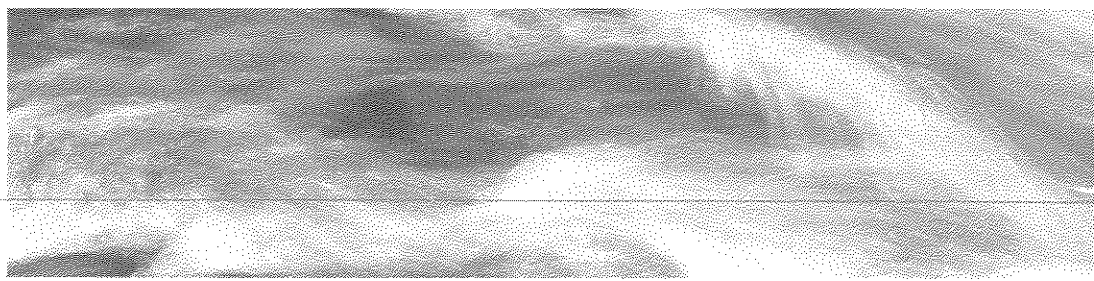




Southwest Water Company
Utility Group



California Public Utilities Commission
Division of Strategic Planning
Attention: Edward Howard
505 Van Ness Avenue
San Francisco, CA 94102

Dear Mr. Howard:

Pursuant to the invitation currently presented on the home page of the California Public Utilities Commission (“CPUC” or “Commission”) at www.cpuc.ca.gov, Suburban Water Systems (“Suburban”) hereby respectfully submits its comments on the Commission’s draft Water Action Plan (“Draft”).

Overall, Suburban supports the intent and direction of the Draft’s objectives in regard to future water regulatory policy. We believe that pursuing those objectives will help align the Commission’s water policies with the state’s water policies, to the benefit of all the customers of California investor-owned water utilities.

Suggested Changes - While in general we agree with the Draft’s objectives, we have serious concerns about many of its action items. Our concerns are so numerous and so grave that we recommend excising the action items totally from the document and changing the title to “Water Action Plan Objectives”. In other words, “call it a day” beginning on page 3 after Water Action Plan Objective 6. Action items should be vetted in proper public forums where more input can be obtained and alternative points of view heard and evaluated.

Water Is Not Energy - Water utilities are fundamentally different from energy utilities. And it is here that the Draft’s “Actions to Support Water Plan Objectives” goes most seriously awry. Unlike energy, water is a local business. Unlike energy, water is ingested. Unlike energy, water utilities are far smaller – California’s largest water utility has less than 9% of the revenue of California’s largest energy utility, and less than 4% of its customers. But like energy, water has very little operating leverage; that is, its cost structure is composed mostly of fixed costs such as depreciation, interest and property taxes. This means that companies far smaller than energy embody similar risks. As an example, Valencia Water Company, California’s eighth largest Commission-regulated water utility, has higher plant investment per customer than either Edison or PG&E.

Our Concerns - We believe that some of the Draft’s action items error badly by failing to recognize the uniqueness of water as compared to energy, failing to recognize water’s comparatively fewer financial resources, and as a result the possibly devastating impact that the revolutionary reforms it is recommending could have on the financial health of the industry.

Following are some of Suburban’s concerns:

- The Draft endorses the concept of increasing block rates, saying “Thus, there is significant opportunity to implement this approach to rate design.” It compares CPUC-regulated utilities to other kinds of water utilities and concludes that while the use of increasing block rates is common, “. . . among CPUC-regulated water utilities, increasing block rates are virtually non-existent.”

The Draft should have explored why increasing block rates are “virtually non-existent” among CPUC-regulated water utilities. The reasons have been well documented: resulting revenue instability and revenue erosion. Putting it simply, conservation rate structures can be effective and sales do decline; that is, customers respond to the price signals they are getting and reduce their usage accordingly, sometimes substantially, but often unpredictably. Unless accurately factored in up front into the rate design, those revenue instabilities can threaten a utility’s viability.

Increasing block rates have an additional serious weakness from the standpoint of rate equity. Larger users typically have the lowest peaking factors, therefore it costs less to serve the larger users per unit of water than other users, all other things being equal. Smaller users tend to have the highest peaking factors. In contrast, increasing block rates typically charge large users more, small users less.

