

Decision 98-05-057 May 21, 1998



**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

In the Matter of the Investigation and Suspension  
on the Commission's Own Motion of Tariff Filed  
by Advice Letter Nos. 287 and 287-A of San Jose  
Water Company in Santa Clara County.

(I&S)  
Case 97-08-004  
(Filed August 1, 1997)

Robert A. Loehr, Attorney at Law, for San Jose Water Company,  
respondent.

Jeffrey P. Gray, Attorney at Law, for Garcia Development Company,  
protestant.

**O P I N I O N**

**Summary**

San Jose Water Company's (San Jose) proposed raw water tariff is found to be reasonable and not unlawful. Advice Letters (ALs) 287 and 287-A are accepted as filed.

**Procedural Background**

On June 18, 1997, San Jose filed AL 287 seeking to establish a new tariff, Schedule RW, under which it would provide raw water service within its service area. On July 11, 1997, the Commission received a protest on behalf of Garcia Development Company (Garcia), followed on July 15, 1997 by San Jose's response. On July 16, 1997, San Jose filed Supplemental AL 287-A requesting to extend the tariff's effective date to August 4, 1997 to allow time for the parties to reach agreement. On August 1, 1997, the Commission issued its Order of Investigation and Suspension (I&S), Case 97-08-004, suspending the AL 287 and AL 287-A tariff sheets until further Commission order, and directing the Small

Water Branch to conduct an informal meeting with Garcia and San Jose to attempt to resolve the issues raised by Garcia's protest. Should the issues not be resolved, the I&S ordered the matter go to hearing.

By letter dated September 23, 1997, and distributed to San Jose and counsel for Garcia, the Water Division's project manager informed the assigned Administrative Law Judge (ALJ) that the meeting had been conducted as ordered, and that the participants had agreed on a course of action aimed at resolving the issues. Given the proposed time line, it appeared very unlikely that they would complete the process within the initial 120-day limit imposed by Public Utilities Code § 455, so the Commission by Decision (D.) 97-11-063 extended the suspension by three months, until March 2, 1998. On December 18, 1997, the Water Division informed the ALJ that the parties had reached impasse, and recommended the matter be set for hearing. A prehearing conference was held on January 12, 1998. On February 19, 1998, the Commission by D.98-02-101 extended the suspension for an additional three months, to June 2, 1998, the maximum permitted under § 455. An evidentiary hearing was held on February 23, 1998, and the proceeding was submitted upon the receipt of briefs due March 25, 1998.

**San Jose's AL 287 and AL 287-A**

AL 287 proposes the addition of a new tariff under which San Jose would provide raw water service within its service area. Raw water is water in its natural state prior to any treatment, as opposed to the potable water service which San Jose currently provides to its other customers. In AL 287, San Jose states that it is establishing raw water service because "some customers in San Jose's service area may want untreated water for agricultural and/or other irrigation purposes." Under Schedule RW, customers must provide and/or contribute all facilities needed to transport water from its source to their point of

service, and San Jose is obligated to provide only such raw water at such pressures as may be available from Santa Clara Valley Water District (SCVWD), San Jose's wholesale supplier. Customers whose usage qualifies for SCVWD's \$196.46 per acre foot (AF) agricultural discount would have it passed through to them as periodic refunds. San Jose proposes meter charges identical to those in effect for potable service at the time the AL was filed, ranging up to \$690 per month for a 10-inch meter, and a quantity charge of \$487.09 per AF.<sup>1</sup>

Supplemental AL 287-A did nothing more than extend the tariff's effective date to August 4, 1997.

### **The Garcia Protest**

According to testimony presented at the evidentiary hearing, Garcia was created in the mid-1970's to develop and build residential and commercial real estate projects. Between 1978 and 1980 it acquired Boulder Ridge, 200 acres located in the Santa Teresa Foothills east of Almaden Expressway in the City of San Jose (City), Santa Clara County. Garcia's original intent was to develop and build custom homes on the property, and that matured in the late 1980's into a plan to build a golf course, conference facilities, a hotel and custom homes, and finally into today's plan to build only a stand-alone golf course. Garcia intends to break ground on the project in the Spring of 1998.

