250 connections. For each company, the Commission would set a ceiling rate of \$25 to \$35 per month. If annual customer questionnaires indicate a company is delivering good service, the company would be permitted to file an advice letter rate increase of up to \$1 per month until it reached its ceiling level. (See Ex. 28, pp. 12-13.)

contain variables controllable by the industry." Branch proposes that small water companies be permitted to file for CPI increases for the second and third year following a rate case filing. Alternatively, Branch considers adoption of annual CPI rate adjustments when three-year rate case filings do not apply."

The chairman of the Association's Small Water Company Committee presented evidence tending to show that applying a CPI rate to actual revenues of Armstrong Valley Water Company for 1989 would have increased actual revenues the following year from \$77,364 to \$82,547 and increased rate of return for that company from 2.4% to 5%. (Ex. 17B.) While that rate of return is still well below the company's authorized return, it is double the rate actually received.

The record before us is uncontroverted that Class C and Class D water companies do not earn the rates of return necessary for them to continue offering clean, safe water to their customers. Further, many small water companies do not respond to traditional ratemaking procedures and rarely file for rate review. At the same time, these small water companies face unprecedented increases in costs that if not mitigated will affect their ability to stay in business.

We conclude, therefore, that Class C and Class D water companies should be authorized to file advice letter requests once each year for an increase in the prior year's water service revenue by an amount no greater than the most recent CPI-U index. This increase will only be available to a utility which is not subject to test year or attrition year rate adjustments as a result of an approved advice letter or general rate increase

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<sup>18</sup> We take official notice that the Bureau of Labor Statistics CPI for All Urban Consumers (CPI-U) covers about 80% of the U.S. population. The CPI-U showed increases of 3.6% in 1985; 1.9% in 1986; 3.6% in 1987; 4.1% in 1988; 4.8% in 1989; and 5.4% in 1990. (See Bureau of Labor Statistics, U.S. Labor Department.)

<sup>19</sup> See "Water Utility Risk and Return," April 1990, p. 23.



application, since those increases will have taken CPI factors into account. Nor is a utility required to file for a CPI increase for a year in which it feels its rates are sufficient to cover costs and adequate return. No CPI increase will be permitted to produce revenue in excess of a utility's authorized return in its most recent rate case. If Branch or ratepayers file a valid protest to a utility's proposed CPI increase, then the increase may be stayed pending review of the utility's operations. (See Rule 9, Rules of Practice and Procedure.)

We recognize that an annual rate increase based on the CPI index is a substantial departure from our historic practice in dealing with small water companies. On the other hand, the evidence is clear that past practice has been ineffective for these utilities. If small water companies are to survive, some means must be found to enable them to approach the rate of return deemed necessary for them to operate successfully. We conclude on this record that most small water companies are not going to file for rate increases on any regular basis. Thus, an annual increase based on CPI offers one way to generate needed revenue while still protecting ratepayers (since no CPI increase will be permitted beyond the return authorized in the last regulatory review and rate case). The procedure for requesting an increased based on the CPI index should be a simple one.<sup>20</sup> Except where ratepayers or Branch file an objection, it can be processed quickly. Over time it may permit small water companies to begin approaching the kind of return necessary to replace plant and meet new testing standards.

We note that the 1991 CPI index announced by the Bureau of Labor Statistics on January 16, 1992, was 3.1%. Class C and Class D water utilities meeting the conditions described above

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<sup>20</sup> An advice letter requesting a step rate increase based on CPI should suffice in most cases. The request can be processed following notice to ratepayers and opportunity for protest by customers, Branch or other interested parties.

may file by advice letter for an increase in rates of 3.1% following the effective date of this order.

10. Authorization for Memorandum Account

Leaks in underground pipes, failed water pumps and other unanticipated repair costs are the bane of small water companies. In their testimony, owners of small water companies identified unanticipated repair costs as the single greatest obstacle in realizing rate of return. Agate Water Company's Duncan S. Davis described the problem as follows:

- It's a business that could be good. It's just one of those things. Leak repairs in my business cost \$1,000, \$2,000. If you're allowed to make \$8,000, it doesn't take too many leaks and you're under water. In 1985 I lost \$10,000. Mostly leak repairs. It tips things way out of proportion to what they should be. In comparison to a big company, when you are a little company, \$2,000 in leak repair is quarter of your profit." (Tr., pp. 679-80.)

Because unexpected repair costs are often a one-of-a-kind expense, they may be disregarded in estimating test year expenses for ratemaking purposes. Graeagle's Daniel E. West testified:

- You always have special expenses. In one year it's one thing, the next year it's something else, and the next year it's something else. They are always extraordinary, and so in a test year, they are usually thrown out." (Tr., p. 731.)

The Association's proposal for a cost-of-service method of regulation was justified largely on the basis that it would permit small companies to recover unanticipated repair costs. Except to the extent such costs were recognized in its operating ratio proposal, Branch did not in its initial pleadings seek to address this issue directly.

On the last day of hearing, however, Branch Senior Engineer Arthur Mangold amended Branch's proposals to add a recommendation for establishment of a memorandum account similar to the memorandum account for catastrophic events that the

Commission authorized in Resolution E-3238 following the 1989 earthquake in northern California.

In Resolution E-3238, we authorized utilities, including water companies, to file and make effective on 30 days' notice an advice letter with proposed tariff sheets establishing a Catastrophic Event Memorandum Account. The intent of this account is to capture for consideration for later recovery those costs caused by catastrophic events, such as the Loma Prieta earthquake. Only events that are officially declared disasters by competent state or federal authorities are eligible. Costs authorized for entry into this memorandum account are those necessary for (a) restoring utility service to customers; (b) repairing, replacing or restoring damaged utility facilities, and (c) complying with government agency orders resulting from declared disasters.

Costs recorded in such accounts are only recoverable in rates following a request by the affected utility, a showing of reasonableness and approval by the Commission. In considering a request for recovery, the Commission will examine the extent to which losses are covered by insurance, the level of loss already built into existing rates, and other factors relevant to the particular utility and event.

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 one 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. Witness Mangold testified:

- The Branch does recognize that small water utilities do incur unusual expenses and that there should be a vehicle for recovery of those expenses.... The advantages of a

memorandum account is that it allows for recovery of expenses without violating the retroactive [ratemaking] principle. Another advantage is that it provides an opportunity for a reasonableness review, which we think is very important to the customers." (Tr., p. 942.)

