

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Application of CALIFORNIA WATER SERVICE COMPANY (Applicant) (U-60-W), a California corporation, requesting an order from the California Public Utilities Commission (Commission) authorizing Applicant to increase water rates to fully fund its retiree healthcare plan commonly referred to as a 'Postretirement Benefits other than Pension' (PBOP) plan and to adopt a change in accounting as proposed by Applicant for ratemaking

Application Number
Filed

APPLICATION OF CALIFORNIA WATER SERVICE COMPANY

LYNNE P. MCGHEE
Assistant Corporate Counsel
California Water Service Company
1720 North First Street
San Jose, California 90505-5272
Telephone: 408-367-8228
Fax: 408-367-8430
E-mail: lmcghee@calwater.com

December 21, 2006

APPLICATION

TO THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA:

This Application of CALIFORNIA WATER SERVICE COMPANY (Applicant) respectfully requests as follows:

I.

GENERAL STATEMENT OF AUTHORIZATION SOUGHT:

Applicant files this application (Application) to request authorization to increase rates to fully fund its retiree healthcare plan commonly referred to as a ‘Postretirement Benefits other than Pension’ (PBOP) plan in accordance with Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (FAS) 106 and to recover the associated regulatory asset, which Applicant has recorded in accordance with the California Public Utilities Commission (Commission) Decision (D.) 92-12-015, over a fifteen-(15) year period. On a going forward basis, Applicant requests that the entire FAS 106 PBOP expense be included in customer rates and the recovery of the associated PBOP regulatory asset, which Applicant was authorized to record in D.92-12-015, commence.

II.

BACKGROUND:

In 1990 , FASB issued FAS 106 that became effective in 1993 (summary enclosed, Exhibit “1”), which required companies to account for PBOP costs on an accrual basis rather than on a pay-as-you-go (PayGo) basis. The accrual basis requires companies to recognize PBOP costs during the service life of the employee and not when the employee uses the benefit during retirement. As

such, FAS 106 PBOP expense is greater than PayGo expense, which utilities previously used for both financial reporting and rate-setting purposes.

The Commission issued D.92-12-015, which allowed FAS 106 PBOP expenses in rates, if fully funded, and assured the recovery of any associated regulatory asset representing the difference between PayGo and FAS 106 expense. Applicant filed Advice Letter 1341 (enclosed, Exhibit “2”), effective June 13, 1994, to adopt FAS 106 and establish a regulatory asset.

Applicant has complied with FAS 106 for financial accounting purposes. Since Advice Letter 1341, Applicant has continued expensing at the PayGo basis and recording the difference between PayGo and FAS 106 PBOP expense as a regulatory asset. This accounting has lowered rates to the ratepayer as only PayGo expense has been currently collected and recovered in customer rates. As shown in this Application, Applicant’s ratepayers have benefited and will continue to benefit by Applicant’s deferred recognition of FAS 106 expense immediately in rates and the subsequent recovery of the regulatory asset.

For 2005, the PayGo expense was approximately \$1.3 million; whereas, the FAS 106 expense was approximately \$2.04 million. The balance of Applicant’s PBOP regulatory asset is approximately \$9.87 million as of December 31, 2005 (enclosed, Exhibit “3,” California Water Service Group Annual Report 2005, reference to Note 12, page 57).

By this Application, Applicant requests authorization to collect the full FAS 106 PBOP expense, which Applicant will fund and contribute to its PBOP plan as well as to recover its regulatory asset for deferred PBOP expense in accordance with D. 92-12-015 over a fifteen-(15) year period.

III.

COMPLIANCE WITH D. 92-12-015:

Pursuant to D.92-12-015, utilities are entitled to recover the full FAS 106 expense in rates for PBOP expense. As set forth in ordering paragraph 1 of the decision, “Employers' accounting [FAS 106 expense] for post-retirement benefits other than pensions (PBOP), shall be adopted with the following modifications, as discussed in this order, for regulatory accounting and ratemaking purposes....” Furthermore, D.92-12-015 provides that utilities should establish regulatory assets to recover the difference between the FAS 106 and the PBOP expense until such time as the utility is allowed to recover the full FAS 106 expense in rates. Ordering paragraph 4 of the D.92-12-015 states “[T]he utilities shall establish and maintain a regulatory asset pursuant to Financial Accounting Standards Board's Statement No. 71....”

Applicant has complied with D.92-12-015 and now requests recognition of the full FAS 106 PBOP expense in rates and recovery of its PBOP regulatory asset over a fifteen-year period.

