

PUBLIC UTILITIES COMMISSION505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298

May 10, 2004

Agenda ID #3550
Ratesetting

TO: PARTIES OF RECORD IN APPLICATION 01-09-062 ET AL.

Enclosed are the draft decision of Administrative Law Judge (ALJ) Bushey and the alternate draft decision of Commissioner Kennedy. They will not appear on the Commission's agenda for at least 30 days after the date they are mailed. The Commission may act then, or it may postpone action until later.

When the Commission acts on the draft decision or the alternate, it may adopt all or part of it as written, amend or modify it, or set it aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties to the proceeding may file comments on the draft decision and the alternate draft decision as provided in Article 19 of the Commission's Rules of Practice and Procedure (Rules). These rules are accessible on the Commission's Website at <http://www.cpuc.ca.gov>. Pursuant to Rule 77.3 opening comments shall not exceed 15 pages. Finally, comments must be served separately on the ALJ and the Assigned Commissioner, and for that purpose I suggest hand delivery, overnight mail, or other expeditious method of service.

/s/ ANGELA K. MINKIN
Angela K. Minkin, Chief
Administrative Law Judge

ANG:hkr

Attachment

Decision **DRAFT DECISION OF ALJ BUSHEY (Mailed 5/10/2004)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of California Water Service Company (U 60 W), a Corporation, for an Order Authorizing It to Increase Rates Charged for Water Service at Its Bear Gulch District.

Application 01-09-062
(Filed September 21, 2001)

And Related Matters.

- Application 01-09-063
- Application 01-09-064
- Application 01-09-065
- Application 01-09-066
- Application 01-09-067
- Application 01-09-068
- Application 01-09-069
- Application 01-09-070
- Application 01-09-072
- Application 01-09-073
- Application 01-09-074

**OPINION ADOPTING RETROACTIVE EFFECTIVE DATE
SURCHARGE METHODOLOGY**

Summary

In this decision, we adopt a methodology for calculating the effective date surcharge for California Water Services Company (Cal Water).

Background

On February 2, 2003, Cal Water filed a motion stating that the Commission's decision in this proceeding had been delayed beyond that contemplated by the Rate Case Plan.¹ Cal Water contended that the delay had caused it financial harm, and requested that the Commission either grant Cal Water an interim rate increase or set an early effective date for the anticipated increase.² In support of its request, Cal Water cited to Apple Valley Ranchos Water Company (Apple Valley), Decision (D.) 02-03-046 and Pub. Util. Code § 455.2. (See Cal Water Motion at pages 4 and 6.) Cal Water did not propose a methodology for calculating the surcharge to collect the retroactive amounts that would be required should the Commission grant the request for an immediate effective date. In D.03-04-033, the Commission denied Cal Water's request for an interim rate increase but granted Cal Water's request for an immediate effective date. Cal Water filed no subsequent motions proposing a methodology for calculating the surcharge.

On August 21, 2003, the Commission approved Apple Valley's rate increase and included a specific surcharge in the tariffs to recover the retroactive amounts. (See Appendix B of D.03-08-069.) Approximately two weeks later, the Commission issued D.03-09-021 where it authorized Cal Water to implement a substantial rate increase and, like Apple Valley, to collect the retroactive amounts contemplated by D.03-04-033 via a surcharge. The Commission also specified

¹ Re Schedule for Processing Rate Case Applications by Water Utilities, 37 CPUC2d 175 (D.90-08-045).

² By setting an effective date prior to the final determination, the Commission ensures the utility that any rate change will have retroactive effect. Here, the Cal Water increase approved on September 5, 2003, is retroactively effective to April 3, 2003.

that Cal Water should use the same methodology to calculate the surcharge as used by Apple Valley.

In its application for rehearing of D.03-09-021, Cal Water objected to using the Apple Valley Methodology to calculate its retroactive surcharge. Cal Water contended that it had developed an alternative methodology that will result in \$358,547.91 in additional revenue being collected from ratepayers. Cal Water argued that it was “entitled” to this amount. Cal Water stated that the Apple Valley decision was issued after the close of the record in this proceeding, and that it had no opportunity to comment on whether the Apple Valley Methodology should be applied to Cal Water.

In D.04-01-052, we agreed with Cal Water and granted limited rehearing to consider whether the Apple Valley Methodology should be applied to Cal Water. That decision set briefing dates for the issue.

