

August 15, 2006

Jonathon P. Tom
Water Division
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

Subject: Reply Comments on Proposals to Implement the
Water Action Plan and Improve the Rate Case Plan

Dear Mr. Tom:

By this letter, San Gabriel Valley Water Company ("San Gabriel") responds to recommendations made in comments separately submitted by California American Water Company ("CalAm"), Park Water Company ("Park"), and the Division of Ratepayer Advocates ("DRA") regarding methods to implement the Water Action Plan and improve the Rate Case Plan.

The following reply comments support effective implementation of the Water Action Plan through the general rate case ("GRC") process. Even so, some of the recommendations as discussed below fail to advance the objectives of the Rate Case Plan or the Water Action Plan. Indeed, many of these recommendations will complicate and delay rate case proceedings without advancing the objectives of the Water Action Plan.

It is helpful to review the function of the Rate Case Plan before assessing the potential refinements in this Phase II. The objective of a GRC is to set rates based on a forecast of sales and the reasonable costs of service that are anticipated during the period the rates will be in effect. The existing Rate Case Plan incorporated many shortcuts to enable the Commission staff to process on a timely basis the increased number of GRCs now being filed. Many submitted comments and recommendations address additional shortcuts without regard to any impact on the desired matching of sales and reasonable costs of service to that expected to be incurred during the rate case cycle. San Gabriel strongly urges the

Commission to reject any proposal that will likely lead to a material mismatch between adopted rates and the underlying sales and cost of service.

1. Based on its understanding of the filed comments, San Gabriel supports the following recommendations of CalAm, Park, and/or DRA:

(a) DRA's recommendation to have DRA and a company witness meet, confer, and collaborate on developing the deficiency notice.

(b) DRA's recommendations to work collaboratively with the utilities to revise and to clarify the Master Data Request so as to make it a more effective tool in the GRC process.

(c) CalAm's (and CWA's) support for Alternative Dispute Resolution in general rates cases.

(d) Park's recommendations supporting the inter-agency relationship between the Commission and DHS, coordinating all water quality reporting with DHS (although activating Phase II of the Water Quality Oll is not necessary at this time).

(e) Park's and CalAm's recommendations regarding a Water Quality Memorandum Account to allow for emergency development and construction of water treatment plant and other emergency replacements, and Park's recommendation for the designation of a CPUC water quality contact.

(f) CalAm's recommendation of a low-income assistance program funded through a state-wide pool.

(g) Park's and CalAm's suggestions supporting water conservation and Park's recommendation that the Public Advisors Office prepare a brochure explaining the benefits of the Commission's rate design policy and its relation to water conservation, which can then be provided to water utility customers.

(h) Park's suggestion that training and professional development for CPUC staff to enhance their efficiency be given a high priority.

(i) CalAm's recommendation that the Commission authorize infrastructure system replacement surcharges ("ISRS") to fund plant replacement and to reduce rate spikes, and Park's recommendation of a Distribution System Improvement Charge ("DSIC") to promote water infrastructure investment.

(j) Park's recommendation for a standard procedure and timetable for utility requests for interim rate relief.

(k) DRA's and CalAm's recommendations to designate settlement rates, if available, as Interim Rates in place of the current practice of relying on inflation factors applied to current rates.

2. CalAm's recommended 4-1/2 year rate case cycle is a step backward and contrary to law - CalAm recommends that all water utilities file a GRC once every 4-1/2 years, covering alternating 4- and 5-year periods. CalAm does not specify how the current single Test Year plus two Escalation Year format would be modified to accommodate that 4-1/2 year cycle.

A 4-1/2 year rate case cycle greatly lengthens the interval between GRCs. The Commission has expressed a need for frequent GRC filings to comply with Public Utilities Code Section 455.2 (which requires water companies to file GRCs every three years) and to avoid "stale" adopted data; yet CalAm's recommendation would increase the existing 3-year rate case cycle by a full 50%.

Another problem with CalAm's recommendation is that either Test Year forecasts will have to be made into the more distant future if more Test Years are added (resulting in less accurate forecasts) or the number of Escalation Years will be increased (Escalation Year estimates are made by applying general inflation factors to earlier Test Year forecasts with no attempt to forecast what is actually anticipated for the Escalation Year). Either way, the variances between adopted sales, revenue, expense, and rate base estimates and actual experience will unfortunately increase.

