

WATER/DJE:jrb*

**WATER DIVISION
Water Advisory Branch**

**RESOLUTION NO. W-4165
September 16, 1999**

RESOLUTION

(RES. W-4165), ORDER DENYING TWO WATER UTILITIES' REQUEST TO ESTABLISH A MEMORANDUM ACCOUNTS FOR RECORDING COSTS RESULTING FROM THE MITIGATION EFFORTS IN RESPECT TO THE YEAR 2000 (Y2K) COMPUTER PROBLEMS; BUT ALLOWING A PROCESS TO SEEK RECOVERY PROSPECTIVELY.

SUMMARY

Two Class A water companies have filed Advice Letters requesting memorandum accounts to track costs associated with their efforts to mitigate the Y2K computer problem. One Class B water company sent a letter asking for similar coverage. Other water companies have inquired informally of the Water Division whether the Division would support such memorandum account treatment. This resolution denies regulated water utilities the authority to create memorandum accounts for Y2K expenses and investment. This resolution does allow, after January 1, 2000, the filing for inclusion in ratebase investment associated with Y2K mitigation efforts not otherwise included in existing revenue requirement.

BACKGROUND

The California Public Utilities Commission ("CPUC" or "Commission") has regulatory authority over certain essential telecommunication, energy, transportation, and water services throughout California. Most of these services are inter-related; the water industry relies upon a steady, reliable source of electricity, and in some cases natural gas, to power its pumps to maintain system pressure and supply. The water industry also relies upon the transportation industry to obtain gasoline and diesel fuel for its vehicles and standby generators, and it relies upon the local telephone utilities to provide the necessary phone lines to maintain storage tank levels by signaling when pumps should be turned on and off.

California water utilities, like their energy, telecommunications, and transportation counterparts, have been responsive to the requirements of the Commission's Resolution. M-4792, dated November 19, 1998, which ordered among other things that each utility shall:

- prioritize its Y2K efforts to address safety and reliability of service delivery systems ahead of billing and other administrative systems;
- provide quarterly updates of its responses;
- develop contingency plans to address Y2K problems which may ensue, and report such contingency plans to the Commission not later than July 1, 1999; and
- certify not later than November 1, 1999, that all of its essential service delivery systems are Y2K compliant or Y2K ready.

The water companies for the most part, to date, have complied with the Commission's timetable.

The Commission-regulated water companies which serve about 20% of the water customers in California have been preparing for this event and have expended funds to test and modify their systems and to develop contingency plans in the event of a disruption of water supply. These companies have been providing the Commission with this information and have also been describing the actions in their annual reports to their shareholders.

One Class A shareholders' report notes that in a worst case scenario the company may be unable to deliver water to its customers because wholesale suppliers cannot provide water or power supplies may not be available to operate pumping equipment. This company maintains emergency response plans that are reviewed and updated on a regular basis. Those plans were the basis for developing the Y2K service interruption plans. Fixed site and portable auxiliary power generators are located throughout the service territories. Emergency water connections are maintained between certain company's water systems and those of adjacent purveyors. Each district has identified high-profile water users, such as hospitals and has developed contingency plans for continued service in the event of a service disruption.

Another Class A notes that it has made major upgrades to its computer hardware and software programs. It reported that, to date, there have been no significant costs associated with Y2K readiness that have not been approved by the CPUC for recovery through rates. That company notes that it is significantly dependent upon third party suppliers, such as energy and telecommunications companies and wholesale water suppliers. The company is preparing its contingency plans which will likely include among other things, increased staffing during critical periods, manual

back-up for automated systems and the use of standby generators capable of providing power during a blackout.

A third Class A notes that current Y2K expenses, those related to computer systems and hardware, are not materially different than the usual on-going level of information systems related expenses. Plans are being formulated to minimize the impact outside services may have in providing supplies and services.

Another Class A water company notes that in the worst case scenario, if its main water supplier is unable to provide water to the company, and power supplies are interrupted, and the computer system that controls the water function fails, the company may be able to use its standby generators to pump limited water from its wells to the distribution system.