On February 20, 2004, Cal Water filed its brief on the surcharge methodology, and argued that the Apple Valley Methodology should not be applied to Cal Water because it “would constitute an unconstitutional taking under applicable law” and that the Apple Valley Methodology is “not suited” for Cal Water.³ Cal Water also stated that it had filed tariff sheets implementing a surcharge based on the Apple Valley Methodology, as directed by the Commission’s Water Division. Although not stated by Cal Water, we infer that it seeks authority to increase the revenue amount to be collected pursuant to the surcharge tariff.

³ In its brief, Cal Water refers to D.03-04-033 as granting “interim rate relief.” (See, e.g., page 2.) That decision, however, did not grant Cal Water’s request for interim rate increase but rather established a retroactive effective date for the final decision.

The question presented is the product of two decisions, D.03-04-033 and D.03-09-021. The first decision made the second decision retroactively effective. The methodology for calculating the surcharge necessary to implement this artifice is the issue at hand.

Overview of the Methodologies

The Apple Valley Methodology is derived from the Commission's basic ratemaking approach, and is conceptually consistent with fundamental ratemaking forecasts and calculations, as we explain below.

The Commission sets rates by using forecasts of annual revenue requirements and annual water consumption. These forecasts are all made on a yearly basis—not on a daily or monthly basis. In circumstances such as here, and in the earlier Apple Valley rate case, when resolution of the rate case is delayed, these forecasts support calculating lost revenue based on the ratio of the number of delayed days to the total number of days in a test year. Multiplying this ratio by the total annual revenue yields the amount of revenue requirement “lost” due to the delay.

This revenue requirement is then divided by forecast sales for the one-year prospective surcharge period to determine the specific surcharge. In sum, the surcharge is calculated based on the forecasts that the Commission routinely uses to set rates and is consequently consistent with those forecasts.

In its brief, Cal Water states that its “methodology entails using the company's actual water sales data during the relevant period from April to September of 2003 for the districts at issue.” Cal Water then sets out a tabulation of recorded water sales and compares them to the sales Cal Water says are implied by the Apple Valley Methodology. Finally, Cal Water tabulates the revenue it claims to have lost due to using the Apple Valley Methodology. Nowhere in the brief does Cal Water set out the specific calculation steps in its

methodology, although Ordering Paragraph 1 of D.04-01-052 required such specifications.

For our purposes today, we need not go beyond Cal Water's request to calculate the surcharge based on actual sales. This is sufficient information to enable us to evaluate Cal Water's proposed methodology.

In essence, we reject Cal Water's Methodology because any attempt to calculate "lost" revenue based on actual sales, as advocated by Cal Water, would necessarily lead to additional delay in implementing the surcharge, as well as require multiple rate increases. Ratemaking policy disfavors both of these outcomes. A complete set of all actual sales data for the delay period will not be available on the date the revised rates go into effect. Accordingly, the utility would be unable to reliably calculate the surcharge revenue requirement. A later, second rate increase would be required when the sales data became available. The resulting further delay and a second rate increase would cause additional administrative costs for the utility and the Commission, and can lead to customer confusion. The Apple Valley Methodology avoids these problems by using forecast data.

Cal Water's Objections to the Apple Valley Methodology

Cal Water contends that the Apple Valley Methodology is not reasonable as applied, and that it violates the U.S. and California Constitutions. As analyzed below, Cal Water's contentions are without merit.

A. Is the Apple Valley Methodology Reasonable?

Pursuant to the Public Utilities Code, all Commission approved rates must be just and reasonable. (§ 451.⁴) The Apple Valley Methodology uses

⁴ All statutory citations are to the Public Utilities Code unless otherwise indicated.

existing ratemaking data and concepts to determine the revenue requirement necessary for the surcharge to collect the retroactive amounts. Because the calculation data is drawn from the rate case decision, there is limited potential to dispute the calculations. Reducing potential contentiousness, particularly at this last stage in a rate case, is a valid ratemaking goal. This Methodology also allows for implementation, without further delay, of the complete rate increase. Consequently, we conclude that the Apple Valley Methodology is a reasonable means to determine the retroactive effective date surcharge.

Cal Water contends that using actual sales data will enable it to collect more revenue from its customers, which, Cal Water asserts, will more closely reflect what would have occurred, had the rate increase actually been in place on the effective date. Based on the limited description provided by Cal Water, we see both administrative and conceptual deficiencies in the proposal.

