



California
American Water

VIA E-MAIL AND U.S. MAIL

Edward Howard
California Public Utilities Commission
Division of Strategic Planning
505 Van Ness Avenue
San Francisco, CA 94102-3298

Re: **California-American Water Company Comments on
California Public Utilities Commission Draft Water Action
Plan**

Dear Mr. Howard:

As directed in the November 10, 2005 letter from California Public Utilities Commission ("Commission") Executive Director Steve Larson, California-American Water Company ("California American Water") hereby submits its comments on the Commission's draft Water Action Plan. California American Water commends the Commission for taking the initiative to identify policy objectives and explore alternative approaches to water regulation. California American Water appreciates the opportunity to provide comments on the Commission's draft Water Action Plan.

The Commission's draft Water Action Plan contains many innovative proposals that will help utilities deliver safe and reliable water to their customers at reasonable rates. California American Water has included many of these same in its Proposed Application for its Los Angeles District general rate case, filed November 7, 2005 (TEND1305). For example, in its Proposed Application, California American Water sets forth an Infrastructure System Replacement Surcharge (ISRS), which is similar to the Distribution System Improvement Charge proposed in the draft Water Action Plan. California American Water also recommends de-coupling the revenue requirement from sales and setting up a conservation memorandum account to track the costs of implementing the California Urban Water Conservation Council's best practices. Finally, similar to the draft Water Action Plan, California American Water proposes a program for assistance for low-income customers and seeks to streamline the regulatory process by fully consolidating rates for its three Los Angeles District service areas.

California American Water generally supports the proposals set forth in the Commission's draft Water Action Plan. The Commission should implement these proposals through a combination of issue-specific industry-wide proceedings as well as individual company proceedings. In its comments below, California American Water discusses the merits of several key proposals, including some of the proposals that are also part of California American Water's Proposed Application for its Los Angeles

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District. California American Water also discusses certain recommendations that should be revised or dismissed.

Conservation

California American Water commends the Commission for putting conservation at the forefront of its water regulation policies. California's water resources are limited, and increased growth is making water more and more scarce. Conservation is one of the most cost-effective ways to maximize California's limited water supply. California American Water agrees with the draft Water Action Plan that direct participation by all Class A and Class B water utilities in the California Urban Water Conservation Council will help further the Commission's conservation goals. Participation in the California Urban Water Conservation Council will encourage complementary and consistent water conservation efforts by all Class A and Class B water utilities. This will lead to more efficient implementation of water conservation programs than if each water utility acted independently. Recovery of expenses related to these efforts in general rate cases is a crucial component in facilitating such participation. California American Water also supports the Commission's other conservation-related proposals such as promotion of metered service, customer education, implementation of increasing block rates, severing the connection between the revenue requirement and water sales and reduction of energy consumption. On this last point, reduction of energy consumption, California American Water suggests that the Commission also consider exploring ways to make electric utility energy efficiency and conservation programs available to water companies

Low-Income Assistance

Unlike the telecommunications and energy industries, the water industry does not have a standard low-income assistance program available to all customers of Commission-regulated water utilities. Currently, the Commission considers low-income assistance programs on a company-by-company and district-by-district basis. This has resulted in significant variation in the amount and availability of low-income assistance and disproportionate burdens on non-low-income customers. California American Water agrees with the draft Water Action Plan that a standard low-income assistance program for all water utilities, including establishment of a pooling program to support it, is necessary. This is just the first step, however. California American Water urges the Commission to explore the possibility of a statewide low-income assistance program that would apply to and be funded by customers of all water companies, both public and private. This will involve cooperation with other state agencies and possibly legislative action, but serves the public interest by ensuring that all assistance is available to all low-income customers.

Similarly, California American Water agrees with the proposal in the

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draft Water Action Plan to examine the policy and legislative changes needed to address low-income consumers living in multi-family housing. Although these consumers are not direct customers of the water companies, they are still affected by water rates. Water is one of the most basic human needs and it is crucial that the Commission explore ways to provide assistance to all low-income water consumers, whether they are served by public or private water utilities and whether they are direct or indirect customers.