Filings to the Commission

Citizens Utilities Company (Citizens) by Advice Letter (A.L.) 325-W, filed March 1, 1999, requested that the Commission "approve the recording of costs directly incurred in connection with its Year 2000 (Y2K) readiness and mitigation efforts in a separate memorandum account. Since Citizens has recently received a rate case decision (D. 98-10-056) for test years 1998 and 1999, it is our primary intent to establish a memorandum account to reflect only those Y2K related costs which were not considered or reflected in that proceeding. Due to the nature of the Y2K problem being outside the control of Citizens, we are uncertain of any atypical expenditures that may be incurred in connection with the readiness and mitigation efforts. Citizens believes that the establishment of a memorandum account will afford us a fair opportunity to recover any expenditures of an unforeseen nature that may be incurred.

"Citizens will request rate recovery of the amount recorded in the memorandum account by either a separate application specifically requested for that purpose or in a future rate setting proceeding." There were no protests.

San Jose Water Company (SJWC) by A.L. 312, filed March 16, 1999, requests it be allowed to "record any costs directly incurred in connection with it (sic) Y2K readiness and mitigation efforts in a separate memorandum account". SJWC believes that the establishment of a memorandum account will afford a fair opportunity to recover any expenditures of an unforeseen nature that may be incurred. SJWC last rate case decision (D.96-07-036) did not include any mitigation costs for the Y2K Problem.

"SJWC will request rate recovery of any amounts recorded in the memorandum amount by either a separate application, or in a future rate-setting proceeding." There were no protests.

One Class B water company, Elk Grove Water Works, sent a letter dated February 1, 1999, asking for similar coverage.

What Are Other States Doing?

Because the Y2K problem affects other states' utilities as well, we surveyed them to determine how they are addressing the issue of cost recovery. The National Regulatory Research Institute (NRRI), electronically surveyed the state members of the National Association of Regulatory Utility Commissioners (NARUC). At this time, of the 10 Commissions responding to the NRRI survey, only one, Colorado, for one natural gas company has made provisions for cost recovery of prudent Y2K related expenditures. All the other Commissions who responded to the survey have either received no request for recovery or have denied the requests.

DISCUSSION

Staff reviewed the Class A filings related to the Y2K problem and the companies' own annual reports to their shareholders, and concludes that, for the most part, the companies are well prepared as far as their own operations are concerned. The problem that remains is the reliability of suppliers to these companies whether it be energy, telecommunications or wholesale water providers. Some water companies have expended significant funds, both expense and capital, to get ready, while others are waiting for direction from the Commission.

Is There a Need for a Memorandum Account?

The public's health and welfare is dependent on adequate water supplies for public health reasons as well as for fire protection. Our memories are not too short to recall the Oakland-Berkeley firestorm in 1990 as well as the Loma Prieta and Northridge earthquakes and the reliance upon water to fight the resulting fires.

It is incumbent upon the water utilities to prepare for such disasters, and in most cases it appears that they have, with the increased sizes of water mains and the ability to manually control pumping and storage systems, and with the ability to provide emergency, portable and fixed, electric generators for such occasions. We note that most, if not all, water companies have already included in their 1998 and 1999 operating budgets dollars to address the computer software and hardware problems, have hired consultants to advise them, and have developed contingency plans.

We recognize full well the importance of keeping the water flowing, as well as keeping the other regulated utilities functioning. Water companies, as regulated utilities, are dependent upon other suppliers, such as telephone companies, who already have standby generators to back-up their central offices, energy companies who are dependent upon other energy companies and other water suppliers who are dependent on energy supplies, and etc. But water companies can still supply water even if the others' infrastructure

breaks down. With adequate storage, emergency generator backup and cross connections with other water companies, minimum flows can be maintained.

We think it may be prudent for the water companies to invest in some additional, back-up facilities, over and above those dollars already expensed or capitalized for this purpose, and we recognize that this additional investment and expense will be costly. We also note after a careful reading of their contingency plans filed on or about July 1, 1999, with the Water Division and in response to survey to the American Water Works Association (AWWA) that most of the companies have addressed those additional expenditures, such as purchasing or leasing of additional emergency generators, making provisions for water testing and emergency planning. We will not authorize a memorandum account for this purpose, that is, for expenses, depreciation and return on investment related to addressing the Y2K contingency as it appears that the expenditures, mostly expenses, have already been expended.