Cal Water's proposal requires actual customer sales data, which will not be available for at least one full billing cycle after the rate increase takes effect. This will necessitate an additional rate increase soon after the general rate case increase. Rate increases in rapid succession are disfavored due to the administrative burden placed on our staff as well as customer dissatisfaction.

We are also reluctant to incorporate further delay in implementing the complete rate increase. The purpose of the surcharge is to recover revenue requirement associated with service provided after the effective date and before the final rate increase. Temporal shifts in revenue requirement are disfavored because current customers are paying costs associated with past service, which

they may not have received.⁵ Such shifts are also contrary to cost-based water ratemaking policy adopted by the Legislature in § 701.10. We note that the amount Cal Water seeks authorization to include in a revised surcharge, \$358,547.91, is associated with service provided in April through September 2003, nearly one year ago.

Attempting to retroactively reconcile the rate increase to actual sales invites numerous factual and policy disputes. Because Cal Water did not present a comprehensive proposal for our consideration, we can only imagine how Cal Water would address conceptual issues such as increased customer conservation in response to higher rates, changes in the uncollectible rate, and how to adjust for subsequently discovered billing errors, to name a few. These disputes, and the implementation delay, are largely avoided by using the Apple Valley Methodology.⁶

Therefore, we conclude that the Apple Valley Methodology is a reasonable means of implementing a surcharge to effectuate a retroactive general rate increase.

⁵ For example, the Commission's experience in telecommunications reparations cases shows that significant numbers of customers change service providers, up to a third a year. (See D.99-04-023.)

⁶ Cal Water correctly observes that the Apple Valley Methodology assumes that water sales are constant throughout the year, and that this assumption is not consistent with actual sales patterns, which typically peak in the summer. Thus, Cal Water concludes that the Apple Valley Methodology would be inappropriate for a rate increase delay that covers an above or below average sales period. Cal Water, however, provides no suggested means for allocating the annual revenue requirement among the 12 months, to determine the "lost revenue" on a monthly basis.

B. Is the Apple Valley Methodology Constitutional?

Cal Water contends that the Apple Valley Methodology confiscates its property in violation of the U.S. and California Constitutions. We begin our analysis of Cal Water's argument by reviewing the applicable constitutional ratemaking standards, and then comparing our decision to those standards.

Cal Water cites Duquesne v. Barasch, 488 U.S. 308 (1989) and FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944) as supporting the conclusion that applying the Apple Valley Methodology would constitute a "taking." As set out below, Cal Water's reliance on these decisions is misplaced.

In Hope Natural Gas the U.S. Supreme Court held that it is the "end result" that determines whether a rate order violates the U.S. Constitution not the particular ratemaking methodology used:

Under the statutory standards of "just and reasonable" it is the result reached not the method employed that is controlling. It is not the theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.

* * *

From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard, the return to the equity owner should be commensurate with the returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

(Hope Natural Gas, 320 U.S. at 602-3, citations and quotations omitted.)

More recently, the Court has continued its reliance on the “end result” or rate of return to equity holders as the yardstick for evaluating rate orders and again rejected arguments that “the Constitution requires that subsidiary aspects of . . . ratemaking methodology be examined piecemeal.” (Duquesne Light, 488 U.S. at 313.) The Court restated the Hope Natural Gas requirements that rate orders must enable a company to maintain its financial integrity, to attract capital, and to compensate investors. The Court went on to specifically reject any requirements for ratemaking methodology:

The economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The Constitution is not designed to arbitrate these economic niceties. Errors to the detriment of one party may well be cancelled out by countervailing errors or allowances in another part of the rate proceeding. The Constitution protects the utility from the net effect of the rate order on its property.

(Duquesne, 488 U.S. at 314.) In Duquesne, the Court observed that the rate orders at issue resulted in revenue reductions of 0.4% and 0.5% for the two utilities and summarily concluded that “the overall impact of the rate orders . . . is not constitutionally objectionable.” (*Id.* at 312.)

In sum, the U.S. Supreme Court requires that a utility demonstrate that the net effect of a rate order is to jeopardize the utility’s financial integrity, ability to attract capital or compensate investors.

The California Supreme Court also focuses on the end result of the ratemaking order and declines to review ratemaking methods:

The fixing of rates is a legislative act. The standard is that of reasonableness. One challenging a rate-fixing order on constitutional grounds of confiscation is charged with the burden of showing that the evidence does not support the commission’s findings and that the rate as finally fixed is unreasonable and will result in confiscation. Such burden is

coupled with a strong presumption of correctness of the findings and conclusions of the commission, which may choose its own criteria or method of arriving at its decision, even if irregular, provided unreasonableness is not clearly established. Thus, responsibility for rate fixing, insofar as the law permits and requires, is placed with the commission, and unless its action is clearly shown to be confiscatory the courts will not intervene.