CalAm's proposal would require notice of the Proposed Application which is not currently required. Under their proposed schedule, such notice would be given up to two years prior to the effective date of the adopted GRC rates and, since changes to the Proposed Application would likely be presented six months later in the Application (under another CalAm proposal), the notice would as a result provide information that must later be superseded, resulting in additional confusion. Still another problem is the alternating January-July applications which will cause confusion both with customers and local governmental agencies that have an interest in the rate proceedings.

Finally, CalAm's proposed schedule (which they did not discuss with San Gabriel or any other utility) has San Gabriel filing its GRCs in July of Year 4 and January of Year 9. Since San Gabriel's last GRC was filed in July 2005 and its next is scheduled for July 2007, the company should be scheduled on the current timetable, ahead of utilities that already filed rate cases in 2006.

Rearranging and lengthening the rate case schedule causes unnecessary delay and confusion and does not comply with existing law. The existing 3-year rate case cycle works reasonably well and should be retained. No changes to the current filing schedule are necessary.

3. CalAm's and DRA's recommended single GRC application for multi-district water utilities will complicate and not simplify GRCs - In recommending that GRCs for all rate districts of a water utility be filed simultaneously, neither CalAm nor DRA disclose their positions on statewide rates for each utility.

CalAm's and DRA's blanket recommendations are overly broad. For example, San Gabriel has two very different rate districts, and a simultaneous filing of GRCs would not result in any efficiencies (indeed, it would result in inefficiencies). San Gabriel's Los Angeles County division service area is mostly built-out, overlaps portions of fifteen different cities plus some unincorporated areas, and relies on groundwater from the Main San Gabriel Basin for practically all of its water supply. Public participation hearings in this division are sparsely attended. About 50 miles to the east, the Fontana Water Company division serves most of the City of Fontana and surrounding areas. It is a growing region, and the much more diverse water supply mix is highly dependent upon weather conditions. Public participation hearings there are widely attended. As a result, the issues in the respective GRCs for these divisions have no meaningful overlap.

If its two rate cases are handled together, San Gabriel foresees an increased risk in the form of greater companywide revenue fluctuations from year to year. Typically, a water utility receives a full rate increase in the first Test Year and smaller rate increases in the second and third Escalation years, during which the adopted return is less likely to be achieved. With rate cases filed sequentially, revenues and earnings tend to be more stable from year to year. However, if the two GRCs were filed at the same time, revenues and earnings will likely spike up during the first year, and earnings would decline during the second and third years. This problem would be compounded under CalAm's protracted 4-1/2 year rate case cycle.

San Gabriel recommends that the current procedure for sequential filing of rate cases be retained.

4. CalAm's recommended 18-month processing time for GRC applications is unnecessary and a major step backward - CalAm would have utilities file their Proposed Applications a full six months prior to filing their Applications, thus protracting the time and effort by all parties to process a GRC from 12 to 18 months. Its stated rationale is to reduce discovery and to promote settlement opportunities. The GRC process is already far too lengthy and too complex, and any elongation of the process will instead have the opposite effect and will compound these problems. Ratepayers are not benefited when the cost of regulation is

Jonathon P. Tom
August 15, 2006

unnecessarily increased without any corresponding benefits. Lengthening the GRC process will not benefit the utilities, the Commission and its staff, or the ratepayers.

The purpose of a Proposed Application is to ensure that once the actual Application is filed, DRA and other parties have sufficient information to immediately begin their analyses of the utility's request. CalAm's proposal completely undermines this purpose. Under the current procedures, the Proposed Application is superseded several weeks later by the Application, and the changes between the two filings can be material. By lengthening the interval between these two filings, the Proposed Application will become that much less relevant to the proceeding. Changing economic and operating conditions during the six-month interval would necessitate greater updates and changes to Test Year forecasts. Moreover, additional resources would be required to respond to questions and to supply information on initial forecasts and positions taken in the Proposed Application that may be different when the Application is eventually filed after such an unnecessarily protracted lead time (e.g., a utility's need for a particular capital project might be replaced in the Application due to subsequent changed conditions. Information furnished to and any analyses done by Commission staff and interveners on the superseded capital project would then be rendered useless). In a nutshell, the work load could be doubled-up if two distinct filings (i.e., the Proposed Application and the actual Application) must be separately analyzed by the parties. Also, lengthening the time for analysis leads to more data requests, not fewer and more focused data requests as contended by CalAm.

Likewise, settlement opportunities would not be enhanced by expanding the procedural schedule. Parties are most likely to settle issues when hearings are imminent (i.e., on the proverbial courthouse steps). Parties are less likely to compromise when there is more time for economic conditions to change and more time for further negotiations before hearings. If anything, the Commission ought to implement a formal, disciplined, and facilitated ADR process to compel early resolution and settlement of issues.