At some point in the 1980's, SCVWD constructed its Almaden Valley Pipeline across or adjacent to Boulder Ridge to transport raw, untreated water between San Luis Reservoir and SCVWD's La Rinconada Treatment Plant in Los Gatos. Where Garcia would need potable water at Boulder Ridge, it would

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<sup>1</sup> All rates are cited at the June 17, 1997, level unless otherwise noted. Quantity and service charge rates for current services have been revised for attrition since that time, but AL 287 does not propose similar adjustments in raw water rates.

purchase it from San Jose. Rather than use San Jose's potable water for golf course irrigation, however, Garcia's hope was to take raw water directly from the pipeline under pressure, paying SCVWD its very much lower wholesale raw water rate.

In 1995, Garcia did enter into an agreement with SCVWD under which Garcia at its own expense installed a pipeline turnout, a meter, and related facilities and took irrigation water for growing peppers on a portion of the property. When San Jose raised service territory issues with SCVWD, SCVWD notified Garcia that it intended to revoke its agreement, leaving Garcia to deal with San Jose as the exclusive certificated retail water purveyor for the area. In subsequent negotiations, San Jose apparently stood by proposed rates that were essentially those it now proposes to establish under AL 287 and AL 287-A. Garcia's protest asks that AL 287 and AL 287-A be rejected, and a raw water rate be established that would charge Garcia the same quantity rate as San Jose pays to SCVWD.

#### **Discussion**

San Jose proposes raw water tariff rates consisting of the same service charges by meter size found in its potable, recycled and resale water tariffs, and a quantity rate set at its \$557.09 per AF potable rate less the \$70 per AF treated water surcharge added to potable deliveries from SCVWD, or \$487.09 per AF. It bases its pricing method on obtaining the same contribution to margin from raw water customers as from potable customers so that if any current potable customers should switch to raw water, their contribution to the costs of running San Jose's system, and thus the rates charged to the remaining potable customers, would be unaffected.

Garcia, on the other hand, maintains that as a new customer to San Jose's system, its taking water at a quantity rate passed through from SCVWD would

not burden other customers in the same way that a current potable water customer who switches to raw water might. It maintains that San Jose's service charges (ranging up to \$690 per month for the largest, 10-inch meter size Garcia uses) cover San Jose's fixed costs of service to Garcia and a positive contribution to margin. Garcia would set the quantity rate at the same \$240 per AF San Jose pays SCVWD.

Garcia also suggests that the Commission may want to consider establishing rates that differentiate between new customers and switching customers. Applicants for raw water service who had not previously taken potable service would presumably be eligible to take raw water at San Jose's cost plus the service charge. In effect, they would enjoy a quantity charge of about half what San Jose proposes in AL 287 and AL 287-A which in turn is already \$70 per AF lower than the potable charges today's customers are paying.

We accept the position of both sides that raw water customers should pay a lower quantity rate than potable water customers. The special conditions in San Jose's proposed tariff require that "The customer must provide and/or contribute all facilities needed to transport the water from its source to the customer's point of service," and "The utility will supply at the point of connection only such raw water at such pressures as may be available from time to time from [SCVWD]." In short, San Jose need neither construct nor maintain facilities, nor treat, pressurize or deliver water. SCVWD makes available its existing pipeline, customers construct, operate and maintain almost everything needed, and San Jose reads the meters and bills. Raw water customers do cost less to serve.

San Jose is also correct that if current customers were to switch freely from the potable tariff to a raw water tariff with a quantity rate set at SCVWD's wholesale rate to San Jose, it would exert upward pressure on rates for the

remaining potable customers. San Jose's system has grown to what it is today with the plant needs of all of its customers taken into account. Water sources, storage, pumping, treatment facilities, transmission and distribution mains, all contain some increment of cost, albeit unquantifiable, that might not have been there but for today's customers' needs. To allow some by switching from one tariff to another to abandon to others the obligation of supporting fixed costs which were in part attributable to them would not be just to those who remain.

The record reflects that neither San Jose nor Garcia has done a study to determine how many of today's potable customers might potentially switch to raw water if it were to become tariffed. There was some indication through a San Jose data response read into testimony by a Garcia witness that San Jose had identified as an example of the potential for switches, forty-two City potable services along a park located near a raw water line. It was also made clear, however, that for some customers it would not be a simple matter to convert an existing potable system to raw water. Conversion can be very expensive because of the requirement to differentiate between installed raw and potable water systems.