Pacific Telephone and Telegraph Company v. PUC, 44 Cal. Rptr. 1, 8 (1965)
(citations and quotations omitted).

Proving an unconstitutional confiscation of property under California law, as under federal law, requires that the utility show that the “end result” of the rate order undermines the utility’s financial integrity. Similarly, California courts will not inquire into the method used by the Commission in setting the rates.

Cal Water states that the Apple Valley Methodology violates the U.S. and California Constitutions by depriving Cal Water of \$358,547 to which it is “entitled” pursuant to D.03-04-033. As noted above, however, a claim of confiscation requires a showing that the “end result” of the order undermines the utility’s financial integrity. Cal Water has presented no evidence on this point and our review of the record fails to find any support for the claimed confiscation.

The record in this proceeding shows that the amount Cal Water disputes, \$358,547, is about 0.25% of the total revenue requirement for the affected districts.⁷ The U.S. Supreme Court summarily rejected reductions of 0.4% and 0.5% in revenue requirement as being constitutionally objectionable in

⁷ Total annual operating revenues are \$144,383,100 for the 14 affected districts. (See D.03-09-021 at Attachment E.)

Duquesne. Cal Water's lack of evidence on the "end result," i.e., Cal Water's overall financial return, and the record in this case thus disprove any allegations of confiscation.

Cal Water concludes its argument by stating that the "Commission must adopt a methodology which permits Cal Water to recover the interim rates to which it is entitled." (Cal Water Brief at page 5.) As noted previously, the Commission did not grant Cal Water an interim rate increase in D.03-04-033, nor did the Commission specify how the retroactive effective date for the final rate increase decision would be implemented. Thus, Cal Water has not shown any specific "entitlement" that was "taken" by using the Apple Valley Methodology.

As noted by the U.S. Supreme Court, however, the judgments required in a rate case often "do not admit of a single correct result." (Duquesne, 488 U.S. at 298.) While Cal Water has not provided us the calculation details needed to specifically review its method, we have determined that ratemaking consistency and the administrative ease of one rate increase, on balance, favor continued use of the Apple Valley Methodology.

Comments on Draft Decision

The draft decision of the Administrative Law Judge (ALJ) in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.7 of the Rules of Practice and Procedure. Comments were filed on _____ and reply comments were filed on _____.

Assignment of Proceeding

Susan P. Kennedy is the Assigned Commissioner and Maribeth A. Bushey is the assigned ALJ in this proceeding.

Findings of Fact

1. The Apple Valley Methodology calculates a “pro rata share of adopted revenue requirement” based on the ratio of retroactive days to the total number of days in a test year.
2. The Apple Valley Methodology can be applied and the surcharge calculated at the time the general rate case increase is implemented.
3. The Apple Valley Methodology is consistent with general ratemaking concepts.
4. Cal Water proposed using actual sales to determine the revenue to be recovered through the surcharge.
5. Revenue requirement, sales, and rates are set based on aggregate annual amounts, not on a daily or monthly basis. Actual daily or monthly sales cannot be readily reconciled to annual revenue requirement.
6. Administrative ease, avoiding further delay, and limiting customer dissatisfaction are valid rationales for selecting ratemaking methods.
7. Assertions of loss of 0.2% of annual revenue requirement does not support a claim of confiscation.

Conclusions of Law

1. The Apple Valley Methodology is a reasonable way to calculate the surcharge necessary to implement the retroactive rate increase authorized by D.03-04-033.
2. Cal Water’s request to increase the amounts to be recovered in the surcharge should be denied.
3. The Commission’s decision to use the Apple Valley Methodology is constitutional.
4. Today’s order should be made effective immediately.

O R D E R

Therefore, **IT IS ORDERED** that:

1. The request of California Water Service Company to change the calculation of its surcharge is denied.

2. Application (A.) 01-09-062, A.01-09-063, A.01-09-064, A.01-09-065, A.01-09-066, A.01-09-067, A.01-09-068, A.01-09-069, A.01-09-070, A.01-09-072, A.01-09-073, and A.01-09-074, are closed.

This order is effective today.

Dated _____, at San Francisco, California.