Specifically, Applicant has complied with the D.92-12-015's ordering paragraphs as follows:

1. Applicant's use of benefits/years-of-service approach does not result in a cost of more than 10% of the employees' total service life attribution method (See attached Letter from Milliman dated December 22, 2005, Exhibit “4.”) (Ordering paragraph 1(b) of D.92-12-015)
2. Applicant is amortizing its transitional benefit obligation (TBO) over a 20-year time period beginning January 1, 1993. The TBO was approximately \$4.96 million as of January 1, 1993, and was approximately \$2.2 million as of January 1, 2006. (See attached Note 12, California Water Service Group 2005 Annual Report, Exhibit “3.”) (Ordering paragraph 1(c) of D.92-12-015)

3. Applicant has established and will continue to use an independent trust(s) for the receipt, investment, administration and disposition of PBOP. In 1993, Applicant established a 401(h) trust. On December 21, 2005, Applicant's Board of Directors approved the formation and funding of two Voluntary Employee Beneficiary Associations (VEBA) trusts to allow increased funding called for by FAS 106. (Ordering paragraph 2(a) of D.92-12-015)
4. Applicant has not requested and does not intend to request tax-deductible contributions grossed-up for ratemaking. (Ordering paragraph 2(b) of D.92-12-015)
5. Applicant has only used and intends to only use PBOP trust funds for PBOP. (Ordering paragraph 2(c) of D.92-12-015)
6. Applicant has used and will continue to use actuarial based assumptions to contribute and fund PBOP expense. (See Milliman SFAS 106 Actuarial Valuation for year ending December 31, 2005, Exhibit "5," year ending December 31, 2004, Exhibit "6," and year ending December 31, 2003, Exhibit "7.") (Ordering paragraph 2(d) of the Decision)
7. Applicant's tax-deductible contributions in any given year have not and will not increase over the prior year's PBOP expense recovery by more than 1% of the utility's total prior year's operating revenues. (See attachment which sets forth Applicant's operating revenues, Exhibit "9" column J.) (Ordering paragraph 2(f) of D.92-12-015)
8. Applicant can not apply surplus pension assets to fund its PBOP expense because it is not in an overfunded position. (See Note 12, Exhibit "3.") (Ordering paragraph 2(g) of D.92-12-015)

9. Applicant has not withdrawn and does not intend to make withdrawals from its PBOP or VEBA trusts other than to pay PBOP expenses. (Ordering paragraph 3 of D.92-12-015)

10. Applicant has established and maintained a regulatory asset pursuant to FAS 71. Applicant has not sought recovery of such regulatory asset. Applicant's tax-deductible limits have not exceeded PBOP. Applicant intends to amortize the regulatory asset until the regulatory asset reaches a zero balance. (Ordering paragraph 4 of D.92-12-015)

11. Applicant has not and does not intend to include its regulatory asset as a rate base component subject to a return on investment. (Ordering paragraph 5 of D.92-12-015)

12. Applicant is not accruing interest on its regulatory asset. (Ordering paragraph 6 of D.92-12-015)

IV.

DISCUSSION:

Applicant's FAS 106 PBOP expense exceeds its PayGo expense, which is included in Applicant rates (See Exhibit "8"). In accordance with D.92-12-015, Applicant records the difference between the FAS 106 PBOP and the PayGo expense as a regulatory asset.

In recent years, Applicant has experienced a dramatic increase in its healthcare costs. As such, the difference between FAS 106 PBOP and PayGo expense recorded as a regulatory asset has also grown, dramatically. As shown on Exhibit "8," the annual difference (annual amount deferred and recorded as a regulatory asset) has grown approximately 10 times from 1993 to 2004. Applicant is deferring approximately twice what Applicant expenses, funds and includes currently in customers rates. Without changes to assumptions adopted by Applicant in 2005, the

PBOP expense difference (increase in the regulatory asset) would be approaching \$2,500,000 per year.

Applicant's independent financial auditors, KPMG, have expressed concern with the recovery of the PBOP regulatory asset. Their concern arises due to the escalating rate of healthcare costs, and no formal indication from the Commission (other than the Commission's D. 92-15-012, over fourteen years ago) that such amounts will be recoverable. Since previously deferred amounts (amounts recorded as a regulatory asset) have not been included in customer rates and healthcare costs are rising, there is a continuing increase in this regulatory asset. KPMG has informed Applicant's Board of Directors that Applicant must provide further support that the regulatory asset is recoverable or Applicant may be required to write-off the regulatory asset to the extent recovery is not authorized by the Commission. (See Management's Discussion and Analysis Results of Operations and Financial Condition, Exhibit "3," page 32.) The write-off of the regulatory asset would have a significant financial impact on California Water Service Group's (Group) financial statements and may even require restatement of Group's financial statements. In this Application, Applicant is requesting Commission action necessary to avoid further reporting on this issue.

