



ORA

Office of Ratepayer Advocates
California Public Utilities Commission

Dana S. Appling, Director

505 Van Ness Avenue
San Francisco, CA 94102
Phone: (415) 703-2544
Fax: (415) 703-2057

<http://ora.ca.gov>

November 23, 2005

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

Attention: Edward Howard

Dear Mr. Howard,

Please find attached ORA's comments on the Commission's draft Water Action Plan. ORA commends the Commission's efforts to develop a Water Action Plan (WAP) to guide the Commission in developing policy in the regulation of investor-owned water utilities. Having a clear set of priorities, principles and actions to guide the Commission should encourage the development of equitable, efficient, reliable and well-managed water systems that can sustainably provide affordable, high quality water to the customers they serve.

For the most part, the draft WAP is presented in terms of strategies and actions the Commission will consider going forward. However, a number of the proposals in the draft WAP, if adopted, could provide unnecessary incentives to water utilities at the expense of ratepayers. Others are complex and require careful review. ORA urges the Commission to open rulemakings or investigations to fully consider the implications of the proposed policy changes. Not only will this assure due process and allow the Commission to hear from all interested stakeholders, it is also an efficient use of the Commission's and parties' resources.

ORA does not attempt to provide in depth feedback on the merits of the various proposals at this time, but we look forward to providing that analysis in the appropriate forum for the Commission's review.

Sincerely,

A large, stylized handwritten signature in black ink, appearing to read "Dana S. Appling".

Dana S. Appling
Director

ORA Comments on CPUC Draft of WATER ACTION PLAN

1. **Forum for consideration of Water Action Plan proposals.** ORA encourages the Commission to open rulemakings/investigations to consider industry wide implications of the proposed policy changes noted below rather than dealing with them individually in each utility general rate case (GRC). Addressing the proposed policy changes through rulemakings not only assures that there is due process and an opportunity for all affected parties to be heard, but is also an efficient use of Commission's and parties' resources.

ORA notes that the GRCs for Class A water companies are now on a faster track than in previous years due to P.U. Code Section 455.2 which essentially requires new rates be effective a year after the GRC is filed. This time requirement may constrain fully fleshing out policy proposals that present a substantial departure from past practice and may limit the amount of collaboration between parties that would otherwise be possible. In addition, parties to a GRC are generally limited to those parties in the local area, whereas a rulemaking could pull in a broad range of stakeholders. If the Commission chooses not to use rulemakings as the forum for vetting the issues raised in the Water Action Plan (WAP), ORA recommends that the Commission at least require utilities to file separate applications where it will be possible to allow for more in depth consideration than would be possible in a GRC.

In addition, many of the proposals are related and should be considered together. For example, the determination of whether and when cross-subsidization of customers in differing water districts is justified may trigger the need to review issues that go beyond the scope of the particular GRC. This could include needed modifications to the Commission's merger and acquisition rules if costs of acquired water systems will be borne by existing ratepayers in the future.

2. **Add water affordability as a fifth guiding principle.** (Page 2) Water affordability is a real and growing concern for many water utility customers. There are large numbers of households who face tough choices and real economic hardship. Any water service termination due to bill nonpayment has the potential to adversely affect the health and safety of the occupants and habitability of the housing unit. Water rates for basic human needs should be low enough so that those on low- or fixed-incomes will not need to curtail or eliminate other essential services to pay their water bills.

ORA suggests the inclusion of 5th guiding principle – “Water Affordability” to highlight the importance of access to water to meet basic needs as a fundamental human right. ORA notes that several of the Commission's proposed water strategies recommend consideration of options that address this concern, so ORA believes this is already a Commission priority but recommends stating so explicitly.

3. **Need for integrated water planning.** (page 3, #1; page 11, #3) ORA supports CPUC efforts to collaborate with DHS on water quality issues and DHS, DWR, SWRCB and Cal EPA as well as

other state and local agencies on maintaining reliable water supplies. ORA believes that investor-owned water utilities will increasingly need to be involved in public-private partnerships to deal with uncertainties and potential emergencies in the provision of water. They will also need to be concerned with water use from the industrial and agricultural sectors which could have impacts on the watersheds and groundwater basins.

