

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

In the Matter of the Application of California-
American Water Company (U-210-W), for
Authority Pursuant to Public Utilities Code
Section 454 to Restructure and Consolidate its
Rates for its Monterey and Felton Districts

Application No. A.04-08-012
(Filed August 11, 2004)

**DIRECT TESTIMONY OF TOD LANDIS
ON BEHALF OF
FELTON FRIENDS OF LOCALLY OWNED WATER**

I. INTRODUCTION AND BACKGROUND

Q. Please state your name and address.

A. My name is Tod Landis. My address is P. O. Box 688, Ben Lomond, California 95005.

Q. On whose behalf are you testifying in this proceeding?

A. I am testifying on behalf of Felton Friends Of Locally Owned Water (“Felton FLOW”). Felton FLOW is a Recipient Committee formed under the laws of the State of California for the purpose of representing the interests of residential ratepayers of California American Water Company’s (“Cal-Am’s”) Felton District. Its mission is to secure local ownership of the Felton water system.

Q Are you a member of Felton FLOW?

A. No, I am a not a member of Felton FLOW but I am assisting Felton FLOW in this proceeding and share its objectives.

Q. Have you previously testified before the California Public Utilities Commission?

A. No, and I do not claim to be an expert in regulatory issues. In preparing this testimony on behalf of Felton FLOW I have, however, reviewed a number of prior Commission decisions and filings pertinent to the problems in Felton and potential remedies to such problems and have prepared my testimony and recommendations based upon my independent review and analysis of this material. I am also personally familiar with and have investigated the specific and unique facts and circumstances pertaining to the Felton District that bear on the issues under consideration by the Commission in this proceeding.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to: explain the unique circumstances pertaining to the Felton District; the reasons why action is warranted to remedy ownership and management deficiencies in the District and to provide relief from high current and future water rates; the alternative means available for addressing these concerns; urge Commission support for divestiture of Felton District facilities to a public agency if local voters confirm their desire for such a remedy through support of a bond measure providing for such a public acquisition; and urge the Commission to approve the consolidation of Cal-Am’s Felton, Sacramento and Larkfield Districts for ratemaking

purposes, on an interim basis, rather than the consolidation of the Felton and Monterey Districts that Cal-Am has proposed in this Application 04-08-012.

Q. Please describe Cal-Am's Felton Water District.

A. Cal-Am's Felton District is located in the San Lorenzo Valley in the mountains of Santa Cruz County, approximately eight miles north of the City of Santa Cruz, and includes the isolated mountain community of Felton and surrounding unincorporated areas of the County. It has approximately 1,310 water customers, most of whom are residential customers and many of whom are on fixed incomes. It has experienced almost no growth in recent years and has little potential for future growth. It has a very good local supply of clean, healthful water from two springs, one well and a surface diversion from Fall Creek. These sources of water supply are fully adequate to meet the needs of Felton District residents. Cal-Am's Felton District shares water supply in the San Lorenzo Valley water basin with the San Lorenzo Valley Water District ("SLVWD"), a public agency that provides water service to most of the balance of the San Lorenzo Valley not served by Cal-Am.

At one time, Cal-Am's Felton District facilities were physically interconnected with and jointly owned and operated with the facilities now owned and operated by the SLVWD. Citizens Utilities owned and operated all of these facilities until approximately 1965 when all of its facilities in the vicinity, except those in what became the Felton District, were acquired through a public acquisition. As a result of this acquisition, ownership of many of Citizen's facilities in the vicinity passed to the SLVWD.

In 2002, Citizens' remaining water utility facilities in Felton were acquired by American Water Works Company, Inc., Cal-Am's then independent shareholder owned parent corporation.¹ Before this transaction was even closed, however, RWE Aktiengesellschaft, a huge German holding company with diverse interests in many non-water businesses scattered throughout the world, acquired American Water Works Company, including Cal-Am and all of its subsidiaries, through a subsequent acquisition and merger.² RWE did so through the purchase of 100 percent of the stock in American

¹ American Water Works Company also acquired Citizens' water utility facilities in Larkfield, Sacramento and Montara and in a number of other states in this same transaction. The Commission approved the sale by Citizens of its water utility facilities in California and acquisition of such facilities by American Water Works Company in September 2001 in D.01-09-057.

² The Commission approved RWE's acquisition of and merger with American Water Works Company in December, 2002 in D.02-12-068, conditioned on, among other things, divestiture of Cal-Am's Montara District facilities to the

Water Works Company for which RWE paid a substantial acquisition premium. American Water Works Company shareholders were richly rewarded as a result of this subsequent acquisition in rapid succession following their acquisition of Citizens water utility facilities, even though they owned the Citizens facilities in Felton for an extraordinarily short period of time and implemented no changes during this brief period of independent ownership that were evident to Felton District ratepayers.

As a result of this merger mania, ownership and control of local water facilities and services in Felton passed to a foreign conglomerate and the results have been significant and adverse to Felton District ratepayers. Since the RWE Aktiengesellschaft takeover, ownership and management deficiencies have resulted in a significant deterioration in service in the Felton District, the already high rates charged Felton District ratepayers are escalating further, and management has been not only unresponsive, but actually hostile to the needs and concerns of the local community.

The SLVWD's management and operation of the former Citizens' facilities it now owns and operates in the vicinity has, in contrast, been much more responsive to the needs and concerns of the local community and the rates it charges have dropped substantially below those charged Felton District ratepayers by Cal-Am.

II. HIGH RATES AND SERVICE PROBLEMS

Q. Could you please explain what basis Felton FLOW has for claiming that the rates charged Felton District ratepayers by Cal-Am are extraordinarily high.