Garcia argues that there are likely no current customers for whom the economics of switching make sense, thus no current contribution to margin would be lost if raw water were provided at SCVWD's wholesale rate passed through by San Jose. That is apparently based in part on an assumption that all potential raw water customers share cost and usage characteristics that are at best similar to golf courses, i.e., very large investments in extensive distribution facilities on the customer's premises. But Garcia's witness also testified that its agricultural raw water use at Boulder Ridge before SCVWD terminated service had entailed about \$15,000 to \$20,000 in investment, in contrast to the \$1,200,000 that it would cost to build a raw water irrigation system for the golf course.

Future agricultural raw water users would pay about \$291 per AF at San Jose's proposed tariff rate, or \$44 per AF at Garcia's. Garcia's witness also opined that parks use less water than golf courses, with the implication that the City's forty-two park services would not be able to justify a switch to raw water. There was no indication whether there might be others with different usage characteristics, e.g., agricultural, industrial or commercial customers with high volume and/or point-use needs, located within economic reach of current or planned raw water facilities in San Jose's territory.

Even Garcia's witness stated in his Exhibit 3 direct testimony:

"Moreover, it is simply impossible for the Commission to tell, at this point in time, if any other potable water customer will take service under AL 287, what the impact on rates will be (large or small) or whether growth in potable water sales will offset any lost [contribution to margin] due to customer switching which could eliminate the need to increase rates."

All of this leaves unsettled the questions of whether Garcia's cost characteristics are truly representative of those of all other potential raw water users, and how likely it is that current potable customers might switch to raw water.

In any case, San Jose does not propose Schedule RW as a Garcia-specific tariff. It would be a generic tariff applicable to all future raw water customers, even though its filing may have been precipitated by Garcia's situation. Lacking a thorough study to determine how many of today's potable customers might potentially switch to raw water if it were to become tariffed, it would be prudent to err on the side of caution. Since San Jose's potable system was built based on the needs of current and future customers, the raw water rate we authorize must be one that protects remaining customers from unjustly absorbing the fixed costs left behind should potable customers switch to raw water service. The questions

then become what specific rates are appropriate for such a generic tariff, and whether we should differentiate between established and new customers.

San Jose points to recycled water pricing in support of the reasonability of its raw water price compared to Garcia's, citing California Water Code § 13510 et seq. which declares as state policy to encourage development and use of recycled water as a "new basic water supply." San Jose argues that pricing raw water, which is not a new basic water supply, below recycled water would make raw water the favored product for any consumer who had a choice between the two, thus tending to defeat the intent of state policy. Garcia would price raw water at \$240 per AF. Under AL 287 and AL 287-A, the prices for recycled, raw and potable water would be \$430, \$487 and \$557 respectively for irrigation users. San Jose has used the same pricing method for raw water as it maintains the Commission has approved for its recycled water tariff, i.e., for both it subtracted from its potable rate SCVWD's \$70 treatment surcharge and, for recycled water, the City's South Bay Water Recycling Program (SBWRP) incentive.

Garcia objects that the Commission has never approved San Jose's recycled tariff, that it became effective automatically in the absence of protest without Commission scrutiny. And it observes that the precise recycled rate cannot be determined from the tariff but depends on the untariffed SBWRP discount the City offers at any given time, making it difficult to establish the sort of parity that San Jose suggests. Garcia further counters in brief that allowing recycled rates to set a floor for raw water rates is akin to asking raw water users to subsidize the City's recycled water program.

Garcia is correct in its first point, San Jose's recycled water tariff did become effective automatically. And it is also true that the precise recycled rate cannot be determined from the tariffs alone. But San Jose is also correct here in that its method and the tariff would assure that raw water for non-agricultural



use cannot be priced below recycled. For irrigation customers, the price would currently fall about midway between recycled and potable as noted above. We reject Garcia's argument that considering the relationship between recycled and raw water rates amounts to subsidization of the City's recycling program. As will become apparent, we intend to examine San Jose's proposed raw water quantity price independently of recycled water and only then make the comparison. A raw water price which fell below that for recycled would give us pause for precisely the reason San Jose suggests.