We believe that Branch's proposal is justified by the evidence in this proceeding. The concept was supported by every water company owner who testified. The Association effectively endorsed the proposal in urging cost-of-service regulations, where repair expenses would be reimbursed following a reasonableness review after the fact. Moreover, Branch's proposal has the attraction of simplicity. A small water company, perhaps assisted by the Association or by Branch, would file an advice letter and tariff sheets establishing a memorandum account for unanticipated repair costs. It then would record those repair costs that, in its judgment, could not have been foreseen and are crucial to providing service to customers. When the time came to seek recovery of such costs, through a one-year surcharge or as part of a rate case, the water company would file an advice letter request with an appropriate showing. As with any rate increase request, the Commission staff will review the basis for the increase and make a recommendation to the Commission as to the amount in the memorandum account to be recovered in rates.

Branch's witness was careful to note that details on how unanticipated costs will be reviewed have not been fully developed. Clearly, a utility should not be permitted to recover costs already factored into its latest rate case, nor should recovery be permitted where a reasonably prudent operator would have taken steps that would have avoided the repair costs. In

general, however, we believe that both Branch and the industry know recoverable repair costs when they see them.<sup>21</sup>

Accordingly, we authorize Class C and Class D water companies to establish a memorandum account for unanticipated repair expenses and to inform Branch by letter when they have done so. A utility then may book to such account those necessary repair expenses that could not reasonably be anticipated in its last rate case, that are critical to provision of service to ratepayers, and that are not already reflected in rates. Recovery of these expenses would be by an advice letter filing when the total exceeds 2% of revenues. In all events, when recovery of these costs is sought, the burden will be on the utility to justify the reasonableness of the claimed expenses.

#### 11. Recommended Rate of Return

Class B, C, and D water utilities are permitted to file advice letter requests for rate relief without need of a formal hearing. In establishing revenue requirements, Branch analyzes each company's operating costs and recommends a rate of return and a return on equity from within a standard narrow range. The current standard rate of return for 100% equity financed water utilities (which includes virtually all Class C and D water utilities) is 10.75%, plus or minus .25%." This standard, in effect since 1989, is based on analysis of current interest

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<sup>21</sup> Branch shifts direction somewhat in its brief by suggesting that the Commission adopt "on a conceptual basis" an Unusual Event Memorandum Account (UEMA) and an Offset Expense Memorandum Account (OEMA), then directing staff to develop necessary guidelines for developing these accounts. The Association objects to Branch's introduction of these proposals on brief, without opportunity for cross-examination, and it urges that the Commission "not punt the ball" in this manner. (CWA Reply Brief, p. 9.) We agree with the Association that the UEMA/OEMA proposals are not properly before us on this record.

<sup>22</sup> See Ex. 9, a CACD memorandum entitled "Fair and Reasonable Rate of Return for Small Water Utilities," dated April 10, 1989. The memorandum recommends a standard rate of return range for 100% equity financed water companies of 10.5% to 11%. Prior to this memorandum, the recommended range was 10.25% to 10.75%.

rates, rate of inflation and other economic considerations. Consideration also is given to recent returns authorized for Class A water utilities.

Because of its findings of higher risk for Class D and Class C companies, Branch recommends that the Commission adjust the standard rate of return to 14.4% for Class D companies and to 12.1% for Class C companies.<sup>23</sup> Branch recommends no change in rate of return ranges for Class B companies. In Branch's view, the opportunity to earn 14.4% on investment will encourage owners of small water utilities to invest in plant.

Arguing that Branch's mathematical model is flawed,<sup>24</sup> Toro urges the Commission to set generic rates of return at arbitrary points above the highest return granted to a Class A water company. Witness Gibbons proposed that a generic rate be set 1.5 percentage points above the Class A level for Class B companies, 3 percentage points for Class C and 5 percentage points for larger Class D companies.<sup>25</sup>

The Association supports any generic rates of return that better reflect the risks of small water companies. However,

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<sup>23</sup> The recommended rate of return is derived through use of a modified Capital Asset Pricing Model, a formula equating return on equity to the interest rate of risk-free investments, plus a risk premium derived from Branch's mathematical equation. The risk premium, or beta value, derived from the equation is 1.288 for Class C and 9.1 for Class D. (See Ex. 1, pp. 61-65.) In its brief, Branch changes the beta value for Class D utilities to 2.54, resulting in a recommended 15% rate of return. However, this recommendation was not presented at hearing and is not supported by the evidence of record.

<sup>24</sup> Toro notes correctly that data used in Branch's CAPM formula reflect a number of errors made by small utilities in their annual reports. Moreover, the CAPM formula without adjustment produces an unwieldy 53% return for Class D utilities. Branch adjusted that result by various factors to arrive at a 14.4% recommendation.

<sup>25</sup> Gibbons suggests that "little" Class D companies be regulated on the basis of quality of service rather than on a rate-of-return basis.

both the Association and small water company witnesses regard rate of return as academic, since few Class C and D water companies ever come close to reaching the rates of return authorized in the past. Agate Bay Water Company, for example, has achieved its authorized rate of return only once in its 42 years of operation. The owner of another small company, in business for decades, testified that he did not know what rate was authorized for his company because there was no chance of reaching it.

We believe that the record supports an upward adjustment in the range of rate of return for small water companies, if for no other reason than to encourage the capital expenditures that new water quality regulations will require. We further find that Branch has established an adequate evidentiary showing for the rates it recommended at hearing. Therefore, we will adopt a new range for rate of return for Class D water companies of from 13.9% to 14.4% for Class D utilities, and from 11.6% to 12.1% for Class C utilities. Use of a range allows for acknowledgement of differences in water quality, service and management.

We also recognize that the range of returns we adopt today may require revision from time to time. Because we recognize that Class C and Class D water utilities are fundamentally different from Class A water utilities in terms of the operational and financial risks they face, it is not appropriate to tie the range of returns to those of Class A utilities. Instead, we will have CACD prepare an annual recommendation to the Commission on the appropriate range of returns for Class C and D utilities. Consideration will be given to changes in financial conditions and substantial changes in operational conditions meriting adjustments to the range of reasonable returns. CACD's April 10, 1989 memorandum entitled "Fair and Reasonable Rate of Return for Small Water Utilities" is a useful model. CACD will present this memorandum to the Commission on or before April 1 of each year beginning with 1993.