A. Yes. I understand that rate comparisons between different water utility districts are difficult to do in a meaningful way in light of differences in rate structures, customers, climate and usage. The Santa Cruz County Local Agency Formation Commission ("LAFCO") recently completed a very useful comparison of rates in water utility districts in the vicinity of Felton, however, including Cal-Am's Felton District, SLVWD, Scotts Valley Water District, Lompico Water District, Central Water District (Aptos Hills), Soquel Creek Water District, and the City of Santa Cruz Water Department. This analysis was completed in August 2003 and was based upon a comparison of average monthly customer bills for July 2003, prior to Commission issuance of D.04-05-023 approving a large general rate increase for Cal-Am. LAFCO's analysis assumed uniform water usage by customers in all districts for purposes of comparison. LAFCO's analysis

Montara Sanitary District and RWE's commitment to pass 100 percent of the benefits of the merger through to ratepayers.

demonstrated that the rates Cal-Am charged Felton District ratepayers at that time, prior to Cal-Am's last general rate increase, exceeded the rates charged by six of the seven other districts in the vicinity and exceeded the rates charged by the neighboring SLVWD by over 40 percent.³

The Commission has also considered rate levels in the Felton District. It recently did so in conjunction with A.02-09-030 et al, Cal-Am's recently concluded application for a general rate increase in the former Citizens districts, Felton, Monterey and Larkfield. In D.04-05-023, issued last May, the Commission authorized revenue requirement increases for Cal-Am that, if implemented in full, would have resulted in an increase of 34.6% in Felton for 2003 and an additional 7.1% for 2004.⁴ Depending upon customer usage, this revenue requirement increase could result in increases in individual Felton District customer bills by as much as 51.6% in 2003 along, and an average *additional* cost per customer of \$248.00 over the two-year period.⁵ In light of the high current rates in the Felton District and the "rate shock" that would result if the revenue requirement authorized in D.04-05-023 were fully implemented, the Commission concluded that rates should not be increased in Felton at that time. Any increase in Felton rates was deferred as a result of the Commission's concerns regarding rate shock, and the Commission ordered Cal-Am to file a new application to permit the Commission to consider consolidating the Felton District with other Cal-Am districts, for ratemaking purposes, in order to mitigate these exorbitant rate increases.⁶

This proceeding is in fact a direct result of the Commission's own concerns about high rate levels and potential rate shock in the Felton District.

³ A copy of the LAFCO staff's Staff Report for its August 6, 2004 meeting containing this bill comparison is attached to this testimony as Attachment 2 and incorporated herein by reference. Felton FLOW requests that the Commission take official notice of this portion of the LAFCO Staff Report containing this bill comparison.

⁴ D.04-05-023 at 2.

⁵ See D.04-05-023, Appendix E, at 1.

⁶ The Commission stated, "The rate increases and rate levels that our adopted revenue requirement would produce for Felton may indeed produce 'rate shock.' For this reason, we will not raise Felton's rates . . . at this time." D.04-05-023 mimeo at 63. The Commission also stated, "because of the size of the rate increases that our authorized revenue requirement would likely produce for Felton . . . the public interest would be better serviced by a timely consideration by this Commission of rate consolidation proposals . . . that fully address the issues identified above." D.04-05-023 mimeo at 42.

Q. Could you please explain the basis for Felton FLOW’s claim that ownership and management deficiencies have resulted in deteriorating service since RWE Aktiengesellschaft took over the Felton District?

A. Yes. When RWE Aktiengesellschaft’s sought Commission authorization to acquire American Water Works Company and its Cal-Am water utility subsidiary, it promised that significant benefits would be achieved as a result of this acquisition and committed to pass through 100% of these benefits to ratepayers. Felton District ratepayers have not seen these promised benefits, however. Instead RWE owned Cal-Am has sought huge increases in rates while service has deteriorated. Felton FLOW attributes the deterioration in Felton District service quality to inattentive corporate ownership and management by RWE and a poorly planned and executed shift in management responsibility for Felton District operations by Cal-Am from local district personnel to remote management personnel in Cal-Am’s Monterey District office.

The following incidents illustrate the deterioration in service provided by Cal-Am to Felton District ratepayers since RWE took over ownership and control of Cal-Am and Cal-Am transferred management of local Felton District operations to Monterey.⁷

a. Failure to Recognize and Respond to Personnel Problem

On July 3, 2003, Mr. Daniel Goldstein contacted Cal-Am's Felton office regarding an unusual amount of water on Laurel Avenue near his home. Two Cal-Am servicemen responded and evaluated the situation. After some time, one determined that the excess water was ground water. Mr. Goldstein and his contractor asked how it was possible for the serviceman to know this and suggested the serviceman check a neighbor's water meter to see if a pipe had ruptured there. At this point, Mr. Goldstein relates, one Cal-Am serviceman asked the other to call their manager to the site. Mr. Goldstein asked why, and the younger serviceman made what Mr. Goldstein called “some very disparaging comments about the Downs family, including that “they were a**holes, crazy, and probably listening.” That service call ended without finding the cause of the problem, which was later determined to be a broken water pipe not ground water.

⁷ In its Reply to Protests Cal-Am argued that "current service quality is not relevant" and that "current service quality should be disregarded." Cal-Am Reply to Protests at 16. The ALJ ruled otherwise, however, to the extent that evidence of service problems may support an argument that such problems may be aggravated by Cal-Am’s proposed consolidation of districts. "However, that does not mean that you can't make an argument that [service] will be worsened by this proposed application. You may make that argument because that goes to the merits of whether the application should be granted or not." A.04-08-012 PHC Transcript, at 6. Felton FLOW submits this evidence for precisely the purpose allowed by the ALJ.