Garcia's argument for a pass-through quantity rate is based in large part on its witness' conclusion that the \$690 monthly service charge more than covers all of San Jose's costs of serving Boulder Ridge except purchased water. The witness summarized those costs as the monthly meter and turnout maintenance costs and the cost of customer accounting and billing, which he estimated at not exceeding \$150 per month in total. In his view, the remainder of the \$690 per month would be available to cover fixed costs. Neither Garcia nor San Jose attempted further to quantify a generic raw water customer's portion of overheads shared among all customer classes. We note that in San Jose's last general rate case, administrative and general expenses came to \$38 per AF of sales for 1997, or about \$875 per month at Garcia's projected usage of 276 AF per year. Thus Garcia's share of administrative and general expenses alone would far exceed its claimed contribution to margin.

San Jose's proposed raw water quantity charge is its tariff price for potable water (\$557.09 per AF) less the treated water surcharge added to potable water deliveries from SCVWD (\$70 per AF), for a total proposed raw water price of \$487.09 per AF. "Since the proposed raw water discount reflects the differential in the cost of service between potable water service and raw water service, any existing potable customer of San Jose who may convert from a potable service to

a raw water service will continue to contribute the same margin to San Jose, thereby imposing no adverse effects on San Jose's other customers."

SCVWD's \$70 per AF surcharge is not the actual difference in San Jose's variable costs for serving raw versus potable customers. In fact, less than half of San Jose's water is purchased from SCVWD; the remainder comes from wells and surface water sources. And there are very significant variable pump taxes, pumping power costs, and chemical and testing costs that don't apply to raw water customers. Seventy dollars per AF is simply a proxy for all of the variable cost differences in the aggregate.

At the prehearing conference, the ALJ directed San Jose to prepare and sponsor an exhibit extending its pricing exercise to listing and quantifying significant cost differences in serving raw water under the conditions of the proposed tariff versus the average cost of serving water to its potable water customers. San Jose's response was included in Exhibit 1.

San Jose's Exhibit 1 calculation of what cost savings should and should not be reflected in a raw water tariff in order to preserve contribution to margin was problematic. For example, on the variable costs side, potable to raw water switchers were appropriately relieved of the costs of system average water quality, water treatment, and treatment plant power costs. These are indeed costs that would disappear with the switch to raw water and thus not have to be assumed by the remaining potable customers. Switchers were not, however, relieved of system average well pumping power costs, and San Jose used a speculative and arbitrary figure for possible future pressure boosting power costs. On the facilities side, switchers were relieved of depreciation expense on the treatment plant they would leave behind, but not of the return on it, nor of depreciation or return on the remainder of San Jose's very extensive potable system plant investment which they would also leave behind. The distinction is

puzzling and inappropriate here. None of these fixed facilities costs would disappear as present potable customers switched to raw water, so all would have to be picked up by those who remain behind. San Jose's witness took a micro-approach that appears arbitrary in what costs it included and did not.

We will take a macro-approach based on the figures in San Jose's last general rate case. First, neither party suggested using other than San Jose's current potable service charge structure. If for no other reasons than consistency with potable, recycled and resale service, and the fact that it makes the remaining calculations far more straightforward, we accept that as a reasonable approach. Next, we determine how much of San Jose's fixed costs are recovered in the potable service charges, knowing that switchers would continue to contribute the same amounts through their unchanged raw water service charges. The remainder of San Jose's fixed costs per AF of potable sales, and all of raw water customers' variable costs, must be captured in the raw water quantity rate. These figures are available from D.96-07-036 in San Jose's last general rate case. In distinguishing between "fixed costs" and "variable costs," it is appropriate to use the definition the Commission established in D.86-05-064 in connection with its investigation into water rate design policy.

Using this method shows that San Jose's service charges produce revenue to offset about 47% of its fixed costs. The remaining fixed costs to be recovered in the potable and raw water quantity rates amount to \$189 per AF. Raw water service's variable cost is SCVWD's \$240 per AF charge plus the remaining variable costs as defined in D.86-05-064 of about \$43 per AF. Thus the total raw water quantity charge to maintain contribution to margin would be about \$472 per AF.

Alternatively, one could begin with San Jose's potable price (\$557 per AF), subtract out all potable water variable costs (\$370 per AF), and add back the

variable costs associated with raw water service (\$283 per AF). The result is similar, \$470 per AF.