The other challenge increasing block rates introduce is contention in rate cases. Currently, rate design is usually not a significant issue in rate proceedings. But when increasing block rates are introduced, numerous new issues are raised: the spread of usage between the tiers (commonly called breakover points), the rate differences between the tiers, and differences in tariff design by customer class. Attached is an excerpt from a recent Arizona decision where even after substantial agreement on the number of tiers for each of the customer classes, there remained dispute about how the blocks were to be designed and possible discrimination against commercial and industrial customers. With stringent timelines built into California’s new rate case plan, the last thing we need to be doing is creating new areas of contention in rate cases.

It is also curious that the Draft only considers increasing block rates as an action item and not other commonly used rate structures. Some studies suggest that increasing block rates may be less effective than simple uniform rates with excess or seasonal charges.¹

On this same topic, we have a concern about how the Draft proposes to benchmark water’s conservation accomplishments. The Draft would establish an objective that would “Strengthen Water Conservation Programs **to a Level Comparable to those of Energy Utilities**” (emphasis supplied). Strengthening water conservation programs is a worthy objective. However, water and energy are fundamentally different industries and trying to create a “conservation horse race” between the two industries is not wise.

In addition, the Draft should have been more wary about endorsing programs that are in effect anti-conservation oriented. We are referring to bill averaging which the Draft suggests would assist low income ratepayers. Studies have shown that bill averaging increases energy demand,² and the same would probably be true for water.

- The Draft proposes a solution to the aforementioned revenue erosion problem. It suggests a new regulatory tool that is revolutionary for water: a revenue adjustment mechanism. Revenue adjustment mechanisms are touted as reducing utility risk exposure, such as that associated with inverted block rate structures.

While common in energy, revenue adjustment mechanisms designed to decouple sales from earnings are, to our knowledge, virtually unheard of anywhere in the country in the water sector.³ We do not object to considering, after adequate public review, innovative ratemaking methods as a

¹ Jordan, Jeffrey L., Albani, Rick, Using Conservation Rate Structures, Journal AWWA, August 1999.

² Beard, T. Randolph, Gropper, Daniel M., Raymond, Jennie E., Bill Averaging Programs and Consumer Behavior: Theory and Evidence, Journal of Regulatory Economics, 13:19-35 (1998)

³ Mention is often made of a supposed WRAM authorized for California-American Water Company, D.96-12-005. However, the recovery mechanism authorized in that decision was not intended to decouple revenue from sales as is proposed in the Draft. Rather, the WRAM required that one half of the normal fixed monthly service charge would be recovered instead by an additional quantity charge on all consumption.

means for accomplishing the Draft's objectives. We object strongly, however, to the Draft taking concepts that can only be described as revolutionary for the water industry, and with no public review, attempting to carve them in stone.

Twice before water adjustment mechanisms have been considered by the Commission, and twice rejected. First in I.84-11-041 the California Water Association recommended adoption of a Sales Adjustment Mechanism to insure recovery of fixed costs, arguing that "it is a viable alternative whenever service charge revenues are designed to produce less than a given percentage of fixed cost" (D.86-05-064, p. 7). The Commission rejected CWA's recommendation.

However, we do not believe that a 100% recovery [of fixed costs] is balancing a utility's interest with customers' needs. Although such a goal would substantially reduce a utility's financial risk and lead the utility towards a guaranteed recovery of revenues, particularly if a SAM were implemented, it would not only eliminate a utility's incentive to provide the best possible service at the most reasonable price, it would substantially burden the average residential customer. (D.86-05-065, p.7)

In what is commonly known as the Risk OII decision, D.94-06-033, the Commission once again rejected revenue adjustment mechanisms for water:

An ERAM would assuredly relieve sales risk. But most Class A water companies today are earning at or close to forecasted sales levels, and econometric forecasting (discussed later in this decision) holds the promise of even more accurate predictions, since it can include factors like residual conservation. Under current ratemaking, there is incentive to hold the line on costs. By contrast, an ERAM carries with it an implied disincentive. Our experience suggests that efforts to reduce costs are less intense if a utility can simply raise rates to reach any shortfall in sales revenue.