Moreover, Applicant believes that continuing to record a significant portion of PBOP expense as a regulatory asset is not in the best interest of all ratepayers and may result in overcharging future ratepayers. The increase in healthcare costs is not expected to abate in the near future. Without the change in assumptions Applicant implemented in 2005, Applicant would be deferring approximately twice the amount that it is currently expensing and recovering in customer rates (See Exhibit "8").

Applicant also contends that it is fair and equitable and in the best interest of all its ratepayers to begin recognizing these additional costs Company-wide at the same time. Since Applicant has 24 separate rate districts and general rate cases are filed over a three-year period, all customer rates should be adjusted simultaneously. This will avoid ratepayers paying different amounts and disproportionately recognizing the PBOP liability,

Finally, Applicant seeks to advise the Commission that Applicant intends to change its accounting of PBOP expense for ratemaking purposes and seeks to bring the issue to resolution prior to Applicant's filing of a general rate case (GRC) for its general office scheduled for July 2007. Since Applicant's PBOP expense is reviewed in its general office rate-setting proceeding, Applicant requests that the Commission take action to approve its request prior to Applicant's formal 2007 general rate case (GRC) filing.

Applicant has complied with D.92-12-015 and will continue to record the difference between its PayGo costs and its FAS 106 PBOP expense as a regulatory asset until Applicant is authorized to include the additional expense in customer rates.

V.

TAX ISSUES:

In order to receive a current year tax deduction for any additional contribution to its PBOP, Applicant has established two Voluntary Employee Beneficiary Associations (VEBAs), which allowed it to increase PBOP plan contributions and match its FAS 106 PBOP expense. VEBAs will also allow for contributions, which Applicant will fund and contribute to its PBOP plan, as Applicant is allowed to recover its regulatory asset.

VI.

RATEPAYER IMPACT:

Applicant has completed a net present value analysis and examined the inter-generational impact on ratepayers as shown on Exhibit “9.”

Columns on Exhibit “9” represent the following:

Column A shows the FAS 106, which has been expensed on its books, and going forward without California Water Service Company Other Postretirement Plan (Plan) changes.

Column B shows PBOP deferred each year, and going forward without Plan changes: however, it is unlikely the Applicant may continue to defer expense after 2005.

Column C shows the cumulative amount of PBOP expense deferred without Plan changes.

Column D shows the total FAS 106 expense without Plan changes (=A+B).

Column E shows the total FAS 106 expense with Plan changes.

Column F shows the cumulative amount of PBOP expense deferred and the effect of amortization.

Column G shows fifteen-year amortization of 2005 balance of \$9.8 million.

Column H shows the FAS 106 expense and the amortization of the regulatory asset.

Column I shows the annual change in PBOP expense.

Column J shows Applicant’s operating revenues.

Shaded amounts are projected, using a projected 5% increase annually.

Column D non-shaded amounts show costs that Applicant would have included in rates had Applicant used the full FAS 106 expense for ratemaking purposes in prior years. The shaded area shows what Applicant expects to pay recognizing FAS 106 expense (assuming an annual 5% increase in FAS 106 expense and healthcare costs) in future years. Column D shaded amounts also show FAS 106 expense starting in 2007, assuming no Plan changes.

Column H shows PBOP costs that Applicant has included in rates and anticipates to be included in rates based on the recovery of its regulatory asset over the fifteen (15) years with Plan changes.

The net present value (using a discount rate of 7%) of Column H is substantially less than Column D, which show a savings to ratepayers of \$14.6 million. Without taking into account

changes in PBOP assumptions, ratepayers would save on a net present value basis \$2.4 million, see Exhibit “11.” Over the 28 year period, shown on Exhibit “9,” ratepayers save \$38.2 million. Clearly, Applicant’s deferment of PBOP expense as a regulatory asset and inclusion of FAS 106 PBOP expense starting in 2006 rates and its delayed recovery of the regulated asset benefited ratepayers.

As shown on Exhibit “9” ratepayers between 1993 and 2006 save \$13.4 million and between 2007 and 2021 save \$26.3 million. Therefore, inter-generational ratepayers, before and after Applicant begins full FAS 106 expense and recovery of its regulatory asset, benefit.

In accordance with Exhibit “9”, the change in accounting for PBOP costs requested by Applicant is less than 1% of revenues (Applicant 2005 revenues were \$309 million and additional expense, including the recovery of the regulatory asset is approximately \$1.4 million). However, at this time, Applicant requests a surcharge of twelve cents per customer (\$0.12) to fully recover its regulatory asset as shown in worksheet Exhibit “12” by 2021.

VII.