Karen and Everett Downs live next to Mr. Goldstein and had been involved in a long-running dispute with Citizens and later Cal-Am concerning the location of pipes and valves on their land and the way they had been installed. They filed a complaint with the Commission and a prehearing conference in the complaint was held February 19, 2002. After hearing about the latest incident, Mrs. Downs contacted Cal-Am to complain about the employee's latest misconduct near her home. In response, Cal-Am's President wrote to Mrs. Downs that he had conducted an investigation but was "unable to draw any specific conclusions regarding you[sic] allegations". In fact, wrote the President, his employees had received many compliments for "their professionalism, their courtesy and efficiency."⁸ Mrs. Downs was struck by the fact that, nearly a year after Cal-Am took over operation of the Felton districts, its management team was still not aware of obvious personnel problems in the Felton district. They were too far away. Bill O'Brien, resigned from Cal-Am on December 5, 2003.⁹ Then Mr. Goldstein corroborated the Downs version of the incident in a letter to Mr. Townsley.¹⁰ He wrote that the company account contained several inaccuracies and added "Hopefully you will understand why I can't assign any credibility to your Felton office, your investigative practices or your letter." Finally, Cal-Am "completed a re-investigation" and sent the Downs a letter of apology. This time the company President wrote that what had occurred was "not at all consistent with our standards."¹¹ It was reflective, however of a pattern in practice of poor management oversight of Felton District operations.

b. Broken Valve Serving Washington and Lincoln Avenues, Poor Supervision

Mr. O'Brien left Cal-Am on December 5, 2003. The next week Cal-Am left notices on some Felton residents' porches that maintenance work would be performed on their streets. A Felton resident, I'll call her Y because she asked her name not be used, contacted me by phone on Tuesday, December 16, 2003. She told me that her water had gone off, and that she had seen my name in the newspaper in a story about Cal-Am. I advised her to call the papers themselves, then drove over to meet her. She related the following story to me. The week following December 8, 2003, she found two notices on

⁸ Letter from Paul Townsley dated November 2, 2003, a copy of which is attached as Attachment 3 to this testimony.

⁹ See Cal-Am's Answer to Felton FLOW Data Request #1, Question 2.

¹⁰ Letter dated December 17, 2003, a copy of which is attached as Attachment 20 to this testimony.

¹¹ Letter from Paul Townsley dated February 8, 2004, a copy of which is attached as Attachment 4 to this testimony.

her porch, which she gave to me.¹² The notices warned that water would be turned off the following Monday, December 15, 2003, and that it would be necessary to boil water beginning on that day. On the following Monday, the 15th, her service was not interrupted but on the following Tuesday, the 16th, it was. When she called the Cal-Am customer service number to find out what was happening she reached someone in Illinois, who told her: "You should have been boiling your water beginning last week." The notices of December 8, 2003, were, however, the only notices she received, and she received no notice warning her to boil her water before December 15, 2003. Not surprisingly she was concerned by Cal-Am's confusion. The local newspaper reported that a Cal-Am work crew broke a valve, causing the first outage.¹³ It also reported that X was then working as an "interim operations supervisor" in Felton. In other words, the individual who had threatened Mrs. Downs and who she later complained about to Cal-Am, had been promoted by Cal-Am and made a supervisor.

Cal-Am management should have realized that X was in over his head on this task and was not dealing with the local community in an appropriate or professional manner.

c. "Black Gunk" at Washington and Oak, Inadequate Notice To Customers

Cynthia Dzendzel and Kenneth Gorny, who live at the corner of Washington and Oak have been active in FLOW, and I have known them for about two years. Last December or January, black "gunk" came out of their faucets. Although they are not sure about the date this event occurred, they are sure that they received no notice of any kind from Cal-Am before it occurred. The couple received a boil notice only after seeing the black gunk. Mr. Gorny spoke to a Cal-Am employee, who was working in the neighborhood, and asked him what had happened. The employee told him that a Cal-Am crew had mistakenly opened a valve.

d. Improper Closure Ada Street, Poor Supervision Of Employees

Incredibly, one day after the fiasco on Washington and Lincoln Avenues, on Wednesday, December 17, 2003 Cal-Am undertook and botched another project, this time on Ada and Hillcrest Avenues.¹⁴ In this case, residents along Ada were surprised and angered to find their driveways blocked without notice. Residents received notice

¹² Cal-Am Notices, copies of which are attached as Attachments 5 and 6 to this testimony.

¹³ "Water outage outrages" by Jondi Gumz, [Santa Cruz Sentinel](#), December 17, 2003, a copy of which is attached as Attachment 7 to this testimony.

¹⁴ "Water company at odds with customers—again", by Jondi Gumz, [Santa Cruz Sentinel](#), December 18, 2003, a copy of which is Attachment 8 to this testimony.

two hours *after* work began. The local newspaper also reported that the company gave a false report to the county Public Works Department about the matter. John Swenson, a senior engineer with the Santa Cruz County Public Works department, is quoted as saying: "We were told residents were noticed." Another paper described what happened next. Charles Kemp, from the Monterey office, "happened to be at [the Felton] Cal-Am office." He ordered the work on Ada Street stopped.¹⁵ It was not until Mr. Kemp arrived in person from Monterey that the misguided and improperly conducted maintenance work in Felton came to a halt.

e. Poorly Planned Resurfacing, Unsafe Condition on Hillcrest Avenue

There have also been continuing problems on Hillcrest Avenue. These problems were explained in a letter from Lisa Meyer to the county Public Works Department in September, 2004.¹⁶ Cal-Am replaced a main on her road and then resurfaced it, but the work was shoddy. In her letter she wrote: "Our paved country road turned into a graveled, bumpy, and highly unattractive mess, drainage culverts that we maintain as part of our landscape were filled with excess debris." I discussed her letter with Ms. Meyer, who is active in FLOW, and we exchanged emails. She said she also noticed that crews working on the road piled dirt from the project in another family's front yard, then spread the material, covering their redwood chip ground cover. The crew left the road work incomplete, with a two inch layer of gravel that neighborhood residents complained about, and covered an opening in a pipe with duct tape and gravel only, creating a hazard. Later a horse's leg punched through the duct tape and into the hole. Felton is a rural area, and horses are common here. Cal-Am spokesman Evan Jacobs later admitted that the paving was "not to our standard" and will be redone.¹⁷

f. Leak Near Hydrant Neglected For Eight Weeks

Mr. Lewis, a Felton resident I have known for many years, complained to Cal-Am about a leak near a fire hydrant, but nothing was done. The leak created puddles where he noticed mosquitoes breeding. He told me that after repeated calls to the Cal-Am customer service center—and more than eight weeks—the leak had still not been repaired. I recently contacted Mr. Lewis for an update. Finally, after Mr. Lewis

¹⁵ "California American Finds Itself in Hot Water", by Glenn Hines, [San Lorenzo Valley Press](#), a copy of which is attached as Attachment 9 to this testimony.