The evidence is sparse as to Class B companies. Branch concludes that the risks of Class B companies are similar to the risks of Class A companies. The Association addresses Class B company rates only in its recommendation (which is unopposed) that the advice letter procedure be made available to all Class B utilities. Toro offers conclusory views but presents little evidence to support a different rate of return for B utilities. We note that several of the recommendations adopted in this decision apply to Class B companies. As to rate of return, we will continue to deal with Class B utilities on a case by case basis.

#### 12. Recovery of Fixed Costs

In Re Water Rate Design Policy (1986) 21 CPUC 2d 158, growing out of our investigation in I.84-11-041, we adopted a "flatter" rate design policy permitting water utilities to recover up to 50% of their fixed costs<sup>26</sup> in service charges. Previously, the service charge was designed to recover 30% to 35% of a company's fixed costs, with the remainder recovered as part of use charges.

In Rate Design Policy, we rejected the recommendation of some utilities to design rates so that 100% of fixed costs could be recovered in the service charge. To do so, we said, "would substantially reduce a utility's financial risk and lead the utility toward a guaranteed recovery of revenues..." (21 CPUC 2d, p. 161.) While we continue to hold that view as to the industry as a whole, we are persuaded on this record that such a reduction in financial risk is warranted for small water companies.

Based on its analyses, Branch recommends that Class D water companies be permitted to recover up to 100% of fixed costs

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<sup>26</sup> Fixed costs include maintenance expense; transmission and distribution expense; customer account expense, excluding uncollectibles; administration and general expense; rent expense; depreciation expense; property tax expense, and gross return on investment. (See 21 CPUC 2d at 160.)



in the service charge, and that Class C water companies be permitted to recover up to 65% of fixed costs in the service charge. The recommendation, which is unopposed,<sup>27</sup> is based on Branch's conclusion that Class D companies are 9.7 times riskier and Class C companies are 1.3 times riskier than Class A and B companies.<sup>28</sup>

Small water companies face capital investment risk. Increased recovery of fixed costs through the service charge can mitigate that risk, thus making small companies more attractive in terms of securing loans for capital improvements and encouraging increased equity investment. The effect on most ratepayers should be negligible, since water use rates will decline as fixed costs within those rates are transferred to the service charge. We will adopt Branch's proposal. As utilities file rate cases in the future, Branch is directed to apply rate design intended to capture 100% of fixed costs in the service charge of Class D utilities and 65% of such costs in the service charge of Class C utilities.

### 13. "Small Claims Court" Procedure

Along with cost-of-service regulation, the Association has a second major recommendation for regulatory reform on behalf of small water companies. It urges an informal appeals process, or small claims court procedure, to resolve disputes that arise in the advice letter process between small companies and Commission staff members responsible for reviewing rate proposals.

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<sup>27</sup> During the hearings, at the direction of the administrative law judge, parties conducted an informal workshop to consider whether there was a consensus recommendation on any proposals. Branch's proposal on recovery of fixed costs was supported by all parties.

<sup>28</sup> Hence, 9.7 times the 50% fixed cost recovery permitted large companies equates to 100% plus for Class D utilities, and 1.3 times 50% equates to 65% for Class C utilities.

The Association urges the Commission to establish a procedure by which Class B, C, and D water companies that have filed for advice letter rate changes may appear before an administrative law judge to resolve disputes with Branch. The appearance could be by a brief written filing, or it could be by oral testimony only, with or without a court reporter.

In support of this, eight owners of small companies presented direct testimony recounting experiences in which, they allege, Branch engineers reduced the owners' cost estimates unreasonably and presented them with the choice of accepting the reductions or implementing a formal rate case hearing. A sampling of owners' testimony illustrates their view:

- I was given a take it or leave it choice. What could I do? I took it." (Fulton, Ex. 23, p. 6.)
- When I told the staff person I want to 'go to the wall on this issue,' I was told that I had no choice, that I could take what they were going to give me or go through a formal hearing." (Davis, Ex. 25, p. 4.)
- [Branch] informed me that if I was not willing to accept the staff's recommendations, I should file a formal rate increase application. This was for a rate case involving our 61-customer Rancho company with an allowed profit of \$1,350 per year." (Guidotti, Ex. 17, p. 15.)

Branch notes in response that the advice letter procedure is a relatively simple and low-cost process. Nevertheless, formal hearings (PU Code § 728) are available to owners as a matter of right and may be required if Branch and an owner cannot agree to all issues. The Association responds that this apparent choice of proceedings is illusory.

- The choice of taking what Staff gives them or going through a formal rate application process is really no choice at all for the small owners. After taking nine months to process an advice letter rate request, no owner--who is already losing money--is going to want to start all over again and incur the additional time and expense of going through

a formal rate application process. As Mr. Smith (Sierra City Water Works) recognized, the time it takes to have new rates approved 'means we're losing money for that whole period.'" (CWA Opening Brief, p. 24.)

Branch has presented no witnesses to try to rebut the owners' testimony. On cross-examination, however, Branch has demonstrated that some small water companies obtain rate relief only because Branch personnel have gone out of their way to assist them. One owner testified that he simply did not want to take the time to file a rate case, and that he did so only after a Commission engineer spent two days at his office completing the necessary paperwork. Others acknowledged that their way of dealing with the system was to accept without comment whatever Branch proposed by way of rate increase. Owners acknowledged that they receive prompt advice when they phone Commission staff for assistance, that Branch's small water company newsletter and other outreach efforts have been welcome, and that the regulatory staff has "shown improvement" in recent years.

We conclude from this, without surprise, that regulators are rarely popular with those whom they regulate. The Water Utilities Branch is obligated to protect the interests of ratepayers in the absence of competition. That task collides from time to time with the interests of utilities, big or small.

Nevertheless, the evidence is uncontested that lack of an appeal process before an impartial referee is at least perceived by owners of small water companies as a reason for not appearing before the Commission. Lack of appeal is perceived as the mark of a system in which the deck is stacked against the small utility. Although Branch argues that the existing advice letter procedure requires no change, we detect in its evidence a willingness to experiment with an appeals procedure if that would

encourage more small companies to seek regular review of rates and operations.<sup>29</sup>

We therefore authorize in this order a process by which a Class B, C, or D water utility, filing for rate review by way of advice letter, may request consideration by an administrative law judge of any dispute that it alleges exists with Commission staff.

Utilities already are served by an informal appeal procedure established by the Water Branch. A utility's dispute with a staff member may be appealed to the chief of the Water Branch and to a CACD assistant director. We believe that this procedure should remain in place.