For example, in terms of water quality, industrial or agricultural uses of water may contaminate aquifers or overdraft the groundwater basins. Agricultural water use accounts for 80% of the water usage in California. In addition to urban water conservation, there is great potential for improvements in agricultural water-use efficiency as farmers move to more efficient irrigation methods. Improving both urban and agricultural water use efficiency may well provide the easiest, fastest and cheapest option to meet future increases in water demand.

ORA recommends the Commission encourage the investor-owned water utilities to engage in more collaborative planning with other local and regional water users and agencies to consider creative options “outside of the box”.

4. **Strengthening Water Conservation Programs to a Level Comparable to those of Energy Utilities.** (pages 5 – 9) ORA fully supports this objective. Conservation is increasingly important and as stated in the draft WAP, it provides the least expensive source of new water. ORA highly recommends the Commissions open a rulemaking on water conservation to consider all conservation-related measures on a consolidated basis – conservation pricing (metered water service, increasing block rates (IBRs), conservation discounts, reduced meter charges, etc.), standardized protocols for measuring cost effectiveness and reporting requirements, utility conservation incentives (revenue de-coupling, earnings on utility demand side investments other financial rewards for meeting goals), and the conservation measures themselves. To compensate for changes in risk, the rulemaking should also consider adjustments to utility rate of return. ORA further recommends that in determining cost effectiveness of conservation measures, water, wastewater, electricity and gas savings should be included if possible. The rulemaking could also consider feasibility of including water capacity savings from avoided plant additions. These proposals are linked and should be considered together in a comprehensive manner.

ORA notes that energy efficiency in California took a giant leap forward in the early 1990s as a result of the Statewide Collaborative Process undertaken by environmental and consumer groups, utilities, major industries and governmental officials who were united in their commitment to reassert California’s international leadership in energy efficiency. At that time, the Commission “wished to take a fresh look at DSM programs from the perspective of five regulatory goals: economic efficiency, minimizing energy bills for all consumers, rate stability, maintaining utility financial health, and contributing to societal goals.”¹ The Commissioners urged the Collaborative to focus on the idea of utility shareholder incentives for increased investment in energy efficiency. They asked the Collaborative to be imaginative and innovative

¹ *An Energy Efficiency Blueprint for California*, Report of the Statewide Collaborative Process, January 1990, page 5.

and return to the Commission with a recommended consensus approach. This Collaborative reached consensus on ways to revitalize and expand utility demand side management budgets and to create shareholder incentives for investments in energy efficiency. It also developed standardized measures of cost effectiveness, standardized reporting requirements, utility specific programs and budgets. ORA believes water conservation among the investor-owned water utilities could also benefit from a collaborative process and consolidated review – one that would incorporate diverse viewpoints and interests. We hope the Commission will consider options for this type of process.

Finally, ORA supports having Class A and B water utilities follow the Best Management Practices (BMP) identified by the California Urban Water Conservation Council, and recommends that Commission require each utility to demonstrate that they have the capability to effectively implement their proposed conservation program prior to granting rate recovery. Utilities should submit cost/benefit analyses and a plan with sufficient staffing, resources, an implementation schedule and program evaluation proposal.

5. **Rate structures that encourage efficient use of water.** (page 5, #1, page 6, #4) ORA supports Commission consideration of rate structures that encourage more efficient use of water such as increasing block rates (IBRs) and metered water. As a means to encourage more water conservation, ORA recommends the Commission also consider changes to the traditional water rate design which puts half of the fixed costs into a monthly meter/service charge.
6. **Incentives for acquisition of small private water utilities.** (page 5, #5) ORA acknowledges the difficulties faced by small water systems in replacing or upgrading aging infrastructure to meet new, and more stringent, drinking water requirements as well as the financing constraints faced by water companies. As noted in the draft WAP, the Legislature enacted the *Public Water System Investment and Consolidation Act of 1997*, or P.U. Code Section 2720 to provide incentives to privately held water corporations to purchase small struggling water systems. The incentive provided by the Act was to allow fair market value as the standard when establishing rate base for an acquired public water system instead of original cost less depreciation.² In implementing these sections, the Commission issued D.99-10-064 which established guidelines for mergers and acquisitions of water utilities. Section 2720 and Commission regulations apply to all acquisitions, not just small water companies. As a result, a number of large companies have acquired other large companies resulting in official synergy savings, but questionable benefits for their captive California ratepayers. To the extent that additional incentives are needed, the Commission should limit the applicability of the incentives to the purchase of small Class C and D water systems, those with 2000 connections or less, where economies of scale are still achievable and real improvements in water and service quality will result. ORA supports the Commission exploring what incentives might be created for municipal utility acquisition of