¹⁶ Letter from Lisa Meyer, a copy of which is attached as Attachment 10 to this testimony.

¹⁷ See "Prepare for evening road work" by Jondi Gumz, October 14, 2004, [Santa Cruz Sentinel](#), a copy of which is attached as Attachment 11 to this testimony.

contacted the Commission, the leak has been repaired, but a hole around the hydrant remains.

III. ROOT CAUSES OF PROBLEMS WITH FELTON

Q. Why does Felton FLOW believe that these service problems are attributable to ownership and management deficiencies?

A. Since RWE acquired the Felton District, Felton FLOW understands that not only has ownership of the Felton facilities changed, but a number of changes have been made in the organization and management of Felton District operations, as well. Two such changes are particularly noteworthy. First, as a direct result of this change in ownership, there has been a major shift in corporate oversight from American Water Works Company, an independent parent corporation with a focus on managing water utility facilities in the United States, to RWE Aktiengesellschaft, a German holding company with a focus on a diverse portfolio of widely ranging business operations, including nuclear power plants and other energy facilities, scattered throughout the world. This has significantly reduced corporate management attention, responsibility and accountability for local concerns in small water districts, especially Felton. And second, there has also been a shift in responsibility for management of Felton District operations, in particular from the local district to management personnel in Cal-Am's Monterey District office. According to Cal-Am, this consolidation of the Felton and Monterey Districts for management and oversight purposes became effective on January 15, 2002.¹⁸ As a result of this action, the Monterey and Felton Districts have already been consolidated for purposes of management and operations, to the best of Felton FLOW's knowledge without prior Commission approval, for over two years.

Felton FLOW believes that the absence of effective corporate oversight, and the absence of local management in Felton with both knowledge of and sensitivity to the needs and concerns of the local community and responsibility and authority for operation and oversight of local Felton District facilities, have been significant contributing causes to the deterioration in service evidenced by the specific examples cited in this testimony. Centralizing management in Cal-Am's Monterey has not served the interests of Felton District ratepayers to date and Corporate RWE management in Germany does not have the time or interest necessary to address the problems of such a small, distant water utility

¹⁸ Cal-Am Answer to Felton FLOW Data Request #1, Question #1.

district such as Felton. Felton FLOW believes that further consolidation of the Felton and Monterey Districts, for ratemaking purposes, under RWE's inattentive corporate oversight and the Monterey District's ineffective managements would only serve to further aggravate the problems Felton has experienced since RWE acquired American Water Works Company and consolidated management operation and oversight in Monterey.

IV. POTENTIAL REMEDIES

Q. What means does Felton FLOW believe are available to address the concerns of Felton District ratepayers regarding high rates and deteriorating service?

A. Felton FLOW believes the problems being experienced in Felton are attributable primarily to the fact that management of RWE and its subsidiaries American Water Works Company and Cal-Am have national and corporate priorities that are not compatible with the needs and concerns of ratepayers in the Felton District. The management attention and priorities of RWE and its subsidiaries appear focused on matters other than the problems of the Felton District. To the extent they have evidenced interest in Felton, they appear interested in little beyond maximizing the return they earn on their investment in the water utility facilities they acquired from American Water Works Company's former shareholders. The Felton District is a very small district with little growth potential and limited opportunities for synergy savings through operation in coordination with Cal-Am's other districts, all of which are located some distance from Felton. As a result, there is little opportunity for RWE to recover the large acquisition premium it paid for American Water Works Company facilities and meet its need for increased returns from the Felton District other than by raising rates. Cal-Am's actions since it was acquired by RWE support this conclusion. As noted above, service in the Felton District has deteriorated while RWE appears to have given no time or attention to Felton's problems and Cal-Am has focused its attention primarily upon increasing rates. Cal-Am requested revenue requirement increases of 56.6 percent for 2003 and 70.1 percent for 2004 for the Felton District in its most recent consolidated general rate increase for the former Citizens' Districts, Felton, Sacramento, Larkfield and Montara, filed shortly after RWE acquired control.¹⁹ And I understand that Cal-Am recently

¹⁹ See A.02-09-030 et al., and Direct Testimony of Reed Schmidt on Behalf of the County of Santa Cruz, at 5.

requested further additional rate increases in some of these districts and has more increases planned for the Felton District as well.

A number of potential remedies have been proposed for these problems, including (a) consolidating the Felton District with other Cal-Am water utility districts for ratemaking purposes; (b) modifying D.02-12-068, as requested by the County of Santa Cruz in its petition to modify filed in A.02-01-036²⁰, to prohibit Cal-Am from charging rates above its actual cost of service in the former Citizens districts, including Felton; and (c) the divestiture and public acquisition of the Felton District facilities by a local public agency more responsive to local needs and with access to lower cost tax exempt financing.

Q. Does Felton FLOW believe that a consolidation for ratemaking purposes would remedy the problems in the district and best meet the needs and concerns of Felton District ratepayers?