- The Draft includes an action item that would require the Commission to adopt incentive regulation for water utilities in their General Rate Cases. As with the WRAM proposal, the Commission has already considered incentive regulation for water. In 1997 the Commission held a series of workshops on Alternative Regulatory Methods and in a subsequent workshop report (copy attached) decided that there would be no formal rulemaking on the matter. Following is an excerpt from the workshop report:

This is not to say that the participants did not propose some improvements in the regulatory process. Many were concerned that there was not enough emphasis on improved performance, especially that there were no direct rewards to the utility for innovative actions that saved the customers money. But no one thought that the next step should include a formal rulemaking that would propose and potentially adopt changes to existing regulation. All parties believe that the existing water Workplan proposals to investigate methods of improving regulation combined with openness on the part of the staff to develop or consider utility-proposed changes during rate cases was the best approach.

Similarly, the Draft suggests that the Commission consider implementing "financial rewards" and "financial penalties" for meeting or not meeting conservation goals. The link between sales and conservation measures, while it surely exists, is at best a tenuous one. The "carrot and stick" is not a good approach for achieving utilities' commitment to conservation.

- We agree with Valencia Water Company's comments that the Water Management Plan should be regarded as a long-term planning document that does not signal approval of particular projects referenced in its pages. If a utility seeks pre-approval of a water supply project that requires a long term financial commitment, i.e., longer than the three year general rate case time frame, a long term procurement plan should be prepared and submitted with the general rate case that provides a detailed analysis and review of the financing alternatives for consideration by the Commission. As always, these projects will be subject to the full range of regulatory review as they reach the stage of actual implementation.

Sincerely,

A handwritten signature in cursive script that reads "Robert L. Kelly". The signature is written in dark ink and is positioned above the typed name.

Robert L. Kelly
Vice President, Regulatory Affairs
Southwest Water Company Utility Group

Attachments

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

Arizona Corporation Commission

2 COMMISSIONERS

DOCKETED

3 JEFF HATCH-MILLER, Chairman
4 WILLIAM A. MUNDELL
5 MARC SPITZER
6 MIKE GLEASON
7 KRISTIN K. MAYES

SEP 30 2005

DOCKETED BY

CR

8 IN THE MATTER OF THE APPLICATION OF
9 CHAPARRAL CITY WATER COMPANY, AN
10 ARIZONA CORPORATION, FOR A
11 DETERMINATION OF THE CURRENT FAIR
12 VALUE OF ITS UTILITY PLANT AND
13 PROPERTY AND FOR INCREASES IN ITS
14 RATES AND CHARGES FOR UTILITY SERVICE
15 BASED THEREON.

DOCKET NO. W-02113A-04-0616

DECISION NO. 68176

OPINION AND ORDER

11 DATE OF PRE-HEARING CONFERENCE:

May 26, 2005

12 DATE OF HEARING:

May 31, June 1, June 6 and June 8, 2005

13 PLACE OF HEARING:

Phoenix, Arizona

14 ADMINISTRATIVE LAW JUDGE:

Teena Wolfe

15 IN ATTENDANCE:

Kristen K. Mayes, Commissioner

16 APPEARANCES:

Norman D. James and Jay L. Shapiro,
FENNEMORE CRAIG, on behalf of
Chaparral City Water Company;

Daniel Pozefsky, on behalf of the
Residential Utility Consumer Office; and

David Ronald, Staff Attorney, Legal
Division, on behalf of the Utilities
Division of the Arizona Corporation
Commission.

22 **BY THE COMMISSION:**

23 **I. INTRODUCTION**

24 **A. Procedural History**

25 On August 24, 2004, Chaparral City Water Company ("Chaparral City" or "Company") filed
26 with the Arizona Corporation Commission ("Commission") an application for a determination of the
27 current fair value of its utility plant and property and for increases in its rates and charges for utility
28

1 methodology and resulting revenue increase proposed by Chaparral City would produce an excessive
2 return on FVRB. There has been no legitimate basis presented for departing from the traditional
3 ratemaking methodology of applying a fair value rate of return to the Company's FVRB in this
4 proceeding. For the reasons advocated by Staff and RUCO, we find that applying a fair value rate of
5 return to the FVRB is just, reasonable, and in accord with the mandates of the Arizona Constitution,
6 and will adopt it in this case.