² State regulatory commissions have always followed the basic principle of setting rates based on actual investment in plant and facilities used and useful to ratepayers. Technically, the scale economies or “synergy savings” of a corporate merger or buyout should balance the additional “acquisition premium” charged to ratepayers, but in reality what customers often see are higher rates – and sometimes significantly higher rates – with little or no improvement in service or quality.

these small water systems. In fact, the merger of contiguous or nearby water systems may offer the most benefits for ratepayers in terms of scale economies and local control. The Commission should consider who will fund any acquisition incentives and evaluate the associated equity impacts.

7. **Costs to existing ratepayers of water system acquisitions.** (Related to page 5, #5) Per D.99-10-064, the Commission estimates “synergy savings” resulting from the merger or corporate acquisition to offset the increased costs associated with allowing the utility to charge rates based on purchase price of the corporate acquisition. However, ORA notes that the acquisition of a struggling small water system may not provide any synergies, but instead bring added liabilities. This would not be a problem under the traditional stand-alone district scenario as ratepayers of the acquired district would be in the same position regardless of who owns their water company. But under cost averaging arrangements, acquisition of a water company with no synergies, may now impose added costs that will be passed on to existing customers through consolidated rates, rate base equalization accounts, surcharges, or other means. ORA recommends that the Commission evaluate the costs that may be imposed on existing ratepayers, in addition to the synergies, in evaluating water system acquisitions.

Also, ORA notes that some small water systems that impose added costs are recent subdivisions in need of upgrades where costs could have been included in the subdivision approval process or paid for by property owners. ORA recommends the Commission consider to what extent existing customers of investor owned water utilities should be required to subsidize such acquisitions and the equity impacts of doing so.

8. **Energy Implications of water management decisions.** (page 8, #7) Energy use by water utilities is becoming increasingly important and is appropriately considered in the WAP. Energy costs are passed through to consumers and can be significant. For example, as aquifers become contaminated, or groundwater levels decline due to overdraft, deeper wells are required, resulting in an increasing amount of energy needed to pump groundwater to the surface. And, for desalination, energy costs represent one third to one half of the cost of desalting water, making desalination costs relatively sensitive to the cost of energy.³ With increasing energy prices, the need to conserve energy in water production is even more important.

ORA notes that decisions on water management are often made without considering energy implications. Water utilities may select new water supply options without assessing the energy costs of producing, transporting or treating the water. They may not evaluate the energy savings produced by using less water. Not factoring in the energy implications of water supply choices can lead to higher rates and excess energy consumption. In order not to exacerbate the strain on statewide energy resources and limit the depletion of fossil fuels, ORA recommends the Commission consider requiring energy consumption of new water projects be minimized. The

³ A one cent difference in the price per kilowatt-hour of electricity results in an estimated \$50 difference in the cost to produce an AF of desalinated water. “For example, water produced by desalination at a cost of \$800 per acre foot with electric rates at \$0.05 per kilowatt-hour would cost \$1050 per acre foot if the electricity instead costs \$0.10 per-kilowatt hour. California Coastal Commission, “Seawater Desalination and the California Coastal Act”, 2004. Page 34.

Commission should also require the water utilities to present the cost of water per acre foot for each water system within their ratemaking districts in their GRCs, and to identify what portion of that cost is energy. This could be helpful in comparing the price of water in various areas. (Rates do not provide a good basis for comparison since rates are a function not only of costs, but also the number of customers over which the costs are divided.)