A. No. Felton FLOW does not believe a consolidation of districts, under RWE's continued ownership and control, would best meet the needs and desires of Felton District ratepayers. In D.04-05-023, the Commission expressed concern regarding high rates and potential rate shock in the Felton District and ordered Cal-Am to file an application to permit the Commission to further consider a consolidation of districts for ratemaking purposes as a possible remedy to this problem. Such a consolidation has potential to mitigate short term concerns regarding the current high rates and rate shock that would otherwise result from full implementation in the Felton District of the Commission's general rate case decision in D.04-05-023, but would not address longer term concerns regarding high future rates. In its application, Cal-Am claims that consolidation of the Felton and Monterey Districts would provide Felton District ratepayers with rate decreases ranging from 20 percent in 2005 to 27 percent in 2019 relative to the substantially higher rates that would result from full implementation of the general rate increase that the Commission ordered deferred in D.04-05-023.

These decreases are, however, only forecasts and are in no way binding on Cal-Am or the Commission and Felton FLOW believes they would ultimately prove illusory if the Commission were to adopt Cal-Am's proposal. The reason for this should be quite clear. Consolidating the Felton District with the Monterey District provides a potential

²⁰ Petition of County of Santa Cruz To Modify Decision 02-12-068 filed December 10, 2003 in A.02-01-036.

means for mitigating high rates in Felton only so long as the stand alone cost of service and rates in Monterey are lower than in Felton. There is a very significant risk, if not probability, however, that rates in the Monterey District will meet or exceed Felton District rates in the not too distant future. The reason for this is that there are severe water supply shortages in the Monterey District that Cal-Am must soon address. Doing so will require very significant additional capital expenditures. These additional capital costs will significantly increase Monterey rates in the near future. Cal-Am's own estimates of future stand alone rates for the Monterey District illustrate this problem. According to Cal-Am, Monterey District rates are expected to increase to such an extent that monthly bills for customers using 10 units of water will escalate from \$56.50 in 2005, to \$76.78 in 2007, and to \$138.48 in 2009.²¹ As a result, by 2007, Felton FLOW understands that Monterey District rates will be higher on a stand alone basis than Felton District rates.

In its consolidation proposal, Cal-Am has proposed that the cost of addressing Monterey's severe water shortage be excluded from the combined district revenue requirement and recovered only from Monterey ratepayers. Felton FLOW has no confidence, however, that water supply costs will be consistently maintained on such a separate basis following a consolidation of districts. No matter what assurances are provided by Cal-Am, there is a significant risk that if the Felton and Monterey Districts are consolidated for ratemaking purposes, some portion of the costs necessary to address the water supply problems in Monterey will be allocated, directly or indirectly, to the Felton District thereby driving rates higher in Felton than they would otherwise be. This would exacerbate rather than alleviate rate shock in the Felton District over the long term.

In addition to this problem, a consolidation of districts for ratemaking purposes would do nothing to address the problems caused by RWE's lack of interest in or attention to the unique problems in the Felton District. Nor would it restore any measure of local control to the local community – an important objective of Felton District ratepayers. As a result of these considerations, Felton FLOW does not believe any consolidation of districts would best address the concerns or long term needs of Felton District ratepayers.

²¹ Cal-Am Application at Exhibit F.

Q. Would modifying D.02-12-068 as the County of Santa Cruz has requested in its pending petition for modification provide an adequate remedy for the problems in Felton District?

A. Such a modification would mitigate the high current rates and rate shock that would occur from full implementation of D.04-05-023 in the Felton District in an a very sensible and important respect, but would only partially mitigate the severe rate shock Felton faces.

On December 10, 2003, the County of Santa Cruz filed a petition to modify D.02-12-068 to prohibit Cal-Am from charging rates in the former Citizens' districts in excess of Cal-Am's actual cost of providing such service and to prohibit RWE Aktiengesellschaft, Cal-Am's then new owner, from recovering through rates charged ratepayers in these districts any portion of the acquisition premium paid by shareholders of Cal-Am's former parent corporation, American Water Works Company, for its acquisition of Citizens California water utility facilities.²² There are good grounds for the County's petition and granting it would provide a logical and efficient means of mitigating, in part, rate shock in the Felton District.

In D.01-09-057 the Commission approved American Water Works acquisition of the California water utility facilities of Citizens Utilities, including facilities in Felton, Sacramento and Larkfield. In doing so, it also provided shareholders of Cal-Am's then corporate parent, American Water Works Company, with an opportunity to recover the acquisition premium they paid to Citizens Utilities for these facilities. The Commission did so by adopting a complicated ratemaking mechanism under which Cal-Am would be permitted to charge ratepayers in the former Citizens districts rates in excess of its actual cost of providing service provided certain conditions were met. Cal-Am was provided an opportunity to charge rates above its actual cost of service for up to 40 years under this mechanism. At the time, American Water Works Company was an independent shareholder owned corporation. Shortly thereafter, American Water Works Company shareholders agreed to sell 100 percent of the stock in American Water Works to RWE Aktiengesellschaft for which RWE agreed to pay a \$2.8 billion acquisition premium. Through this subsequent acquisition, American Water Works shareholders recovered all of the acquisition premium they previously paid for Citizens facilities and more from

²² See generally, Petition of County of Santa Cruz To Modify Decision 01-12-068 filed December 10, 2003 in A.02-01-036.

RWE and, as a result, there was no further need or purpose to be served by the ratemaking mechanism adopted in D.01-09-057 since its purpose had already been accomplished. In D.02-12-068 approving the acquisition of American Water Works by RWE, the Commission made no modification to this ratemaking mechanism, and in effect extended the opportunity previously provided to Cal-Am to charge rates in excess of its actual cost of service in the former Citizens districts.

The County of Santa Cruz has, however, filed a petition to modify D.02-12-068 on grounds that American Water Works shareholders have already fully recovered the acquisition premium they paid and that it is therefore unnecessary and inequitable for the Commission to permit Cal-Am to charge rates above its actual cost of service in Felton and the other former Citizens Districts. Permitting Cal-Am to continue charging rates in the former Citizens district above its actual cost of service simply provides RWE's current shareholders with extraordinary rates of return at the expense of ratepayers for an acquisition premium they did not pay and without providing any further compensation to the former American Water Works' shareholders who actually did pay the acquisition premium at issue for Citizens' facilities.²³ The County's petition remains pending before the Commission.