However, if a utility involved in an advice letter rate case continues to dispute a staff recommendation, and if it has exhausted its appeals to the chief of the Branch and to the CACD assistant director, the utility may request an informal hearing before an administrative law judge. Notice of such appeal, along with a brief statement of the utility's position on a dispute, must be served in writing upon the chief of the Water Branch (thus assuring that staff appeals have taken place). No later than 20 days after receipt, Branch will forward the request for informal hearing, along with a brief statement of Branch's response, to the Chief, Administrative Law Judge Division.

In a manner similar to our expedited complaint procedure (Rule 13.2), an assigned administrative law judge will promptly schedule an informal hearing, without reporter, to hear the appeal request. Evidence will be taken under oath. No attorney at law shall represent any party other than himself.

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<sup>29</sup> In its April 1990 report on water utility risk and return, the Advisory and Compliance Division proposed consideration of a Commission-approved referee to settle disputes over expenses between Commission staff and the utility. The report noted that smaller utilities do not have resources to file for a formal rate case hearing to dispute expenses that have been disapproved.

We intend this hearing to be a form of alternative dispute resolution, with aspects of settlement, mediation, and arbitration. The administrative law judge will exercise his or her mediation skills to seek a voluntary resolution of the dispute, through compromise or through a candid preliminary appraisal of the merits of each party's position. It will be in the interest of both parties to seek informal resolution, since a recommended decision will mean further delay and paperwork.

If a decision is required, the administrative law judge shall promptly (but no later than 30 days of hearing) issue a recommended decision. Separately stated findings of fact and conclusions of law will not be made, but the recommended decision may set forth a brief summary of the facts. The recommended decision may find for or against the utility's position, or it may find that no decision can appropriately be reached without a formal hearing under the Commission's application procedure.

The recommended decision on the contested issue will be incorporated by Branch in its resolution dealing with the utility's advice letter rate request. The Commission may accept, reject, or modify the administrative law judge's recommended decision, as well as any other part of the rate request resolution.

We emphasize again that the establishment of this "appeals" procedure is not a criticism of any Commission staff member. On the contrary, we are more likely to criticize staff when utilities stop doing so. The procedure we establish today is intended to respond to a perception by some small water companies that they are without recourse in disagreements that inevitably arise in rate case filings. If an "appeals" procedure can change that perception, and in doing so encourage small water companies to appear before the Commission more often, then the interests of utilities and ratepayers will be well served.

#### 14. Advice Letter Available to All Class B Companies

There are two principal means by which a water utility files for a change in rates. Class A utilities are required to

file a notice of intent and an application for general rate increase, a process that with evidentiary hearings takes about a year to complete.<sup>30</sup> Each Class A water utility or district is allocated a time for filing its rate case once every three years, either in January or in July. The second means in which rate cases may be filed is by advice letter. Under General Order 96-A, those water companies with projected annual revenue no greater than \$750,000 may avoid the application process and file by advice letter. Such a filing generally does not involve hearings and takes about seven months to complete.

Most small water companies are eligible to use the advice letter filing for rate cases. However, some Class B water companies are not eligible because their gross revenue may exceed \$750,000. The Association recommends that the advice letter procedure be made available to all Class B water companies in order to eliminate general rate case costs. Branch concurs, noting that there are at most three Class B water companies with revenue exceeding \$750,000, and requiring them to proceed by way of application serves no useful purpose. If an evidentiary hearing is necessary for any utility proceeding by way of advice letter, such hearing may be initiated by Branch or by ratepayers by way of protest.

Permitting all Class B water companies to file by way of advice letter should contribute to the efficiency of the rate review process. Although we remove the \$750,000 limitation for these utilities, a cap still remains, since a utility that grows to more than 10,000 service connections will be reclassified as a Class A company and will be subject to our rate case plan for large utilities. Accordingly, our order provides that General Order 96-A shall be amended to provide that Class B, Class C, and

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<sup>30</sup> A revised rate case plan for Class A utilities was adopted in D.90-08-045 on August 8, 1990. The decision refines and memorializes rate case timetables as they have evolved since adoption of the Regulatory Lag Plan in Resolution M-4705 on April 24, 1979.

Class D water companies may file for general rate increases by way of advice letter regardless of the \$750,000 revenue limit applicable to other utilities.

15. Operating Ratio Method

Branch proposes adoption of an operating ratio method of ratemaking as an alternative to existing practice where that method would result in greater benefit to small utilities. The operating ratio method calculates a margin over operating and maintenance expenses, rather than focusing on return on net investment. (See Ex. 1, pp. 51-55.) It provides a greater return to those small utilities with little rate base (because of depreciation or contributed plant) and high expenses. For each Class D utility seeking a rate increase, Branch would have the Commission calculate rates based both on return-on-ratebase regulation and operation ratio, then select the higher result.

Toro, while not opposing the concept, presents evidence that the operating ratio method would benefit only about one in five small utilities. (Ex. 37.) Even for these, the benefit could be minimal. Branch notes that the North Carolina Utilities Commission is now applying modified operating ratio ratemaking to small water utilities. Our own experience with operating ratio --authorized on an experimental basis in 1979 for Class C and Class D water utilities--has not been encouraging.<sup>31</sup>

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<sup>31</sup> Resolution W-2755 (1979) authorized a form of operating ratio method. It was used in eight cases, then abandoned. Branch notes that its current proposal differs markedly from that earlier experiment, in that the former required a reduction if projected earnings exceeded those of a return on rate base.

Nevertheless, it is clear on this record that at least some utilities with small rate base will benefit from an operating ratio calculation. As envisioned, Branch would routinely calculate rates for Class C and Class D water companies under return-on-ratebase and operating ratio, then recommend the higher result. As to criticism that this double calculation will prolong rate requests, Branch states that since the same income and expense numbers are involved, the additional time required will be no more than a few minutes. With that understanding, we will approve Branch's proposal. If Branch, the Association or another party later comes to believe that use of an operating ratio method as an alternative is unduly delaying rate cases, that party should petition the Commission to reexamine this option.

#### 16. Changes to Be Developed in Workshops

In a workshop conducted during the hearings, parties reached agreement in principle on a number of recommendations intended to help small water companies help themselves. The parties recommend that formal workshops be conducted to develop definitive recommendations. Matters to be reviewed are the following:

##### 16.1 Facilities Fee Procedure

Our decision in D.91-04-068 authorized water companies with fewer than 2,000 customers to assess a connection fee and facilities fee for new connections. The rule for assessing a connection fee is straightforward. A utility must file a blank connection fee form in its tariffs. It must advise new customers in advance of the estimated connection cost. The fee may not exceed the reasonable actual cost, including labor and materials, to install the new connection.