These results are close to the \$487 per AF quantity rate San Jose proposes. As noted earlier, all of San Jose's calculations were based on 1997 figures, as are these. The rates in proposed Schedule RW are not subject to attrition during San Jose's current rate case cycle. Since San Jose's potable service charges and quantity charges have both undergone attrition increases since mid-1997, our results would have been higher had we used adopted 1998 figures. Thus San Jose's service charges, its \$487 per AF proposed raw water rate, and its use of \$70 per AF as a proxy for the variable cost differences between potable service and raw service, survive our reasonability test.

Garcia has also suggested we consider whether to distinguish in the tariff between raw water customers who have switched from potable service and those who are new to San Jose's system.

Differing rates for the same service are potentially discriminatory. We could achieve the same end by requiring current potable users who desire to take raw water to pay a potable system exit fee to buy their way out of the common facilities that were constructed based in part on their needs. In effect, it would be a transition charge credited to current potable customers' rates to make them whole for the loss of switchers' ongoing contributions to the potable system's fixed costs. That's unattractive for a number of reasons. Today's potable users who would switch were never made aware that they might some day become liable for what amounts to a disconnection fee to move off of the potable system. There is no such transition charge for potential recycled water customers, nor for high volume potable customers who simply drop their service or drastically lower their consumption.

And distinguishing between a new customer and one already on the system may not be as simple as might at first be assumed. What of a customer who disconnects, then seeks to reconnect later? It is not even clear in the record whether Garcia is today or has ever been a San Jose potable water customer for limited quantities at Boulder Ridge. One of Garcia's witnesses stated in prepared testimony that Garcia is not and has never been a San Jose potable customer, then testified on cross-examination that it is currently. Garcia's other witness testified that it is not. San Jose refers in brief to an existing Garcia potable service connection, but does not state whether it is currently active. Attempting to apply lower rates for the same service to new raw water customers than to those currently taking potable service poses too many concerns given the potential for discrimination.

The result we arrive at independently here is consistent with our conclusion when we examined essentially this same issue before, but for reclaimed water. After suspending and investigating California Water Service Company's (CalWater) proposed Westlake District recycled water tariff, we determined in D.93-06-090 that:

"[I]f we were to treat the reclaimed water service for the Westlake District as a separate and distinct service, the retail reclaimed water rates would be approximately the same as the wholesale reclaimed water rates [that CalWater pays to its supplier]. While this may appear to be a reasonable approach to cost of service based ratemaking, it does not take into consideration that North Ranch, by using reclaimed water, will not be generating its share of potable water revenues which will have to be recovered from other potable water customers. Thus, Westlake District's potable water customers would end up subsidizing North Ranch's reclaimed water service. In addition, North Ranch as a reclaimed water customer would benefit from fire protection provided by the potable water system."

And Conclusion of Law #3:

"CalWater's rates for reclaimed water should be the same as its rates for potable water except for a differential in quantity rates. The difference between CalWater's quantity rates for potable water and reclaimed water should be based on the rate difference between the wholesale rates for potable water and the wholesale rates for reclaimed water."

The similarities are striking. As Garcia observes in its brief, there are also some distinctions to be drawn between that proceeding and this one. North Ranch, the protestant in that I&S proceeding, was a potential switcher from potable water service whereas Garcia's position relies heavily on its being a new customer. And the Commission's noting that reclaimed water customers would garner fire protection benefits from the potable system they would not support may or may not apply to Garcia. There is no evidence on the record of Garcia's future fire protection plans, only mention of a brief, temporary arrangement using raw water late last summer *before* development of the golf course and construction of its club house. Fire protection benefits may well be applicable, however, with respect to both current San Jose customers who switch to raw water and others who would be new to the system.

Garcia points to our statement in the CalWater decision that, "...our decision to treat reclaimed water service as part of the total water service for the Westlake District is not to be considered as a precedent for future ratemaking for reclaimed water. As reclaimed water use becomes more prevalent and we gain more experience in establishing the cost of providing reclaimed water service, we may reconsider our ratemaking treatment in future proceedings." Our determination here does not rely on CalWater as a precedent for either reclaimed or raw water pricing. It does, however, note and draw reassurance from having reached the same result independently for some of the same reasons after examining very similar issues in two different proceedings.