Granting the County's petition would simply ensure that rates in Felton and the other former Citizens districts are set on the basis of Cal-Am's actual cost of providing service, rather than in excess of this level as the Commission did in D.04-05-023. Making this change in ratemaking for the former Citizens districts could provide an immediate and important measure of relief from the current high rate levels in the Felton District and would mitigate rate shock to a degree, but would not provide sufficient rate reductions to prevent rate shock. Reed Schmidt provided an evaluation of the amount of additional revenue Cal-Am would recover from Felton District ratepayers in excess of its actual cost of service through the ratemaking mechanism approved in D.01-09-057 and continued in D.02-12-068. According to Mr. Schmidt's analysis, this ratemaking mechanism would require Felton's 1,310 ratepayers to pay an additional \$64,100 in revenue for 2004 above Cal-Am's actual cost of providing service.²⁴ Even if D.02-12-068 were modified to eliminate this ratemaking windfall for RWE and Cal-Am, the resulting annual reduction in Felton District revenue requirement of approximately

²³ See generally, Petition of County of Santa Cruz To Modify Decision 02-12-068.

²⁴ See A.02-09-030, Direct Testimony of Reed V. Schmidt On Behalf of County Of Santa Cruz at 7.

\$64,000 would not be sufficient to prevent rate shock. Additional measures to further reduce Felton District rates would still be required to fully address concerns regarding high current rates and rate shock in the district.

Q. What remedy does Felton FLOW believe is necessary to fully address the problems in the Felton District and concerns of Felton District ratepayers?

A. Felton FLOW believes that the only practical means of fully addressing the problems in the Felton District and the needs and concerns of the local community is through the divestiture of Felton District facilities to a public agency with an elected board, responsive to the local community, and access to tax exempt financing.

A similar divestiture of a local investor owned water district was considered by the Commission in A.02-01-036, RWE's application for authority to acquire and merge with American Water Works Company. In that proceeding the Montara Sanitary District ("MSD") argued that much greater benefits could be provided to ratepayers in Cal-Am's Montara District through the divestiture of that district to a local public agency with access to tax exempt financing and recommended that the merger be conditioned on such a divestiture of Cal-Am's Montara District. In support of this recommendation, MSD introduced testimony by Reed Schmidt demonstrating that divestiture of the Montara District to a public agency with access to low cost tax exempt financing would provide economic benefits to ratepayers more than 165 times greater than the economic benefits that RWE forecast it could achieve through its acquisition of the facilities. Mr. Schmidt calculated potential savings of \$159 per customer per year through divestiture and public acquisition as compared to \$0.96 per customer year through RWE's acquisition of the facilities in conjunction with its acquisition of and merger with American Water Works.²⁵ According to Mr. Schmidt and MSD, these economic benefits for ratepayers were the result of a significant difference in the cost of capital between RWE and its subsidiary Cal-Am, and public agencies. The cost of taxable interest on corporate bonds RWE and Cal-Am use to finance capital improvements is considerably higher than the cost of higher rated and lower cost tax exempt bonds available to public agencies, including the Montara Sanitary District.²⁶ These economic benefits of public acquisition were in

²⁵ Exhibit 113, Supplemental Testimony of Reed V. Schmidt On Behalf Of Montara Sanitary District (August 6, 2002) in A.02-01-036 at 5-7, a copy of which is attached as Attachment 12 to this testimony.

²⁶ *Id.*, see also Opening Brief of the Montara Sanitary District at 42-46, a copy of which is attached as Attachment 13 to this testimony.

addition to non-economic benefits of restoring water utility facilities to local control and providing greater responsiveness to local community through management of the facilities by a board elected by the local community. As a result of the evidence and argument introduced by MSD in A.02-01-036, the Commission conditioned its approval of the RWE/American Water Works merger on Cal-Am's divestiture of the Montara District to a public agency with access to low cost tax exempt financing.²⁷ The Montara Sanitary District subsequently acquired Cal-Am's Montara District facilities from the company and now owns and operates the facilities under public ownership subject to the oversight of a locally elected board of directors.

Felton FLOW believes that divestiture and public acquisition of Cal-Am's Felton District would provide similar benefits for Felton District ratepayers. There are several reasons for this. First, significant economic savings could be achieved in Felton as have been achieved in Montara through the use of low cost tax exempt financing in lieu of higher cost taxable corporate financing for capital improvements. Second, rates charged ratepayers by a public agency would not include any cost for a return on investment, shareholder profits or income taxes on such profits since public agencies have no shareholders and can provide service on a cost of service basis without any extra markup for profit or income taxes on profits. And third, an equal measure of local control and responsiveness to local concerns could be restored to Felton as was restored to Montara through the public acquisition and return of water utility facility ownership to public hands and to management and oversight by an elected board responsive to local voters. There may be differences in the magnitude of the economic savings and other benefits that could be achieved for ratepayers through divestiture and public acquisition of the Felton and Montara Districts, but the net effect is likely to be similar.

As a result of these considerations, Felton FLOW firmly believes that the best means of addressing the needs and concerns of Felton District ratepayers and for remedying the unique circumstances pertaining to the Felton District is divestiture and acquisition by a public agency, as was done in Montara. It would be logical and convenient for such a divestiture and acquisition to be made by the SLVWD since SLVWD owns and operates facilities that were once physically interconnected and are still quite compatible with Cal-Am's facilities in Felton.²⁸

²⁷ D.02-12-068 Ordering Paragraph 10 at 64.

²⁸ See Letter from Jim Mueller a copy of which is attached as Attachment 1 to this testimony.

Q. Is any effort being made to pursue such a public acquisition of Felton District facilities?

A. Yes, a number of steps have been taken and significant progress is being made toward public acquisition of the Felton District facilities.