We will allow our water companies who can justify "capital expenditures" over and above their 1999 budgeted investment for Y2K compliance, those dollars that would normally be allowed in ratebase and thus earned upon to file by advice letter before March 1, 2000 for "ratebase" offsets. Those companies with general rate cases that included the test year 1999 should be prepared to show that these additional plant additions were not included in the year 1999's revenue requirement. For the other companies it will be necessary to justify the expenditures in their filings. We don't anticipate that the water companies to rush out and over invest or "gold plate" their systems for Y2K emergency preparedness. We expect justification of every capital improvement related to Y2K preparedness, and we will direct our staff to carefully audit these capital investments. We will not allow the companies' ratepayers to fund projects that are not absolutely necessary. With this said, we want to impress upon the water companies that we believe it is not only important, but absolutely essential, to prepare to keep an adequate supply of water flowing.

Memo Account Coverage for Water Utilities Is Not Necessary

A memo account is nothing more than a parking place for "expenses", not investment, that are carried off the various books of account of the companies with the memo accounts. The mere establishment of a memo account does not guarantee recovery of these expenses. The burden of proof is on the company, usually in a general rate case (GRC). The Commission ultimately rules on the reasonableness of these expenses.

Since a memorandum account is expense related only, and since most of Y2K expenses have been spent and since the water companies have detailed their contingency plans for Y2K compliance and mitigation we see no reason for the establishment of the account. The expenses to date are sunk costs, and their recovery would constitute retroactive ratemaking.

Recovery

How do we determine what is reasonable Y2K related investment over and above normal operations? We know that in 1999, some companies booked to their plant account amounts that were in their 1998 construction budget or program, 1999 budgeted additions and some additions from the year 2000 budget. This is normal for the industry, and we know for the larger companies that annual plant investment is fairly predictable and stable over the years. We realize that the reason a company may spend 1999 dollars in 1998 is because one construction job may have to be deferred due to another more important one. We will leave the burden upon the companies to show us, and our staff, who will be responsible for reviewing the Y2K additional expenditures, that these expenditures over and above those dollars already in approved budgets are reasonable.

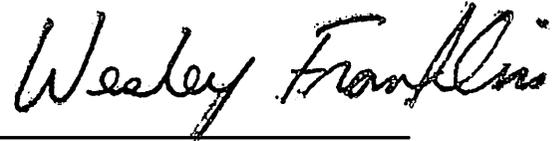
FINDINGS AND CONCLUSIONS

1. There is a possibility of water utility service disruptions unless providers of these services adequately address what has become known as the Year 2000 ("Y2K") issue.
2. Water utilities, more than any other utility, are dependent upon other utilities in order to serve their customers.
3. Most, if not all, major water companies have been addressing the Y2K problem by correcting known problems and developing contingency plans in the event of service disruptions.
4. An adequate supply of water is necessary for health and safety.
5. Most large water companies have included in their operating budgets funds to meet the Y2K problem.
6. California water companies provide service to about 20 percent of the water customers in California.
7. Some companies may need to spend more money than budgeted for Y2K preparation.
8. Two companies have asked for memorandum account treatment for extraordinary costs in preparation for a Y2K event.
9. Water utilities regulated by the Commission should not be authorized the establishment of memorandum accounts in which to record extraordinary expenses and return on capital associated with the Year 2000 issue.
10. Water utilities should be allowed to file for ratebase offsets for those Y2K capital expenditures not already included in rates.

IT IS ORDERED that:

1. The advice letter requests for memorandum accounts for Y2K coverage are denied.
2. Each water utility regulated by the Commission is authorized to file after January 1, 2000, but not later than March 1, 2000, ratebase offsets by advice letter for those Y2K capital expenditure associated with the Y2K problem, not already included in the water utilities rates.

I certify that this resolution was adopted by the Public Utilities Commission at its regular meeting on September 16, 1999. The following Commissioners approved it.



WESLEY M. FRANKLIN
Executive Director

RICHARD A. BILAS
President
HENRY M. DUQUE
JOSIAH L. NEEPER
JOEL Z. HYATT
CARL W. WOOD
Commissioners