The single point that Garcia has pressed most vigorously is that it is not currently a customer and thus would not deprive San Jose of any contribution to margin if it were allowed to enjoy SCVWD's wholesale rate. Nor, Garcia maintains in its brief, is there any likelihood that other, current customers would switch to raw water, even at the lower price it advocates. It is understandable that any new customer would want to take service at the incremental cost to serve it rather than having to pick up a full share of the system's embedded costs and overheads. But once again we come down to the fact that we do not intend this to be a Garcia-specific tariff. In finding San Jose's AL 287 and AL 287-A proposed tariff proper we conform to the longstanding principle of requiring new customers to pick up a full share of the utility's common costs. Garcia would still benefit considerably in taking raw water instead of potable even at San Jose's proposed rates.

#### **Comments**

The Administrative Law Judge's proposed decision was filed and served to the parties of record on April 20, 1998. Garcia submitted timely comments; San Jose did not file comments. We have considered Garcia's comments and are issuing the decision as proposed without changes.

#### **Findings of Fact**

1. San Jose's proposed Schedule RW is a generic raw water tariff intended to be applicable to all, not to Garcia alone.
2. Attempting to apply lower rates for the same service to new raw water customers than to those currently taking potable service poses concerns that make it inadvisable in this instance.
3. The record in this proceeding does not support a finding as to how likely it is that current potable customers might switch to a raw water tariff at either San Jose's or Garcia's proposed rates.

4. Any raw water rates we approve should be at a level at which, if subscribed to by either new or current customers, would not exert upward rate pressures on San Jose's other services.

5. The Commission defined "fixed costs" in D.86-05-064 which adopted the Commission's statewide water rate design policy currently in effect for Class A water utilities. All costs which are not fixed costs are "variable costs."

6. Raw water customers under Schedule RW should bear the variable costs attributable to serving them, plus the same share of fixed costs as customers taking service under San Jose's potable tariffs.

7. San Jose proposes raw water tariff rates consisting of the same service charges by meter size found in its 1997 potable, recycled, and resale water tariffs.

8. Consistent with the Commission's rate design policy for Class A water utilities, San Jose's service charges for potable water, and thus for raw water, cover 50% or less of its fixed costs.

9. The raw water service charges proposed in AL 287 and AL 287-A are just and reasonable.

10. Customers' share of fixed costs not recovered in service charges, plus all of their variable costs, must be recovered in quantity rates.

11. Garcia's proposed quantity rate is less than the variable costs of serving Garcia or other potential raw water customers, and would contribute nothing toward San Jose's remaining fixed costs not recovered in service charges.

12. San Jose has used the \$70 per AF quantity rate difference in the price it pays SCVWD as a proxy for the differential in cost of serving potable versus raw water. This is consistent with a rate design method we have approved previously for reclaimed water rates.

13. San Jose's raw water rate design was based on Commission-adopted results for 1997 in D.96-07-036, its last general rate case.



14. San Jose's proposed raw water quantity rate survives the reasonability test described in the body of this decision. Garcia's proposed quantity rate does not.

15. San Jose's proposed raw water quantity rate appropriately avoids making raw water the favored product for any irrigation customer with a choice between raw and recycled water. Garcia's proposed quantity rate does not.

16. The raw water quantity rates proposed in AL 287 and AL 287-A are just and reasonable.

### **Conclusions of Law**

1. Differing rates for the same service are potentially discriminatory.
2. After a hearing, San Jose's AL 287 and AL 287-A and the tariff sheets filed thereunder have been shown to be just and reasonable and not unlawful.
3. The suspension of AL 287 and AL 287-A should be lifted so as to allow San Jose's proposed Schedule RW to go into effect immediately.

### **O R D E R**

#### **IT IS ORDERED that:**

1. San Jose Water Company's Advice Letters 287 and 287-A are accepted as filed and shall become effective as of the date of this order.

C.97-08-004 ALJ/JCM/wav \*

2. This Investigation and Suspension proceeding is closed.

This order is effective today.

Dated May 21, 1998, at San Francisco, California.

RICHARD A. BILAS

President

P. GREGORY CONLON

JESSIE J. KNIGHT, JR.

HENRY M. DUQUE

JOSIAH L. NEEPER

Commissioners