7
8 **IX. AUTHORIZED INCREASE/DECREASE**

9 With the adjustments adopted herein, the adjusted test year operating income is \$614,247.
10 The 7.6 percent cost of capital translates into a 6.36 percent fair value rate of return on FVRB of
11 \$20,340,298 as authorized hereinabove. Applying the 6.36 percent rate of return to the FVRB
12 produces required operating income of \$1,294,338. This is \$680,091 more than the Company's test
13 year adjusted operating income. Multiplying the deficiency by the gross revenue conversion factor of
14 1.6286 results in an increase in revenues of \$1,107,596, or a 17.86 percent net increase over test year
15 adjusted revenues.
16

17 **X. RATEDESIGN**

18 In its rate application, the Company proposed a two-tier, inverted block rate design, with
19 different breakover points for each size meter based on its cost of service study (Kozoman Dt. at 11-
20 20, Exh. A-14, Sched. G-1 through G-9). In its rebuttal filing, the Company accepted nearly all of
21 the elements of Staffs proposed rate design, including the use of three inverted commodity rate tiers
22 for residential customers on ¾-inch meters, with all other customers having two inverted commodity
23 rate tiers; Staffs recommended breakover points between tiers; elimination of the current additional
24 charge to recover costs for pumping water to elevation zones two and three; elimination of the 1,000
25 gallons of water in the monthly minimum charge; and the continuation of a single, uniform volume
26 rate for irrigation water service (Kozoman Rj. at 34, Tr. at 771-74). Staffs recommended breakover
27
28

points for 1/2-inch residential meters are 3,000 gallons and 9,000 gallons; and for 3/4-inch commercial and industrial meters, one breakover point of 9,000 gallons; with increasing single breakover point as meter sizes increase. The Company states that it recognizes the importance of encouraging water conservation, including the use of rate design to encourage customers to implement conservation measures and reduce their water use (Co. Reply Br. at 37). The Company disagrees, however, with Staff's recommended spread between the commodity rates and also with the commodity rates Staff recommends for irrigation water service.

Chaparral City contends that Staff's recommended inverted tier rate design with its proposed spread between commodity rates may lead to reduced water use by customers, and that if it does, the rate design will impact its ability to earn its authorized rate of return. The Company believes that Staff is actually proposing a "lifeline" rate because Staff's recommended commodity rate for the first tier is below the Company's existing commodity rates, and is only applicable to residential customers on 3/4" meters, and that Staff is using the subsidy of the lower rate for first tier usage to create a larger spread between the tiered commodity rates. The Company asserts that rates should be designed in a way that accounts for possible reductions in water use (Co. Br. at 54-55), and urges that the risk that a new rate design may lead to under-recovery of the Company's authorized revenue requirement should be recognized in the return on equity authorized in this proceeding (*Id.* at 58). Taking the alternative point of view, the Company also argues on brief that if Staff's recommended rate design will not reduce existing customers' water usage, it should not be required to implement inverted tier rates (Co. Br. at 59).

Staff asserts that its inverted tier rate design was developed to promote long term conservation goals, and includes commodity rates that are spread far enough apart to send appropriate price signals to customers regarding the importance and value of water, which is a limited resource in this state. Staff disputes the Company's assertion that its first tier is a "lifeline" rate, because its proposal is not

designed according to income level, but instead is focused on sending an appropriate price signal based on customers' meter size and usage (Staff Br. at 4). Staff states that it cannot predict whether customers will actually decide to use less water in a particular year; that no evidence was presented supporting the Company's claim that there will be a significant short-term change in water use as a result of the implementation of inverted-tier rates; and that the Company's service area still has a rapidly-growing customer base (Staff Reply Br. at 3).

RUCO proposes a rate design that charges each customer the same commodity rate for the same level of usage (RUCO Br. at 14). RUCO's three tier inverted block rate structure has its first breakover point at 8,000 gallons, the present average residential usage, with the second breakover point at 73,000 gallons, which it calculated based on the average of the Company's original proposed graduated breakover points (Moore Dt. at 32). RUCO believes this rate design provides a balanced approach that does not discriminate between classes or meter sizes, and that since its breakover points are based on average customer usage, provides a price incentive against above-average use, which would result in the conservation of water resources (RUCO Reply Br. at 9).

The Company disagrees with RUCO's rate design because it shifts revenue recovery away from residential customers, who have smaller meters, and onto commercial and industrial customers, who have larger meters. The Company believes that RUCO's rate design is inequitable to customers on larger sized meters because customers with smaller meters will have a substantial portion of their usage fall into the lower-priced rate block, with little of their usage reaching into the highest price rate block, while customers with larger meters will have the bulk of their usage fall into the higher tiers, without regard to whether their water usage is excessive or wasteful.