9. **Global Warming.** (Page 9, #8) Since global warming will have an impact on California's water supply, ORA believes it is appropriate to address this topic in the WAP. ORA supports Commission efforts to collaborate with Cal EPA on reducing greenhouse emissions. In addition, ORA recommends the Commission ask the utilities to begin considering the implications of climate change on the safety and reliability of water systems if they haven't already, and to integrate these implications into their long-term water planning.
10. **Emergency Planning.** (Recommended addition to the WAP.) ORA recommends the Commission include something on utility emergency planning in the WAP. What is the ability of investor-owned water utilities to handle emergencies, for example in the case of a major system failure? The Commission should require water utilities to report on this in each GRC.
11. **Environment, new water supply and public input.** (Recommended addition to WAP under Objective #3, page 10.) Endangered Species Act (ESA) and other environmental regulations are limiting water supply options and increasing costs of water production. Water management increasingly involves the protection of public trust resources. And increasingly the public is expressing environmental concerns about water storage, production and conveyance projects before various permitting agencies. In addition to these localized environmental effects, utilities should also consider the broader environmental impacts of new water supply -- such as energy impacts, wastewater residuals, damage to natural ecosystems, and sustainability of water resources for future generations. Water utilities should embrace environmental stewardship as part of their responsibilities.

ORA recommends the Commission consider the long term sustainability of the water resources and the wishes of the local community in making reasonable environmental tradeoffs in selecting among alternatives for new sources of water supply and water management.

12. **Water Management Program/Plan.** (page 10, #1) This point states that the CPUC will seek to use utility filed Water Management Programs as a basis for pre-approval of major water supply projects that require a long term commitment. This document is useful for planning long term infrastructure needs, but ORA does not believe it should be the basis for approval (or "pre-approval") of needed infrastructure. Approval for major projects should be through a GRC or a separate application where cost prudence can be evaluated. The utility Water Management Program/Plan document is more of an overview and would not be sufficient for making reasonableness determinations for major water supply projects. The Water Management Program/Plan is useful in conjunction with a separate application for major projects that need review outside of the GRC cycle, such as Cal Am's Coastal Water Project in Monterey.

- 13. Distribution System Improvement Charge.** (page 10, #2) The WAP makes several new suggestions for ways of funding infrastructure investments, such as the Distribution System Improvement Charge or DSIC, but does not address how the need for those projects would be evaluated. The draft WAP offers this option as a means to ensure that “sufficient investments in infrastructure are undertaken.” ORA urges the Commission to identify whether insufficient infrastructure investment is actually a problem for all classes of water utilities. If not, this option should be targeted to the classes of utilities that need extra help. In contrast to California, other states that have adopted a DSIC use a historical test year where costs are recovered after the fact. In these states, a DSIC enables utilities to earn a return on their investment prior to the next rate case. In California, costs are projected, and included in rates going forward. For Class A water utilities, the Commission approves recovery for depreciation, routine plant maintenance, recurring operating expenses and major plant additions in the utility GRC and it is questionable whether a DSIC is necessary.

Before a DISC is approved, ORA would want to do a thorough evaluation of the investor-owned water utility’s existing infrastructure and establish criteria based on industry benchmarking. Another possibility would be to require a system audit.

- 14. General Comments on promoting infrastructure investment.** (pages 10 – 12) In addition to considering options such as DSIC, pre-approval of projects, pre-pay accounts and special surcharges, ORA recommends that the Commission also consider other options such as:

- strengthening preventive maintenance of the infrastructure to protect the investment by enhancing and enforcing regulation regarding maintenance of water facilities and infrastructure;
- investigating newer technologies such as cathodic protection and corrosion prevention of pipelines; reconditioning of pipelines, pipeline lining;
- Optimizing asset management to replace infrastructure at the right time—these steps would include more rigorous analysis of replacement alternatives and priorities.

Pre-pay accounts or other non-traditional ratemaking surcharges which would allow immediate rate recovery of capital investment outside of the normal GRC process, raise issues of (1) whether the Commission and ORA will be able to do a reasonableness review on those investments, and (2) whether prudence can be determined by looking at an investment in isolation, etc. ORA believes traditional ratemaking methodologies provide all parties with an opportunity to have their interests fairly represented and for the Commission to verify the need for upgrades.

Other questions that arise include how the funds will be treated? Will they be considered ‘contribution’ from ratepayers? How would a surcharge such as the DSIC interface with the GRC process? The options presented in the WAP raise a number of unanswered questions which need to be carefully considered, and weighed against other alternative options.

Finally, ORA believes it is important to make a distinction between "expansion in infrastructure needs" and the need for "upgrading existing infrastructure. The treatment of those should be evaluated separately.