For all of these reasons, San Gabriel urges the Commission to retain the current 12-month schedule in the Rate Case Plan.

5. CalAm's recommendation to meter all connections requires no changes to the Rate Case Plan – CalAm's generalization is much like "exercise is good for you". Of course, this platitude is true in most cases. Of course, metering makes sense. But it is important to acknowledge those situations outside the control of the Commission.

A case in point is large apartment complexes. Does it make economic sense to require retrofitting and re-piping existing buildings just so individual apartment meters can be installed? What about trailer parks? Does either the Commission or the utility have authority to impose individual metering requirements on the park owners? How much water is used by individual apartment dwellers or by individual trailer owners who have little or no irrigation requirements? Will the potential water savings resulting from metering outweigh the cost of retrofitting, re-piping, and metering? Should all private fire service connections be metered when water is only supplied during very rare emergencies?

San Gabriel urges the Commission to reject such platitudes in revising the Rate Case Plan. CalAm is free in its own GRCs to propose its own metering plan for areas within its own system that are not presently metered.

6. CalAm's recommendation to increase the revenue collection in the variable component of rates is another misguided effort that is at odds with important, well-thought-out principles of rate design - Current CPUC rate design requires that all variable costs and 50% of all fixed costs be recovered through the quantity rate. But CalAm thinks that fixed cost recovery through the quantity rate should be increased by an unspecified amount, purportedly as a conservation measure. That makes no sense at all.

Economists argue that appropriate price signals are sent when the charges are based on production costs - that is, fixed rates like monthly service charges should be based on fixed production costs and variable rates should be based on variable production costs. That way, the consumer will purchase a product or service where the value corresponds to the price paid, and the seller will recover its costs regardless of the amount of goods or services produced and sold. However, when fixed cost recovery is shifted to the quantity rate, the recovery of those fixed costs becomes more - not less - dependent on the level of sales, which for water is dependent upon weather conditions rather than on economic conditions or ratepayer life styles. Though CalAm recommends a revenue adjustment mechanism to de-couple sales and revenues, they fail to address the impact of this cost recovery shift on the different classes of ratepayers.

Shifting fixed cost recovery from service charges to quantity rates would provide price breaks to the majority of customers who use lesser amounts of water (e.g., residential customers) and shift the fixed cost burden to a relatively few customers who use a greater amount of water (e.g., commercial, industrial, and public authority customers). CalAm's

recommendation, therefore, may not have the intended impact (i.e., more conservation), but could have severe economic consequences for large customers who probably already maximize their water conservation efforts due to budgetary and cost constraints. Residential customers, on the other hand, would see water as less costly after this cost shift and would tend to use more, rather than less, water as a result.

Before any changes to the Commission's rate design policy, San Gabriel recommends further study of the price elasticity of water service to determine how ratepayers would respond to changes in the quantity rate or in their total monthly bills and of how such cost shift might later affect customer rates if larger users leave (i.e., bypass) the system.

7. CalAm's recommendation that the Commission consider return on equity penalties "where utilities do not promote conservation" would unnecessarily complicate the GRC process - CalAm recommends return on equity bonuses where water utilities promote conservation and return on equity penalties where water utilities do not promote conservation. But why should a water utility demand a bonus to start doing what state law already requires and what responsible Class A water utilities already do?

First, CalAm wrongly assumes that some Class A water utilities do not support and promote conservation. Second, CalAm assumes that the Commission does not already review the conservation efforts of each utility or would not in the future without a bonus/penalty system. Third, CalAm assumes that there is a clear distinction between promoting and not promoting conservation. Fourth, CalAm assumes that if all water utilities promote conservation, that the Commission will authorize higher returns on equity industry wide than the financial marketplace demands. Finally, their recommendation simply adds another complexity to GRCs by introducing a brand new issue (i.e., a bonus/penalty) when utilities already must promote conservation.

CalAm's recommended bonus/penalty system has no merit and should be disregarded.

8. CalAm's and DRA's recommended single annual generic rate of return proceeding is not necessary and will increase the Commission's case load - Supposedly to streamline CPUC regulatory decision-making, CalAm calls for a single annual generic rate of return proceeding; but as a part of the GRC, each company would still put on a showing to determine capital structure, debt cost and company-specific return on equity adjustments that balance that company's specific cost of capital. DRA would limit cost of capital reviews to once every three years (and apply the adopted return to all districts within the company). Both

Jonathon P. Tom
August 15, 2006

suggestions create more proceedings to deal with cost of capital issues, more complexity, and increased time, effort, and cost that the Commission staff and utilities must expend for no demonstrable benefit to anyone.