Of the rate designs presented, we find that Staff's proposal best addresses the goals of conservation, efficient water use, affordability, fairness, and simplicity.⁸ We find also that the risk of

Public comment was presented concerning the Company's irrigation rates as originally proposed by the Company. We note that the irrigation commodity rate we approve herein remains lower than other commodity rates.

1 revenue instability that the Company fears is sufficiently offset by the current growth in the
 2 Company's customer base to allow the implementation of a conservation-oriented rate design at this
 3 time. Although the Company provided testimony speculating that Staff's proposed rate design might
 4 cause such drastic reductions in water usage that the Company would be unable to recover its
 5 authorized revenue requirement, we do not find this conjecture convincing. As Staff's
 6 uncontroverted growth analysis demonstrates, the Company still has a growing customer base (see
 7 Scott Dt., Exhibit MSJ at 5), and new growth will be available to compensate for possible reductions
 8 in usage by existing customers, if demand proves to be elastic and existing customers respond to the
 9 conservation signals by reducing their usage in response to the new rate design. If, even with
 10 customer growth, the Company finds it is not recovering its authorized revenue requirement, it is
 11 within the Company's control to file a rate case. After considering the evidence presented, we find
 12 that it is in the public interest for the Company to implement the conservation-oriented rate design
 13 proposed by Staff.

14 **XI. OTHER ISSUES**

15 **A. Automatic Adjustment Mechanisms**

16 The Company requests approval to implement automatic adjustment mechanisms which
 17 would allow the Company to directly pass through to its ratepayers increases and decreases in two of
 18 its most significant operating expenses, purchased water and power costs, through a surcharge
 19 mechanism.⁹ Staff and RUCO recommend against approval of the requested adjustment
 20 mechanisms.
 21
 22
 23

24 Approximately 90 percent of the Company's water supply comes from Central Arizona
 25 Project ("CAP") water delivered through the Central Arizona Water Conservation District
 26 ("CAWCD") (Hanford Rb. at 3). Under its subcontract with the United States and CAWCD,
 27

28 Adjusted test year purchased water costs are \$823,781 and adjusted test year purchased power costs are \$510,947.

PUBLIC UTILITIES COMMISSION

505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298

RECEIVED
DEC 29 1997



December 19, 1997

TO ALL CALIFORNIA WATER COMPANIES AND OTHER INTERESTED PARTIES

SUBJECT: WORKSHOP REPORT ON ALTERNATIVE REGULATORY METHODS

On May 1, 1997 and again on May 9, 1997 we announced a series of water related workshops. The third workshop, on alternative regulatory methods, was held on August 13, 1997. The results of the workshop are summarized in the enclosed report.

We ask you now for your comments to the report, noting any corrections, omissions and additions. Please submit them to Fred Curry, Chief, Small Water Branch, Water Division by January 30, 1998.

The results of your comments and the report itself will be used to help develop the staff analysis of alternative regulatory methods used in water regulation and the comparison with other utility regulatory frameworks. As the report explains, this may result in an Order Instituting Rulemaking at some future date.

Very Truly Yours,

A handwritten signature in cursive script that reads "Dean J. Evans".

DEAN J. EVANS, Director
Water Division

Enclosure

cc: Commissioners

Alternative Regulatory Frameworks

Workshop Report

On August 13, 1997 the Water Division held its third round of workshops on possible changes to water regulation. The topic of this workshop was Alternative Regulatory Frameworks and the purpose was to discuss and investigate the possibility of modifying the way the Commission determines the rates to be charged by water utilities and, if appropriate, develop an Order Instituting Rulemaking to impose those modifications. All class A utilities were represented.

The Workshop was divided into four phases: 1) define the problem, 2) consider the factors bearing on the problem, 3) consider proposed solutions, and 4) chose the best solution.

In defining the problem, the participants discussed the deficiencies in the present ratemaking process. These include lack of management incentives to improve, planning and scheduling concerns, return on equity determination problems, the amount of workpapers that needed to be created and the amount of time that it took to complete a general rate case.

The factors bearing on the problem included the lumpiness of water plant additions, how the existing regulatory process interfaces with non-regulated water company activities, the uniqueness of the various companies and concern about whether a single alternative regulatory framework is even feasible, the fairness of incentives themselves and who would benefit under what situations and the sophistication of the utility personnel and Commission staff in the regulatory arena.