In early 2003, the SLVWD applied to the Santa Cruz County Local Agency Formation Commission (“LAFCO”) for an expansion of its sphere of influence to include Cal-Am’s Felton District. On September 3, 2003, LAFCO approved the SLVWD’s application. In its determination, LAFCO found that such a consolidation of the SLVWD and the Felton District would have numerous public benefits including reduced rates, rate stability, operational advantages, and local accountability.²⁹

In April 2004, Santa Cruz County and SLVWD entered into a Mutual Aid and Cooperation Agreement for the purpose of undertaking analyses, due diligence and negotiation in relation to the possible public acquisition of the Felton District facilities. The SLVWD is governed by a five person Board of Directors elected to four-year terms by voters within the District’s boundaries and is familiar with the issues and challenges that face the San Lorenzo Valley area, including Felton. It is also capable of owning and operating the Felton water system. I understand that the infrastructure of SLVWD is very similar to that of the Felton District and that the two systems could be easily integrated, providing efficiencies for all water customers in the San Lorenzo Valley.

On July 15, 2004, FLOW submitted petitions to the Santa Cruz County Elections Department pursuant to the Mello-Roos Community Facilities Act of 1982 and asked the Santa Cruz County Board of Supervisors to take necessary steps to establish a Community Facilities District to finance the acquisition of Cal-Am’s Felton District facilities. Under California Government Code Sections 53311 et seq., also known as the “Mello-Roos Community Facilities Act of 1982,” local governments are authorized to create community facilities districts for the purpose of selling tax-exempt bonds to fund public improvements. Property owners that participate in a community facilities district pay a special tax to repay the bonds. Any such indebtedness must first be approved by two-thirds of the voters in the district.

On August 3, 2004, the Board of Supervisors accepted the County Elections Official’s certification of the petitions and found that the petitions contained valid signatures representing support by 71% of those who voted in the last general election

²⁹ A copy of LAFCO’s determination is attached as Attachment 14 to this testimony.

within the proposed District. This was well in excess of the 10% of registered voters required by Government Code Section 53319 for the matter to be placed on the ballot and demonstrates overwhelming public support for a public acquisition of Felton District facilities.³⁰

On August 3, 2004, the County's Board of Supervisors also authorized the expenditure of up to \$50,000 for further steps in the formation of the Community Facilities District.

Felton FLOW expects a bond measure to soon be put before the voters for approval of funds to pursue a public acquisition of the Felton District facilities as was done in Montara. If this measure passes, Felton FLOW understands that local agencies have committed to proceed with such an acquisition.

Q. Does Felton FLOW believe there is anything the Commission should do to address the needs and concerns of Felton District ratepayers in the interim, pending consideration by the voters of a bond measure authorizing and providing funds for a public acquisition of Felton District facilities?

A. Yes, Felton FLOW believes that the Commission can play a very constructive role in facilitating the transition to a long term solution to the problems in Felton. First, the Commission can and must effectively address the problem of rate shock in the Felton District that it took note of in D.04-05-023. It can do so by granting the pending petition for modification of D.02-12-068 filed by the County of Santa Cruz in A.02-01-036 and further, by approving a consolidation of districts for ratemaking purposes, on an interim basis.

Neither granting the County's petition for modification, nor approving a consolidation of districts for ratemaking purposes would provide an adequate long term remedy for the problems in the Felton District or meet the long term needs and concerns of Felton District ratepayers, but such actions could provide necessary relief from near term rate shock, on an interim basis, pending consideration by the voters of a bond measure providing for public acquisition of the facilities. Felton FLOW is opposed, however to the consolidation proposal of Cal-Am.

Cal-Am has proposed consolidating the Felton and Monterey Districts. For the reasons discussed above, Felton FLOW does not believe Cal-Am's proposal would best

³⁰ A copy of the certified petition results is attached as Attachment 15 to this testimony.

meet the needs and concerns of Felton District ratepayers even on an interim basis. In addition to the concerns previously discussed, the Monterey Peninsula Water Management District (“MPWMD”) and the Office of Ratepayer Advocates (“ORA”) have both opposed Cal-Am’s proposal. MPWMD has opposed Cal-Am’s proposal on grounds that: (1) Monterey’s conservation tariff with an inverted rate design, is not compatible with Felton’s rate structure, (2) State Water Resources Control Board proceedings against the Monterey District complicate such a consolidation, (3) severe water shortages in the Monterey District present significant challenges and uncertainties inapplicable to Felton, (4) the significant cost of exploring desalinization to replace the water supply in Monterey that Cal-Am has taken illegally from Carmel Valley further complicate the matter, (5) significant seismic issues associated with the San Clemente Dam also further complicate the matter, (6) Cal-Am’s aging infrastructure and high leak rates in Monterey also complicate the matter, and (7) Monterey’s already high water rates, “among the highest water rates in California,” according to MPWMD, provide relatively little opportunity to mitigate rate shock in Felton.³¹ The ORA has opposed Cal-Am’s proposal on grounds that pending general rate cases and scheduled rate cases for Felton and Monterey in February 2005 will obscure the actual impact of Cal-Am’s proposed consolidation and cause significant volatility in rates.

In light of all of these factors, Felton FLOW believes that consolidating the Felton and Monterey Districts will only exacerbate rate volatility, and uncertainty in the Felton District and produce illusory rate relief based upon hypothetical rates in Monterey that are uncertain and soon likely to change. As a result, Felton Flow does not believe Cal-Am’s proposed consolidation of districts is in the public interest even on an interim basis.

An alternative consolidation proposal has been made by the County of Santa Cruz, however, that would more effectively mitigate the current high rates and potential rate shock in the Felton District and has merit as a transitional measure. The County of Santa Cruz proposed that Felton be consolidated with Cal-Am’s Sacramento and Larkfield Districts in A.02-09-030 et al. and has renewed this proposal in this proceeding.³² Felton, Sacramento and Larkfield are all former Citizens’ districts and

³¹ Protest of Monterey Peninsula Water Management District.