CHANGE TO PBOP ASSUMPTIONS:

As of 2006, Applicant changed the PBOP plan assumptions. Retirees 65 years old and eligible for Medicare contribute approximately 50% rather than 40% of medical claims. Applicant will also allocate 100% of the Medicare subsidy to reduce the company’s expense rather than allocating 20% to offset increases in employee contributions. With these changes, the FAS 106 expense is reduced in 2005 and thereafter. As noted above, Applicant also formed Voluntary Employee Beneficiary Associations (VEBA) to allow additional funding to match the additional contributions.

VIII.

PROCEDURAL MATTERS:

Within 10 days, Applicant will publish notice of this Application in local newspapers of general circulation within each of Applicant's 24 operating districts. Applicant, within 10 days after filing the application with the Commission, will mail a notice to the following stating in general terms the proposed increases in rates: (1) the State, by mailing to the Attorney General and the Department of General Services; (2) each county, by mailing to the County Counsel (or District Attorney if the county has no County Counsel) and County Clerk, and each city, by mailing to the City Attorney and City Clerk; and (3) any other persons who have requested service of Applicant's filings.

Within 45 days, except within 75 days in districts with a 60-day billing cycle, Applicant will furnish to its customers notice of its Application either by mailing such notice postage prepaid to such customers or by including such notice with the regular bill for charges transmitted to such customers. A copy of the notice is attached as Exhibit "13"

Applicant does not believe that issues raised in this proceeding will require an evidentiary hearing. All necessary facts for the Commission to act are contained within this Application. Applicant's current PBOP expense for 2006 is \$1.6 million per D. 05-07-022. The change in accounting for rate setting purposes would increase Applicant's revenue requirement by \$1.2 million (\$2.8 million less \$1.6 million) or approximately 0.4% of Applicant's revenue requirement of approximately \$309.0 million in 2005.

Applicant requests the Commission to act expeditiously. Applicant is the largest operating subsidiary of Group, which is required to periodically report under federal and state security laws. Since recovery of the regulatory asset is a concern to Group's independent auditors, who must opine on Group's financial reports, a Commission resolution upon the issues raised in this Application is requested. Applicant has provided the Division of Ratepayer Advocates an advance draft copy of this Application.

Finally, Applicant's request to recognize the entire FAS 106 expense in current rates conforms with D.92-12-015, is consistent with accounting by other regulated utilities and does not adversely impact ratepayers.

Pursuant to Rule of Practice and Procedure 2.1(c), Applicant includes the following items in this application:

- (a) Category: This filing should be characterized as a rate-setting proceeding pursuant to Rule of Practice and Procedure.
- (b) Need for Hearing: Applicant is informed and believes that hearings are not required and it requests that the Commission approve the Application *ex parte*, see discussion above in this section.
- (c) Issues: The issues are related to accounting for and recovery of post-retirement benefits other than pensions.
- (d) Proposed Schedule: Applicant proposes the following schedule for this proceeding pursuant to Rule of Practice and Procedure 6:

Application Filed:	December 21, 2006
Protest Deadline:	January 20, 2007
Proposed Decision:	Not Applicable
Commission Adoption	May 10, 2007

IX.

MISCELLANEOUS:

(1) The legal name of Applicant is California Water Service Company and its principal place of business is located at 1720 North First Street, San Jose, California 95112.

(2) Applicant is presently engaged in the business of the supply and distribution of water for domestic and industrial purposes in 24 districts throughout the State of California. These systems are not integrated with each other except for routine allocation of General Operation (GO) expenses. PBOP is a GO expense. This Application is applicable to all Applicant's service areas. Applicant can not calculate PBOP expense for a particular rate district as costs are computed for the entire pool of Applicant's employees. Applicant's company-wide recorded earnings for the 12 months ending December 31, 2005, based upon a depreciated rate base, as evidenced by its Summary of Earnings Reports to the Commission, was 7.43% as shown on Exhibit "10."

(3) The Application is made pursuant to the provisions of Section 454 of the Public Utilities Code of the State of California.

(4) Applicant is a California corporation. A copy of Applicant's Restated Articles of Incorporation was filed with the Public Utilities Commission in connection with Application 96-12-029.

(5) The name and address of the person to whom correspondence or communications in regard to the Application are to be addressed is Lynne P. McGhee, 1720 North First Street, San Jose, CA 95112. Email service is welcomed at lmcghee@calwater.com.

(6) Applicant proposes this rate increase as a general surcharge on all customer bills. A proposed tariff titled Schedule PB is attached as Exhibit "14." All of Applicant's

I, Francis S. Ferraro, declare and say that I am an officer, to wit, Vice President of the Applicant, a California corporation, making the foregoing Application; that I make this verification on behalf of said corporation; that I have read the Application and know the contents thereof; that the same is true of my own knowledge except as to the matters that are therein stated on information or belief, and as to those matters that I believe to be true.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on December 21, 2006, in San Jose, California.

/s/ Francis S. Ferraro

Francis S. Ferraro