Acquisition of Small Water Systems

In the draft Water Action Plan, the Commission explores the possibility of providing incentives for the acquisition of small water companies by larger water companies. California American Water supports this proposal and agrees that such acquisitions will help maintain high water quality standards and streamline Commission regulation. Many small water utilities do not have the resources or expertise to comply with increasingly complex water quality regulations. Similarly, Commission regulation can be exceedingly complicated and burdensome for some of the smaller and less sophisticated water providers. Acquisitions of these small water utilities by larger water utilities will provide the smaller systems with the resources and expertise needed to maintain high water quality and also relieve the burden of Commission regulation. The draft Water Action Plan suggests surcharges for capital-related improvements or an adjustment to the allowed Return on Equity as incentives for large water utilities to purchase smaller, troubled systems. California American Water suggests that the Commission also consider allowance of an acquisition premium and consolidation of rates as additional incentives.

In particular, both customers and the purchasing utility would benefit from consolidation of the rates of the small system with the rates of the larger utility. All too frequently the purchasing utility has to raise rates for the smaller system to cover the cost of deferred maintenance of the system. Often customers blame the purchasing utility for the rate increase, despite the fact that it is due to maintenance and repairs that had been postponed too long by the previous owner. Rate consolidation will spread these costs over a larger customer base, reducing the necessary rate increase, which will improve customer satisfaction and strengthen community relations.

Balanced Rates

The draft Water Action Plan notes that the Commission currently focuses more on short-term rate impacts and less on the long-term benefits of infrastructure investment. This policy creates a danger that needed investments will be deferred to keep rates low. If rates are kept artificially low, utilities will not be able to invest adequate amounts in maintenance and upgrading infrastructure, resulting in degradation of service. California American Water agrees with the draft Water Action Plan that the Commission should shift to a more balanced approach that will review the rate case

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revenue requirements in the light of long-term water supply needs, as well as rate impact. This will allow utilities to charge rates that will enable them to earn a fair return on capital and invest in infrastructure, while maintaining reasonable rates for customers.

Distribution System Improvement Charge

As noted above, the ISRS program included in California American Water's Proposed Application for its Los Angeles District general rate case is similar to the Distribution System Infrastructure Charge program proposed in the draft Water Action Plan. Programs such as these are the best mechanisms to promote infrastructure investment. Implementation of programs like the Distribution System Improvement Charge or ISRS removes the speculation currently involved in general rate cases, streamlines the regulatory process by limiting the need for review of all future replacement plans and ensures that a return will be provided only on plant that is actually constructed and in service.

As described in greater detail in California American Water's Proposed Application, such programs address the need for a dedicated revenue stream to offset a portion of the fixed costs of capital additions made to replace existing facilities, the financial problems that result from completion of revenue neutral (non-revenue producing, non-expense reducing) capital expenditures, and the impact of a reduction in per-customer sales on the funding of capital projects to replace existing facilities. Customers will benefit because they will not have to pay for such improvements until they are completed.

Construction Work in Progress

The draft Water Action Plan raises the possibility of recovering the cost of investment in new water plant and related equipment as Construction Work in Progress (CWIP) and accounting for CWIP in rate base. California American Water supports this proposal because it would allow a utility to maintain its income at a time when a single major project could have a dramatic affect on the bottom line. The alternative, recovery of such costs as Allowance for Funds Used During Construction (AFUDC), does not provide utilities with the cash flow needed for significant investments. As noted in the draft Water Action Plan, water utilities also benefit from averaging start-up costs over several billing periods early in the investment cycle, rather than waiting until the plant is actually ready for service, as they would if they used AFUDC.

Customers will also benefit from the CWIP proposal in the draft Water Action Plan. AFUDC results in higher costs to customers due to the higher carrying charges on invested capital. With CWIP, the overall costs of the plant are reduced because the utility has lower interest payments, which leads to lower rates for customers.