Calculating the facilities fee is more complicated. A utility must show that new or replacement plant is required by the new connections, then calculate plant costs on a per-connection basis. D.91-04-068 provides that a small utility's request for a facilities fee be made as part of an advice letter



filing for general rate relief. That permits the request to be considered in light of the overall capital requirements of a utility. Various methods of calculating the facilities fee are set forth in the Commission's decision.

The Association states, and Branch agrees, that small utilities anticipating both developer connections and a need for plant improvement may benefit from the facilities fee if there is a simple procedure for assessing the fee. Otherwise, a small utility may forego seeking the fee because the process is complicated and uncertain. At workshop, we urge that Branch, the Association, and any small water company develop a facilities fee procedure that can be presented to the Commission for approval.

#### 16.2 Guidelines for Payroll Expenses

A recurring subject in the testimony of owners of small water companies is the need for guidelines for determining appropriate salary and payroll costs. Owners of small utilities often work at other jobs. Others are retirees who run small water systems by themselves. Still others hire and train fulltime and part-time assistants. Determining management salary and payroll costs to include in rate base can be the most time-consuming part of rate review, since there are few direct pay comparisons in the area served by the utility.

The Association introduced as Exhibit 13 a 1966 "Guide for Determining Reasonable Amounts of Expensed Payroll for Small Water Utilities." The guide was used by Branch for several years to apply uniform standards to utility payroll requests. The Association urges, and Branch agrees, that an updated version of the guide would remove a major bottleneck in processing small utility rate cases.

Witness Abramson testified that previous attempts by the Association and by Branch to produce a salary guide have been unsuccessful, in part because of diverse management practices and the different living costs in the state. Nevertheless, we believe that progress can be made, particularly if such a guide is limited (at least for the time being) to use only for Class D

and Class C companies. We direct that the parties seek to develop such a guide and report to the Commission on their progress.

### 16.3 Loans for Mandated Improvements

The new or expanded facilities and the costs necessary to meet water quality standards mandated by the EPA and the DHS may well double the cost of water provided by small water companies. For the small utility, this problem is compounded by its inability to borrow from banks and other lending sources because of a history of inadequate earnings.

Branch proposes, and the Association agrees, that the Commission should explore means of encouraging low-interest long-term loans for small water utilities. Branch also urges the Commission to extend, within the limits of its authority, favorable loan repayment procedures. For example, the Commission may be able to extend the policy on payback of Safe Drinking Water Bond Act loans to commercial loans, thus encouraging lenders to lend and utilities to borrow.<sup>32</sup>

All parties urge that these twin loan concepts--extending SDWBA repayment terms to other loan programs, and encouraging legislation for small water company loans--be a major topic at the workshop directed by this order. The evidence is clear that small utilities face substantial facilities costs to comply with new water quality regulations. Our order directs that parties research and be prepared to review this topic at the scheduled workshops.

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<sup>32</sup> The Commission through its Executive Director has stated that it will look with favor upon an application to extend SDWBA loan payback guidelines to federal Community Development Block Grant loan funds. Both programs have offered low-interest loans to water systems unable to obtain conventional financing. Both programs also seek to upgrade water systems to a level of high quality water at minimum cost. (See Ex. 1, App. G, letter of Executive Director Neal J. Shulman to County of Kern, May 24, 1991.)

#### 16.4 Advice Letter Data Request

Finally, the record before us is replete with criticism of the 21-page data request form that operators are required to complete in seeking advice letter rate review. Owners of small water companies testified that they are required to retain a consultant or spend days compiling data, much of which, they allege, is unnecessary for their rate request. Consultant John Gibbons testified that, in his judgment, copies of the 12 most recent power invoices would provide more reliable information than the two pages of detailed power use and cost data that an operator now must provide for each pump in operation. Gibbons and others urged use of a utility's 4-page annual report, supplemented by minimum additional data, to support an advice letter filing.

Branch's witnesses do not oppose revision of the data request form, provided engineers continue to receive reliable information upon which to make ratemaking recommendations.

We ask the parties to review the data request form as part of the small water company workshop. Parties are encouraged to draft in advance simplified data request forms that they believe would provide equivalent information to the form in use today.

#### 16.5 Pilot Project for Cost-of-Service Ratemaking

While we reject for the reasons discussed in Section 16.1 the Association's proposal for cost-of-service regulation of small water utilities, we find that the proposal is one of the more innovative that we have considered in addressing the problems confronting small water utilities. As part of the workshop, therefore, we invite the Association to produce a pilot project in which it would apply its cost-of-service proposal to a representative group of small water utilities to determine the rates that the proposal would produce. The pilot project should take note of and, to the extent it deems necessary, attempt to resolve objections raised at hearing, including the accuracy of cost data, the time it will take Branch to review past costs, and

the willingness of small utilities to file with the Commission under a cost-of-service ratemaking plan. Further consideration of any pilot project proposal will take place at the subsequent evidentiary hearing called to take evidence on workshop issues.

#### 16.6 Workshop and Hearing Dates

Our order directs Branch to conduct a one- or two-day Small Water Company Workshop and issue a written report on results of the workshop within 90 days of the date of this order. The assigned administrative law judge is directed to schedule and conduct a hearing within 45 days thereafter to receive evidence on the workshop topics discussed above and to prepare a proposed order for consideration by the Commission.

#### 17. Proposals Not Adopted at This Time

As discussed below, we reject at this time a number of proposals made by the parties. In part, we believe these proposals have been negated by our authorization today of CPI step increases, memorandum accounts for repair costs and other changes. Nevertheless, each of the proposals below has merit, and we do not foreclose the possibility that they will be considered again--in the same or altered form--in subsequent proceedings.

##### 17.1 Cost-of-Service Ratemaking

The Association proposes a cost-of-service form of ratemaking for Class C and Class D water companies. Under the proposal, these small utilities would file for rates in the future that reflect all actual costs (as documented in their past three annual reports) plus authorized rate of return revenue. The Association states that cost-of-service regulation has precedent in natural gas transportation regulation. As long ago as 1942, the Federal Power Commission permitted natural gas transportation companies to provide service pursuant to rates

based on 1) actual expenses from prior periods, and 2) a pre-determined rate of return."