- 15. Automatic balancing account treatment for litigation and clean-up costs of contamination. (page 12, #4)** A similar matter has been considered, and rejected, most recently in Phase I of the rulemaking on the new rate case plan for Class A water utilities. (R.03-09-005) See D.04-06-018, page 27 (mimeo). In that proceeding, the utilities requested that they be allowed to file an advice letter -- instead of an application -- to open a water quality memorandum account. The Commission found that opening a memorandum account may involve complex factual findings and legal conclusions and that the advice letter process is not suited for such purposes. The Commission also rejected the California Water Association's (CWA) further request to establish a memorandum account even before such an advice letter was approved.

Automatic balancing account treatment with recovery in rates prior to expenditures even having been accrued or reviewed for reasonableness presents even more problems. The PD in Park Apple Valley explains the difference between balancing and memorandum accounts:

"Balancing accounts as authorized by the Commission have an associated expectation of recovery, they have been, so to speak, pre-authorized by the Commission, and it is the recorded amounts that are reviewed for reasonableness. Memorandum accounts, in contrast, are accounts to record costs for tracking purposes to allow the utilities to meet their burden of proof for the later opportunity to recover recorded costs. Recovery is not automatic. Because we cannot predetermine the full scope of recoverable implementation costs, in contrast to the revenue reallocation discussed above, a memorandum account is the appropriate mechanism to recover the reasonable CARW program implementation costs." PD in A.05-02-005 (Park Apple Valley GRC), pg. 31.

This distinction is why water litigation costs are booked into memorandum accounts and not balancing accounts. The cost to be incurred by the utility to seek damages from the polluters and remediation of its water supply is unknown at the time of the event. Granting automatic balancing account treatment suggests that costs booked into a balancing-account will be recovered provided the utility meets its burden of proof of establishing the reasonableness of any expenses booked into the account in the next GRC or a separate Advice Letter filing. A memorandum account just tracks the recorded amounts which are not recovered in rates until all costs are known, recorded, and reviewed for reasonableness.

ORA recommends the Commission continue its policy of requiring applications for water quality memorandum accounts.

- 16. Low-income programs. (page 12)** ORA supports the Commission's strategy on moving forward on this important matter. The Commission should note that D.005-10-044 just expanded the energy low income assistance program, CARE, eligibility guidelines from

175% of federal poverty guidelines to 200%. It might be useful to include these guidelines in the WAP:

Household Size	LIEE Income Limit
1 to 2	\$27,700
3	\$32,500
4	\$39,200
5	\$45,900
6	\$52,600
Each additional	\$6,700

In addition, since affordability of water service is a function of the price of water, the quantity of water consumed and the ability of households to pay, ORA recommends the Commission consider exploring a low-income water conservation program to help customers manage their bills.

17. **Incentive Regulation.** (page 15, #1) ORA recommends adding another sentence that says “Ensure that any form of incentive regulation adopted is both necessary and avoids the type of perverse incentives created by Southern California Edison’s PBR program.”
18. **Streamline CPUC decision making.** (page 15, #2 and page 17, #6) ORA supports exploring various ideas to streamline the regulatory process. However, any streamlined process must allow for the appropriate scrutiny of utility operations and due diligence, must ensure public notice and allow for public participation, and must preserve parties' due process rights including an opportunity to be heard.
19. **Consolidating rate cases.** (page 17, #5) Currently the Commission consolidates the review of up to eight districts in a given utility at once. However, consolidation of districts for the purpose of consolidating rates is another topic that should be considered on a case-by-case basis. (See also ORA comments in #20.)
20. **Cross Subsidization and cost-based ratemaking.** (page 17, #2; page 18, #3; page 19, #6) Cost averaging and other related proposals that break the link between cost-of-service and rates, provide water utilities with incentives to over-invest in individual water systems, disincentives to control costs and a competitive advantage in acquisitions. ORA recommends the Commission address ways to evaluate these issues before moving forward with any cost averaging proposal.
 - a) **Limited Water Supply and Use of Cost Averaging.** ORA believes the cost averaging concept for water has fatal flaws for sustainability. Water is more like land than electricity or telephone service in that it is limited in supply and locally based. While it is true that all utilities have distribution costs, it is difficult to import additional water to an area – both from an engineering and water rights perspective. Many small water systems are stand-alone systems that depend on local surface and groundwater supplies.