One obvious flaw in CalAm's recommendation is that it expands, rather than streamlines, regulatory decision-making by introducing new annual proceedings that do not currently exist. This seems directly contrary to DRA's recurring concern about its limited workforce. Furthermore, it would do nothing to reduce the scope of cost of capital analysis required in the GRC as explained more fully below.

A second flaw in CalAm's recommendation is the assumption that Class A water utilities have commonalities with respect to cost of capital that can be addressed in a single generic proceeding. In comparison with the energy utilities, Class A water utilities are very diverse. Some serve in one specific location, others statewide, and still others (like CalAm's parent) nationwide and worldwide. Some Class A water utilities are publicly traded, while others are closely held. Some water utilities have capital structures that are far more leveraged than others. Some water utilities rely only on local groundwater and surface water, others only on imported water, while still others on some combination of these sources. Some water utilities have serious groundwater contamination issues while other water utilities rely on imported water with its risk of shortages and interruptions. Some water utilities serve fast growing service areas, while others serve built-out service areas. The largest Class A water utility has 750 employees and serves over 300,000 customers, while the smallest Class A water utility has only 16 employees and serves about 20,000 customers. The point is that one size certainly does not fit all relative to the cost of capital issue for water utilities.

Finally, cost of capital is not an academic, generic issue but instead is an issue highly dependent on a great many factors unique to each utility. The Commission cannot determine the cost of equity in isolation without considering capital structure, reflecting current and future financing needs, and evaluating the wide variety of risks borne by each individual utility. Even if the Commission were to determine a generic cost of equity, each utility would still be required to put forth the same level of analysis in its GRC as it does without this generic determination.

The Commission already makes several water utility cost of capital determinations each year. These determinations vary by the utility and by then-current economic conditions, but still provide context for subsequent cost of capital determinations. A new generic proceeding will not streamline the rate case process, but instead will only expand it.

DRA's proposal of determining cost of capital only once every three years is slightly different than CalAm's, but also has shortcomings. Financial conditions often change dramatically over a short span of time. Depending on the timing of the GRC, the adopted return can be higher or lower than the required return existing when the water rates are actually in effect (that's because, as with all costs in the GRC, they are forecasted future costs). Limiting the cost of capital determination to once every three years for multi-district water utilities increases risk to the utility and further increases the variances between the costs upon which rates have been developed and the actual costs incurred during the rate case cycle.

San Gabriel recommends that the procedure of determining cost of capital in each individual GRC be retained.

9. CalAm's recommendation to limit amortization of purchased power and purchased water balancing accounts to GRCs disregards important, recently-adopted Commission policies - Currently, Commission policy requires water utilities to choose between requesting amortization of their balancing accounts either in GRC applications or by advice letter during the interval between rate cases. There are several advantages to the advice letter alternative. An advice letter can be approved much closer to the time the costs are incurred (or saved) and the rate change is requested, while the GRC process is a much longer process, with its main focus on future time periods. With advice letters, the Commission permits requests for amortization of these balances only if and at the time when they are deemed necessary, while GRCs are scheduled for limited specified time slots. Additionally, smaller rate changes between GRCs mitigate any rate shock on customers. Finally, when balancing accounts are reviewed within the scope of a GRC, it could either add potential issues to an already complex proceeding or cause those issues to be overlooked.

Because CalAm's recommendation burdens and complicates the rate setting process and is contrary to recently adopted Commission policies, it should be rejected.

10. Workshops and a new formal Commission rulemaking proceeding are unnecessary - San Gabriel agrees with the CWA comments that found the previous workshops in this proceeding required an inordinate amount time without resulting in commensurate benefits. DRA appears to be inviting ratepayer and public involvement to be heard on what information should be contained in a GRC application and on what procedural steps are necessary to process a GRC application. This is

unnecessary and hardly appropriate to incorporate the Water Action Plan into the GRC process.

Further workshops in this proceeding, especially with the introduction of additional participants and new or complicating issues, would be time-consuming without commensurate benefit. Written comments such as these in which the water utilities and DRA explain their positions and their concerns are far superior to endless workshops in furtherance of the Phase II objectives.