The Association's proposal was presented by Witness Abramson, a retired 33-year veteran of the Commission and former head of the Commission's water division. He described the proposal as a full-cost simple balancing account in which the utility would be allowed to recover through rates all actual costs found to be reasonable. These "costs" would include the net revenues associated with a lower, but guaranteed, rate of return. With some revisions, current utility annual reports would be used to establish required revenue, expenses and rate base. Branch would review these past expenses for reasonableness, conduct public participation hearings, adjust the rate request as appropriate, and prepare the Commission resolution setting rates for the subsequent three-year period.

While the proposal is appealing in its simplicity, it carries with it a number of shortcomings. First, the Association has made no calculation of what its proposal would do to current rates. If rates escalate dramatically at once, both the Commission and small water companies may be reluctant to impose those rates. Second, as noted by the Association itself in criticizing Branch's mathematical models, reliance on annual report data can be misleading. Annual reports prepared by small water companies are not audited and, the evidence shows, they may contain significant errors. To the extent annual reports are used to calculate costs, those errors would translate unreasonably into rates. Third, the full-cost procedure would require changes in annual report forms and in guidelines for salaries and other costs. As demonstrated at hearing, these

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<sup>3)</sup> See Canadian River Gas Company, et al (1942) 3 FPC 32; Distri-gas of Massachusetts Corp. v. F.E.R.C. (1st Cir. 1987) 737 F.2d 1208, 1212. We note that while classical cost-of-service ratemaking based on a single test year is a familiar concept, the Association's proposal differs from that in that it averages costs over a three-year period and adopts a "guaranteed" rate of return.

changes are not easily made. Finally, as noted by Branch and by Toro, there is no evidence that review of three prior years of spending will take less time than current staff review of test year spending and projection of future costs and earnings. It is the length of time of a rate case, along with the necessity of dealing with requests for data and records, that appears to most discourage water company owners from filing in the first place.

In summary, we are not persuaded that the Association's cost-of-service proposal is as simple or as reliable as it first appears, nor are we convinced that the Commission and its staff could process rate cases more expeditiously under this system. Moreover, our authorization in this order for a memorandum account for unanticipated repair costs may accomplish much the same objective as the Association's cost-of-service concept.<sup>34</sup>

#### 17.2 Encouraging Acquisition of Small Companies

The Commission in 1979 adopted a policy encouraging the acquisition of troubled small water companies by healthy larger companies or by public water utilities. (Resolution M-4708.) Since then, there have been more than 100 such transfers and mergers, and the number of small water utilities under the Commission's jurisdiction has been reduced from about 323 to about 223. (Ex. 1, p. 13.)

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<sup>34</sup> In cross-examination, the Association's witness testified as follows:

"Q. Isn't it true that the greatest problem for small utility companies arises out of unanticipated expenses?

"A. Yes.

"Q. Then wouldn't it also be true that if a mechanism were developed to address that problem, you wouldn't need your balancing account [method]?

"A. I can't answer that." (Tr. 795-96.)

Toro and the Association urge that more be done. The Association proposes a policy in which, in most cases, an acquiring company would be permitted to use the higher of rate base or purchase price in future ratemaking cases. (Ex. 12, App. 1.) Toro attacks what it believes to be a recent position of Branch and of the Commission to always use the lower of book value or purchase price in acquisitions, thus discouraging companies like Toro from seeking to buy smaller water systems. Toro would in virtually all cases permit the acquiring utility to earn a return on the depreciated original cost of the acquired system.

The evidence before us suggests that acquisitions of small water companies by private and public entities continues to take place, and Branch's witness testified that proposed acquisitions like those of Toro are evaluated on a case-by-case basis. The proponents of a change in policy have not rebutted this showing, nor have they presented evidence that the changes they propose would result in increased takeovers that are in the public interest. In the absence of such evidence, we decline to adopt changes in the Commission's policy on acquisitions of small water utilities. (See Resolutions M-4708, W-3285.)

18. Comments on ALJ's Proposed Decision

In accordance with PU Code Section 311 and Rule 77.1 of the Rules of Practice and Procedure, the draft decision prepared by the assigned ALJ was issued on January 22, 1992. Timely comments were filed by the Association, by Toro and by Branch.

The Association and Toro note wording that inadvertently could have restricted Class D and Class C utilities from filing for an annual CPI increase. We adopt the substitute wording submitted by the Association to make it clear that a CPI filing may take place in a year when a small water company is not subject to a test year or attrition year increase.

Branch proposes that Class D and Class C water utilities be permitted to establish memorandum accounts for extraordinary repair costs upon written notice to Branch, with an

advice letter filing required only when the utility seeks recovery of such costs. That change also has been made in the final order.

Branch also argues that the evidence shows that at least some small utilities would benefit from an alternative operating ratio method of calculating rates, and it argues that this alternative will not delay rate cases. On consideration of the record as a whole, we agree, and our order authorizes this alternative for Class C and Class D companies.

None of the parties has other comments of significance, other than to repeat arguments made earlier. Branch fails to set forth findings of fact and conclusions of law to support proposed changes, as required by Rule 77.4, and, therefore, most of its comments are disregarded. The Association urges that we defer workshop consideration of low-interest loans and a pilot test of its cost-of-service regulation. While we decline to further limit the subject matter of the workshops, parties may propose or agree to defer or otherwise deal with particular issues.

#### Findings of Fact

1. There are approximately 200 small investor-owned utilities in California that are regulated by the Commission.

2. In a report prepared in April 1990, CACD concluded that most small water utilities have few resources, stagnant or declining customer growth, and little or no capital.

3. As of April 1990, half of the small water companies surveyed by CACD needed large plant improvements, such as wells, water storage tanks, chlorinators and other capital equipment.

4. Branch as part of this investigation surveyed 58 randomly selected water utilities, including 3 Class A utilities, 1 Class B utility, 15 Class C utilities, and 39 Class D utilities.

5. Branch's survey concludes that Class D utilities (those with fewer than 500 connections) are approximately 10 times more likely to fail than are larger utilities, and that



Class C utilities (500 to 2,000 connections) are approximately 1.3 times more risky than larger utilities.

6. On the average, Class D water utilities wait eight years and Class C companies wait six years before seeking general rate cases before the Commission.

7. Branch's survey shows that rate of customer growth of Class A water companies is 6 to 18 times greater than that of Class C and Class D companies.

8. Small water companies generally have a small rate base, because plant has been financed by developer contributions or has been depreciated.