The provision of energy and telephone service to remote areas is more a function of the distribution cost; it does not run up against the limits of the resource locally. Providing water in remote areas that have limited water resources can require costly local infrastructure to produce and treat the water and can be environmentally damaging. Further, provision of water in arid areas can create wastewater disposal challenges in the form of nitrates that can contaminate the groundwater. If water rates do not reflect the true cost of service, they could encourage inefficient and unsustainable uses of water in high costs areas. (i.e. housing developments in the desert.)

ORA recommends the Commission consider the impacts of any water cost averaging proposals on long term sustainability of water supplies for existing customers (with an allowance for growth), on local land use, as well as impacts on the environment both locally and regionally.

- b) **Growth.** Much of the increase in water demand results from new housing sub-divisions. While developers often fund necessary water infrastructure in the form of contribution, it is not always sufficient to cover costs. The Commission should consider to what extent existing customers, who do not benefit from the new subdivision development, should pay the costs of this growth at the margin which imposes high costs, and benefits only a small portion of total customers. As noted above, these costs could be a required part of the subdivision approval process or paid for by property owners.
- c) **When are cross-subsidies justified?** (page 18, last part of #2) ORA recommends the Commission delete the sentence in the draft WAP which states:

Generally, cross-subsidization can be justified when the benefits (lower rates for customers in high-cost areas) exceed the cost (higher rates for customers in lower-cost areas; less-efficient allocation of water resources). (page 18)

ORA disagrees with this conclusion and believes this is an issue that should be carefully considered by the Commission in the appropriate forum, and not prejudged in this WAP. The statement above may be inimical to state water policy, conservation & the interests of other ratepayers in many cases. ORA believes that any cross subsidy programs should be tied to aggressive conservation measures and some assessment of the economic status of the community being served. Allowing cross subsidization without tight controls could be counterproductive to state-wide goals and many Commission objectives with regard to water policy, especially long-term sustainability.

- 21. **Cross-subsidization to support small water systems.** (page 18, second paragraph) If the Commission decides that some form of subsidization is required to keep rates affordable for small water systems trying to comply with new drinking water quality regulations and replace aging water infrastructure, then for equity reasons, it would be preferable to have all California water customers pay a portion of the subsidy. Making drinking water clean, safe, and affordable for all is a public policy goal. The systems that need subsidies are not limited to small water systems of the investor-owned utilities, but also include mutual water

systems and municipal systems. Customers of privately held utilities should not bear the burden of subsidizing smaller privately held water systems, be they Class C or Class D or smaller water districts that are owned by larger Class A or B utilities. Why should the subset of citizens that are private utility customers be the balancing factor here? If the Commission believes that subsidization is necessary, ORA recommends the Commission work with others to pursue legislation to equitably spread the costs out over all water users, and to establish a fund that can provide benefits to small water systems facing a water affordability crisis.

22. **Rates.** (page 18, #3) ORA recommends expanding this section to emphasize just and reasonable rates. In addition to rates providing sufficient revenue to promote adequate investment in infrastructure, the Commission's ratemaking and rate design should be guided by principles of fairness, revenue sufficiency and efficiency. Rates should reflect the cost of service, be affordable and fairly allocate costs of service to various customer classes, avoid undue discrimination and be understandable.
23. **Surcharge mechanism for Construction Work in Progress.** (page 18, #4) It is unclear from the text in this section whether a surcharge mechanism is needed to fund Construction Work in Progress (CWIP). Current Commission policy provides for CWIP accounting for most water projects since they are of short duration. (See D.94-08-031) A construction project that is authorized CWIP treatment goes directly into rate base, and earns the utility's authorized rate of return. Perhaps the title of this section should be revised to indicate the Commission will consider authorizing CWIP accounting for longer term projects.
24. **"Pre-pay account" for plant development costs.** (Page 19, #5) ORA recommends that this not be pre-judged in the WAP, but rather the Commission should consider this option on a case-by-case basis, and conduct a reasonableness review of any and all preliminary costs prior to granting recovery. In addition, the Commission should consider what happens if a proposed plant is later abandoned.
25. **Risk.** The various proposals mentioned in the draft WAP have the potential to either raise or lower the utilities' risk. Changes in risk impact the rate of return. ORA recommends the Commission consider impacts on utility risk and rate of return when reviewing the various proposals.