11. DRA's recommendation to standardize GRC applications and files should not restrict the water utility's evidence or its ability to make its case - Utilities use formats for presentation and methods to make forecasts that sometimes differ from one company to another. Some standardization is clearly beneficial (e.g., formatting of summary of earnings tables); however, forced standardization is not beneficial when it is unduly formulaic and arbitrary.

For example, a water utility should not be restricted in the methodologies it uses to make Test Year forecasts as long as its methodologies are fully explained and supported. Such restrictions (e.g., formulaic customer growth forecasts that ignore changing economic conditions) prevent the utility from accurately forecasting Test Year information on which the adopted rates will be based. Forced adherence to arbitrary methods impede a utility's evidentiary showing and sacrifice principled, fact-based determinations in favor of formulaic and arbitrary methods.

Further, standardization may require a utility to force-fit accounting and operating information into a pre-set format that results in more confusion than clarity. Such standardization may also require utilities, without any corresponding benefit to the company or its customers, to re-tool computer programs or accounting systems that have been in use for many years.

12. DRA's recommends minimizing the types of updates and changes that water companies may submit even though such updates are normally warranted because of the passage of time - This recommendation is extremely vague and thus unworkable. Certainly, San Gabriel agrees that a "moving target" is difficult to evaluate, and prompt processing of GRC applications mitigates the need to update information due to changed circumstances. Note that CalAm's recommended 18-month processing time for GRC applications would necessitate even more updates, while CWA's recommendation of eliminating a formal filing of the Proposed Application would require fewer updates.

On the other hand, all identified errors should be corrected. Likewise, utilities should be able to respond to the positions of staff and interveners who themselves routinely insist upon obtaining and using the most up-to-the-minute information. GRC decisions should be based upon the latest information reasonably available at the time of the evidentiary hearings, and water utilities should not be discouraged from bringing that information to the Commission's attention.

13. DRA's recommendation for a negative presumption if a data request supposedly is delayed has no merit – DRA would have the Commission presume a requested expenditure isn't justified and disallow it if DRA alleges that a discovery request is unreasonably delayed. Such a recommendation would simply encourage squabbles over data requests.

First, there is no allegation that a substantial problem exists in this area. Second, DRA already has adequate, speedy means under the existing Rate Case Plan to resolve any discovery problems that might arise. Third, this could create an incentive for DRA to game the process with extensive data requests, rather than relying on its own analysis, in its attempt to reject a utility's proposals, as it is not unusual for utilities to receive voluminous (and often repetitive and redundant) data requests shortly before the due date for the staff report. Finally, a negative presumption and automatic disallowance of a particular GRC request would do nothing to advance the objective of effective GRCs and implementation of the elements of the Water Action Plan.

DRA can do much on its own to encourage timely data responses by making its requests clear and focused, and by explaining to the utility why the question is being asked (e.g., often time, the information is more readily available in a different format or information different than requested can better satisfy DRA's objective). The timing of data requests also affects response time because of the availability and other workload of the responding company personnel. San Gabriel supports an update of the Master Data Request to include as much as possible of the foreseeable background information that DRA will require in its analysis (as well as to delete voluminous information that is not likely to be needed). Data gathering should be collaborative – not adversarial – and should not encourage a "gotcha" system.

14. DRA's recommendation to limit the number of pages of prepared rebuttal testimony makes no sense – A goal of any GRC proceeding is to fully address issues in order to arrive at the best adopted result. DRA would place an arbitrary (currently unspecified) limitation on the utility's written response to the positions taken by DRA and any interveners.

Jonathon P. Tom
August 15, 2006

Besides making it far more difficult to adequately develop the issues in the GRC, the proceedings would become far less efficient and less effective as utilities would be forced to introduce much of their rebuttal through time-consuming oral testimony at hearings, and other parties would need more extensive cross-examination in an attempt to understand the utility's artificially abbreviated prepared rebuttal testimony. If DRA believes prepared testimony is too long or not on point, they are free to enter objections at hearing.

DRA's recommendation merits no further consideration, because it would prevent the efficient and effective presentation of evidence in the GRCs.

Please note that San Gabriel has not completed its analysis of the Joint Recommendations submitted by CalAm, California Water Service, Golden State Water Company, Natural Resources Defense Council, and Mono Lake Committee and therefore offers no comment at this time on that document. Please call me at (909) 448-6183 with any questions.

Sincerely,

Daniel A. Dell'Osa
Director, Rates and Revenue

cc: Kevin Coughlan
Recipients of July 7, 2006 letter