9. For small water utilities with a small rate base, the risk is in operating expenses rather than cost of capital.

10. Water utilities now are permitted to recover up to 50% of fixed costs in their service charges.

11. Class D utilities are characterized by high operating expenses per customer, in contrast to larger companies, because of diseconomies of small scale.

12. Small water companies often serve isolated rural areas, and owners usually know everyone in the community.

13. Since 1981, Class D companies surveyed by the California Water Association failed to earn authorized rate of return 89% of the time.

14. Since 1981, Class C companies surveyed by the Association failed to earn authorized rate of return 95% of the time.

15. Average rate of return for 1990 for Class D companies surveyed by the Association was -1.6%.

16. Average rate of return for 1990 for Class C companies surveyed by the Association was 1.53% for those with fewer than 1,000 connections and 4.28% for those with 1,000 to 2,000 connections.

17. Owners of small water companies criticize the current regulatory system as too complex and too time-consuming.

18. Owners of small water companies believe that the current regulatory system does not allow recovery of the true costs of running a small utility.

19. 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.

20. Most water companies will face increased operating costs and significantly increased capital costs in complying with new federal and state regulations on water quality.

21. Water utilities with more than 500 connections will pay a one-time fee ranging from \$1,275 to \$6,375 to cover the cost of a state-wide Water Quality Control Plan, pursuant to the California Safe Drinking Water Act of 1989.

22. The Federal Safe Drinking Water Act amendments of 1986 (Public Law 99-339) require increased testing and increased costs of tests for large and small water utilities.

23. The EPA's new "surface water treatment rule," effective in 1993, may require a utility to construct a water treatment filtration facility at a cost of more than \$250,000 if it uses non-filtered surface water.

24. Capital costs of approximately \$172,000 are anticipated for well-head treatment for organic chemicals like DBCP and TCE.

25. As skill and license requirements rise in connection with new water quality regulations, the salary costs of trained personnel also will increase.

26. Total costs of new DHS contaminant level regulations in California are estimated at \$51 million in capital expenses and \$3 million annually in operating and maintenance expenses.

27. Total costs of complying with new state surface water treatment regulations in California are estimated at \$449 million in capital expenses and \$47 million annually in maintenance expenses.

28. The EPA estimates that there will be an aggregate cost nationally of \$15 billion to comply with new Safe Drinking Water Act amendments.

29. A modified Capital Asset Pricing Model devised by Branch yields a premium on rate of return to reflect increased risk. The premium for Class C is 1.288 and the premium for Class D is 9.1.

30. Lack of a process to appeal Branch recommendations is perceived by owners of small water companies as a reason for not appearing before the Commission.

31. There are at most three Class B water companies excluded from the advice letter rate filing procedure because of revenues in excess of \$750,000.

32. Determining management salary and payroll costs to include in rates can be the most time-consuming part of rate review because there are few direct pay comparisons in an area served by a utility.

33. New or expanded facilities and costs necessary to meet water quality standards mandated by the EPA and the DHS may double the cost of water provided by small water companies.

34. Small water companies often are unable to borrow from banks because of a history of inadequate earnings.

35. The operating ratio method of ratemaking calculates a margin over expenses, rather than focusing on return on net investment.

36. The operating ratio method of ratemaking would produce a higher rate of return than cost-of-service regulation in only about 20% of small water companies.

#### Conclusions of Law

1. As a group, the approximately 200 investor-owned small water utilities in California face a growing economic crisis that threatens their ability to deliver clean, safe drinking water to their customers.

2. Traditional ratemaking policies that are satisfactory for large water utilities are only sporadically successful for Class C and Class D water utilities.

3. A majority of Class C and Class D water utilities wait six to eight years to file for regulatory review and rate adjustment because they regard the ratemaking process as too complicated and too time-consuming.

4. The Commission should permit Class C and Class D water utilities that are not now earning authorized rate of return and are not now subject to test year or attrition year increases to file by advice letter for a step increase based on the most recent Consumer Price Index.

5. All Class C and Class D water companies should be authorized to establish memorandum accounts to track unanticipated costs of repairs necessary for a utility's service to customers, and to file from time to time for recovery of such costs following reasonableness review.

6. A generic rate of return reflecting Branch's assessment of risk should be established for Class C and Class D water utilities.

7. The generic rate of return should range between 13.9% and 14.4% for Class D water utilities and between 11.6% and 12.1% for Class C water utilities.

8. Class D water utilities should be permitted to recover up to 100% of fixed costs in the service charge portion of their rate design.

9. Class C water utilities should be permitted to recover up to 65% of fixed costs in the service charge portion of their rate design.

10. The Commission should authorize an appeal procedure by which Class B, Class C and Class D water utilities may appear before an administrative law judge to review disputes with the Commission's staff.

11. General Order 96-A should be amended to permit advice letter rate filings by all Class B water utilities, as well as

Class C and D water utilities, regardless of projected annual earnings.

12. Branch should be directed, at workshop, to develop standard guidelines for determining salary and payroll costs for Class C and Class D water companies.

13. Branch should be directed, at workshop, to develop a simplified information request form for Class C and Class D water companies for advice letter rate filings.

14. Branch should be directed, at workshop, to develop a procedure and form to be used by small water companies to assess a facilities fee for new connections, where warranted.

15. Branch should be directed, at workshop, to develop recommendations to encourage availability of low-interest long-term loans for capital expenditures by small water utilities.

16. Branch should be directed, at workshop, to develop recommendations for simplifying the 21-page data request form that small water companies are required to complete in seeking advice letter rate review.

17. Branch should be directed, at workshop, to invite the California Water Association to conduct a pilot project to further assess the Association's cost-of-service ratemaking proposal.

18. A second round of evidentiary hearings should be scheduled, if necessary, to take evidence on any disputed matters growing out of the industry workshop ordered in this decision.

19. The Commission should adopt the Association's cost-of-service ratemaking proposal.

20. The Commission should adopt Branch's proposal for an operating ratio method of ratemaking as an alternative to return on rate base.

21. The Commission should decline at this time to establish additional incentives for the acquisition of small water utilities by larger companies or by public entities.

INTERIM ORDER

IT IS ORDERED that:

1. A Class C or Class D water utility that is not now earning the rate of return authorized in its most recent rate case and is not now subject to test year, attrition year or other general rate increase is authorized to file once each year by advice letter for a rate increase based on the most recent year-end increase in the Consumer Price Index for All Urban Consumers (CPI-U) announced by the Bureau of Labor Statistics of the U.S. Department of Labor. No CPI-U increase will be granted if projected revenues from the increase exceeds the rate of return authorized in a utility's most recent rate case.