As pointed out in the workshop, the water industry differs from other industries that the Commission regulates in that it is a rising cost industry with considerable economies of scale. As a whole the industry is faced with additional costs required by the Federal Safe Drinking Water Act of 1996 and the need for substantial investment to replace infrastructure that has reached the end of its useful life. Competition is virtually non-existent; there is little product differentiation, and, in the absence of regulation, social misallocation of resources would be high, due to the inelastic nature of water demand. Barriers to entry are obvious (except under a franchise bidding arrangement), and technology improvements will not have a significant impact on system operation over time.

The participants then discussed the potential changes to regulatory methods that might be feasible. The alternatives were to be ranked

against criteria. The following criteria were identified as good evaluators of improved procedures. They should be:

1. simpler
2. fair to customers and shareholders
3. beneficial
4. consistent with industry practice
5. consistent with Commission practice
6. feasible
7. realistic
8. flexible
9. supported by all parties
10. correct (create the right incentives or reduce disincentives)

In discussing improvements, the participants concluded that great strides had already been taken to improve water regulation by modifying the classic rate of return regulatory process over the years. Improvements included the use of settlements and stipulations for all recent GRCs, the attrition process for stretching out the time between rate cases, the use of balancing accounts to handle costs changes, including water, power, water testing and regulatory fees outside the utility's control, the use of rate base offsets for including new plant additions in rates, the availability of CPI increases in lieu of rate filings, the catastrophic event and lead and copper cost memorandum accounts and the simplifications already made to smaller utilities' rate case filing requirements.

For example, in the general Rate Cases for Southern California Water Company filed last year in the Barstow and Santa Maria Districts, a Rate Base Offset type procedure was used in which the rate increase was based on the increase in rate base multiplied by the latest authorized rate of return and by the net-to-gross multiplier. This avoided the controversy related to differences between the staff and utility estimates of numbers of customers, consumption per customer, revenues, general office expense, operation and maintenance expense and administrative and general expense. Ad-Valorem (Property) Taxes were based on the increase in plant and other taxes were based on the increases in revenue and expense. All in all it was a much simplified operation.

In this year's general rate cases for California Water Service Company, a somewhat similar approach is being used. The initial rate increase is being based on the increase in rate base multiplied by the latest authorized rate of return and by the net-to-gross multiplier.

Expenses are being based on a five year average of inflation adjusted recorded figures. That figure is then projected into either one or two test years using anticipated inflation. Revenues are being looked at on the basis of the "Econometric Model" which has been used in the past. The rate increase is being based just on the increase in rate base, but revenues and expenses are being used to calculate a summary of earnings so the "Earnings Test" can be used to test for further attrition year type increases. In the case of the Marysville District, just two test years will be used and in the next set of rate cases, it is proposed that Marysville will be merged into the Chico District along with the Willows District in compliance with Water Division and Commission policy to reduce the number of ratemaking districts. In the case of the Oroville and Selma Districts, there will be one test year and five annual increases based on the latest increases in the Consumer Price Index (CPI). In the case of the South San Francisco District, there will be two test years, and an attrition year. While these concepts may seem complex at first, they have some intriguing attributes that warrant consideration.

The consensus of the group was that there may be some misunderstanding of the present state of water regulation. The participants were also concerned that there might exist a "deregulation for deregulation's sake" attitude that could adversely affect the long term interests of customers if imposed without careful study. It requested a report that contained an outline of the existing water regulatory process, with a comparison to the regulatory improvements imposed on other types of utilities, to see if there was really a social need to modify the existing procedures.

This is not to say that the participants did not propose some improvements in the regulatory process. Many were concerned that there was not enough emphasis on improved performance, especially that there were no direct rewards to the utility for innovative actions that saved the customers money. But no one thought that the next step should include a formal rulemaking that would propose and potentially adopt changes to existing regulation. All parties believe that the existing water Workplan proposals to investigate methods of improving regulation combined with openness on the part of the staff to develop or consider utility-proposed changes during rate cases was the best approach.

Water Division proposes to follow up on this workshop in two ways. First, as requested by the workshop participants, it will produce a report which contains an analysis of the existing methods of water regulation with a

critique and comparison with other utility industries. This report will be prepared during the first quarter of 1998. If appropriate, it will contain a set of proposed modifications to existing procedures and a proposal for additional workshops to investigate some of them. Since many of the existing procedures used in water regulation were developed outside of the Rulemaking process, most of these changes can be adopted without recourse to a formal proceeding; however, if a formal Rulemaking does turn out to be more appropriate, the parties can petition the Commission for one at that time.