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Customers also benefit by averaging plant investment start-up costs over several billing periods.

Cooperation with State and Federal Agencies

The draft Water Action Plan recommends that the Commission strengthen inter-agency relations with the Department of Health Service as a way to maintain the highest standards of water quality and collaborate with the California EPA to reduce greenhouse gas emissions. Additionally, as discussed above, the draft Water Action Plan recommends direct participation in the California Urban Water Conservation Council by Class A and Class B water utilities. While California American Water supports these interagency cooperative proposals, it also urges the Commission to consider the impact of federal agencies, policies and regulations on local water issues. The Commission should explore the possibility of working more closely with federal agencies such as the United States Geological Survey, the United States Bureau of Reclamation, and the U.S. Army Corps of Engineers.

Memorandum Accounts for Purchased Water and Purchased Power

The draft Water Action Plan contemplates eliminating memorandum accounts for purchased water and purchased power in order to eliminate the need for more the thirty advice letter filings per year. Although California American Water recognizes the strain on Commission resources caused by multiple advice letter filings, it disagrees with this proposal. Purchased water and purchased power are often a water utility's most significant costs, and they are costs that are beyond the utility's control. Fluctuations in these costs can create substantial losses (or gains) for a water utility, hence the need for memorandum accounts.

Rather than eliminate purchased water and purchased power memorandum accounts altogether, California American Water recommends that the Commission adopt "full-cost" memorandum accounts to be reviewed during general rate cases, as set forth in California American Water's Proposed Application for its Los Angeles District general rate case. Currently, purchased water and purchased power memorandum accounts only track the difference between the tariff rate per unit of a commodity adopted in a decision and the current tariff rate per unit charged by a selling agency. The current memorandum accounts do not track any variation in supply mix, and/or extraordinary purchases or supply cost reductions that might occur through agreements. In the Proposed Application, California American Water requests that the Commission authorize it to maintain "full-cost" purchased water and power memorandum accounts that track the entire variance between the costs adopted as part of a general rate case decision and the costs actually incurred. Rather than filing for recovery of the memorandum accounts annually, California American Water seeks authorization to file for recovery of the memorandum accounts once every three years as

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part of the general rate case, or at such point that the account balance exceeds a certain threshold. This proposal benefits utilities and ratepayers because it tracks all of the costs and savings associated with purchased water and purchased power, and achieves the objective of streamlining the Commission regulatory process. In the final version of the Water Action Plan the Commission should recommend implementation of “full-cost” memorandum accounts for purchased water and purchased power, reviewed as part of rate cases.

Rate Case Cycle

Appendix B to the draft Water Action Plan notes that the Office of Ratepayer Advocates (ORA) is proposing in the Rate Case Plan proceeding (R.03-09-005) a five-year rate case cycle instead of the current three-year rate case cycle. California American Water urges the Commission not to include this proposal as part of its Water Action Plan. A five-year rate case cycle simply is not practical. It is difficult enough to project capital project needs and anticipate future regulations and operational changes four years into the future, as required by the current rate case plan. If the Commission adopted a five-year rate case cycle utilities would have to project six years out. The longer the forecasted period, the less accurate the forecasts become, putting the utility’s ability to earn a reasonable return at risk. In a five-year rate case cycle it is unlikely that an inflationary amount added to the last test or projected year will provide a sufficient revenue adjustment to maintain an adequate return.

California American Water supports the Commission’s efforts to identify policy objectives and explore alternative approaches to water regulation. The Commission’s draft Water Action Plan contains many innovative proposals that will help utilities deliver safe and reliable water to their customers at reasonable rates and will further the objectives of maintaining high water quality standards, encouraging conservation, promoting infrastructure investment, assisting low-income customers, streamlining the Commission’s regulatory process, and ensuring that rates are balanced and equitable. California American Water urges the Commission to adopt the draft Water Action Plan in accordance with its comments above and begin taking action to implement these objectives.

Respectfully submitted,



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