2. A Class C or a Class 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 either in rates or in a one-year surcharge 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.

3. The rate of return recommended by the Commission Advisory and Compliance Division (CACD) for Class D water utilities is increased from a range of between 10.5% and 11% to a range of between 13.9% and 14.4%. Rate of return may be set at a level above or below this range if facts so warrant in a particular rate case.

4. The rate of return recommended by the CACD for Class C water utilities is increased from a range of between 10.5% and 11% to a range of between 11.6% and 12.1%. Rate of return may be

set at a level above or below this range if facts so warrant in a particular rate case.

5. CACD will prepare a memorandum for the Commission on or before April 1 of each year, beginning in 1993, recommending appropriate adjustments to the range of reasonable returns for Class C and Class D water utilities. CACD will consider changes in financial markets and substantial changes in operational risks by Class C and Class D water utilities.

6. Class D water utilities are authorized to file to recover up to 100% of fixed costs in the service charge portion of their rate design. Class C water utilities are authorized to file to recover up to 65% of fixed costs in the service charge portion of their rate design. Fixed costs include maintenance expenses; transmission and distribution expenses; customer account expenses, excluding uncollectibles; administration and general expense; rent expense; depreciation expense; property tax expense, and gross return on investment.

7. Class B, Class C, and Class D water utilities are authorized to file for informal hearing before an Administrative Law Judge (ALJ) to resolve any dispute that may arise in consideration by Branch of a utility's advice letter filing for rate case review. A utility may request such appeal by serving written notice on the Chief, Water Utilities Branch, (1) stating that the utility has exhausted its administrative appeals to the Chief, Water Utilities Branch, and to the Assistant Director, CACD, and (2) setting forth briefly the nature of the dispute. Within 20 days of receipt, Branch will forward the notice, along with a written response, to the Administrative Law Judge Division, with a copy to the utility. An assigned ALJ will promptly schedule an informal hearing, without reporter, to hear the appeal request. Evidence will be taken under oath, and no attorney at law shall represent any party other than himself. Within 30 days of hearing, the ALJ shall issue a brief recommended decision, which need not contain findings of fact or conclusions of law, and Branch shall incorporate that recommended

decision in the advice letter rate resolution that is prepared for consideration by the Commission.

8. Branch is directed to calculate rates using both return-on-ratebase and operating ratio methods of ratemaking for Class C and Class D water companies requesting new rates and to recommend to the Commission that rate method that produces the higher result.

9. General Order 96-A shall be amended to permit advice letter rate filings by all Class B water utilities, as well as by Class C and Class D water utilities, regardless of projected annual earnings. General Order 96-A, Section VI., third paragraph, is amended to add an additional sentence as follows:

Any utility or district of a utility may request authority for a general rate increase by an advice letter filing if the projected annual operating revenues, including the requested increase, are no greater than \$750,000. This revenue limitation does not apply to Class B, Class C, or Class D water utilities. This revenue limitation does not apply to the exchange telephone utilities.

10. Branch is directed within 75 days of the effective date of this order to conduct a one-day or two-day Small Water Utilities Workshop on the subjects set forth below and, within 90 days of the effective date of this order, issue a written report on results of the workshop to be distributed to all parties and to the assigned ALJ. Workshop topics are:

- (a) Develop a recommended procedure by which water utilities with fewer than 2,000 service connections may file for assessment for a facilities fee for new connections in compliance with Decision 91-04-068.
- (b) Develop a recommended guide for determining reasonable amounts of salary and payroll for Class C and Class D water utilities.
- (c) Develop recommendations for the Commission to follow to encourage low-interest long-term loans for small water utilities faced with constructing or renovating facilities to comply with new federal and state water quality standards.
- (d) Develop recommendations for revising and simplifying the 21-page data request form that small water



utilities are required to complete in seeking advice letter rate review.

- (e) Consider and report on any recommendation by the California Water Association (the Association) or other parties to conduct a pilot project with respect to the Association's cost-of-service form of ratemaking for Class C and Class D water utilities.

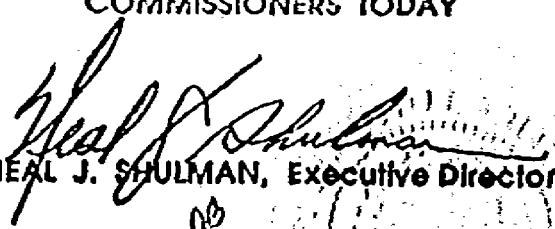
11. The assigned ALJ shall schedule and conduct a hearing within 45 days of receipt of Branch's written report on the Small Water Utility Workshop to receive evidence on the workshop topics set forth above and to prepare a proposed order for consideration by the Commission.

This order becomes effective 30 days from today.

Dated March 31, 1992, at San Francisco, California.

DANIEL Wm. FESSLER  
President  
JOHN B. OHANIAN  
PATRICIA M. ECKERT  
NORMAN D. SHUMWAY  
Commissioners

I CERTIFY THAT THIS DECISION  
WAS APPROVED BY THE ABOVE  
COMMISSIONERS TODAY

  
NEAL J. SHULMAN, Executive Director

APPENDIX A

List of Appearances

Respondents: Martin Abramson, for Park Water Company; Phil E. Guidotti, for Armstrong Valley Water Company and Rancho Del Paradiso Water Company; Earl Marr, for Madden Creek Water Company; Fred R. Meyers, for San Jose Water Company; Daniel D. Rogina, for Rogina Water Company, Inc.; Charles K. Smith, for Sierra City Water Works, Inc.; and John J. Gibbons and R. T. Adcock, for Toro Water Service, Incorporated.

Interested Parties: Michael D. Moynahan, for Metropolitan Water District; Messrs. Nossaman, Guthner, Knox & Elliott, by William T. Bagley, Jose E. Guzman Jr., Attorneys at Law, and Juan Cornejo, for California Water Association; Matthew T. Nussbaum, for Spectrum Economics; and Reed V. Schmidt, for Bartle Wells Associates.

Water Utilities Branch and Division of Ratepayer Advocates: Izetta Jackson, Attorney at Law, Robert E. Penny, Terry Mowrey, and William Thompson.

Commission Advisory and Compliance Division: Cherrie Conner.

(END OF APPENDIX A)