³² See A.02-09-030 Direct testimony of Reed V. Schmidt on Behalf of County of Santa Cruz, at 19-22, and Protest of the County of Santa Cruz filed in A.04-08-012. Santa Cruz filed a protest in A.04-08-013, Cal-Am’s separate application for authority to consolidate its Sacramento and Larkfield Districts for ratemaking purposes, and asked the Commission to take notice of its alternative recommendation in this docket that Cal-Am’s Felton, Sacramento and Larkfield Districts be consolidated in order to better address the concerns of Felton ratepayers on an interim

share common upper management, sources of capital, and billing and accounting resources. Each also uses local personnel for day-to-day operations on site and relies on out-of-state personnel for customer service functions.³³ And they appear to be free of the many complications that a consolidation with the Monterey District would entail. These are also the only districts in which the Commission has permitted Cal-Am to charge rates above its actual cost of providing service.³⁴ As a result, these are also the only Cal-Am district for which the benefits of American Water Works Company's acquisition of Citizens facilities must be distinguished for ratemaking purposes from the benefits of RWE's subsequent acquisition of American Water Works Company and the only districts that may potentially be affected by the County of Santa Cruz's pending petition for modification addressing Cal-Am's recovery of the acquisition premium for each of these districts. I also understand that the rate structures for these districts are similar and free of the complexity added by the very different inverted rate structure of the Monterey District.

I further understand that the rates in both the Sacramento and Larkfield Districts are significantly lower than those in Felton³⁵ while the number of customers is much greater.³⁶ Thus a consolidation of the Felton, Sacramento and Larkfield Districts would

basis, pending a possible public acquisition of Felton District facilities.

³³ See the Commission's observations concerning these similarities in D.04-05-023, at 41.

³⁴ The Commission initially did so in D.01-09-057 on grounds that shareholders of Cal-Am's then corporate parent, American Water Works Company, should be provided with an opportunity to recover the acquisition premium they paid to Citizens Utilities for Citizens' water utility facilities. In order to provide American Water Works Company shareholders with such an opportunity, the Commission authorized a complicated ratemaking mechanism under which Cal-Am's would be permitted to charge ratepayers rates in excess of its actual cost of providing service if sufficient savings from American Water Works acquisition of the Citizens facilities are actually achieved. The Commission provided Cal-Am with an opportunity to charge such rates in the former Citizens District for up to 40 years following the issuance of its decision in 2001. At the time, American Water Works Company was an independent shareholder owned corporation that owned water utility facilities in Felton, Sacramento and Larkfield through its wholly owned Cal-Am subsidiary. Shortly thereafter, American Water Works Company shareholders recovered all of the acquisition premium they paid for Citizens facilities and more as a result of RWE's subsequent acquisition of 100 percent of the stock in American Water Works Company for which RWE paid a \$2.8 billion acquisition premium. The Commission extended this opportunity in approving RWE's acquisition of and merger with American Water Works in D.02-12-068. The County of Santa Cruz has, however, filed a petition to modify D.02-12-068 on grounds that American Water Works shareholders have already fully recovered the acquisition premium they paid and that it is therefore unnecessary and inequitably for the Commission to permit Cal-Am to charge rates above its actual cost of service in the former Citizens Districts. See generally, Petition of County of Santa Cruz To Modify Decision 02-12-068. The County's petition remains pending before the Commission.

³⁵ According to Cal-Am, the rates in Sacramento are nearly three times lower than those in Felton, whereas the rates in Felton and Monterey are within 25 percent of one another. Cal-Am Reply to Protests, at 11.

³⁶ According to Cal-Am, the Sacramento and Larkfield Districts have nearly 60,000 customers while Felton has only 1,310. Cal-Am Reply to Protests at page 13.

provide a much larger pool of ratepayers over which to spread the consolidated district revenue requirement permitting greater potential rate relief for Felton ratepayers with a much more minor effect on the rates of other districts.

For all of these reasons, Felton FLOW believes that a consolidation of the Felton, Sacramento and Larkfield Districts, on an interim basis, would better mitigate high rates and rate shock in Felton and would serve the public interest in facilitating the transition to a long term solution to the Felton District's problems through a public acquisition.

V. **RECOMMENDATION**

Q. **Could you please summarize Felton FLOW's recommendations to the Commission in this proceeding.**

A. Felton FLOW believes that Cal-Am's consolidation proposal fails to adequately address the concerns of Felton District ratepayers or the concerns expressed by the Commission in D.04-05-023 regarding potential rate shock in the Felton District. Felton District ratepayers are also legitimately concerned about deteriorating service and insufficient attention to the local needs and concerns of the community by Cal-Am's management and absentee corporate owner RWE Aktiengesellschaft. Cal-Am's consolidation proposal promises potentially modest short term reductions in rates, at the cost of a significant increase in the risk of large future rate increases, particularly if the high future cost of addressing the severe water deficiencies in Monterey are passed through in whole or in part to the Felton District. Felton Flow believes that the best means of addressing all of the concerns of Felton District ratepayers is through the divestiture of Cal-Am's Felton District facilities to a public agency with a publicly elected board of directors and access to low cost tax exempt financing, as was ordered by the Commission for the Montara District in D.02-12-068.³⁷ Public acquisition was shown by Montara Sanitary District in A.02-01-036, the RWE/AWW docket, to have the potential for producing savings for ratepayers that greatly exceed any RWE could hope to achieve through its ownership of that district. Felton Flow believes long term savings similar in nature, although not necessarily as large, could also be produced through a public acquisition of Felton District facilities. In addition, such a public acquisition and annexation of the facilities by SLVWD would meet the DRA guidelines for water utility district consolidations much

³⁷ D.02-12-068, mimeo at 57-58 and Ordering Paragraph 10 at 64.

better than Cal-Am's proposed consolidation of its Monterey and Felton Districts. As a result, Felton FLOW recommends that the Commission:

(a) Find that divestiture of the Felton District facilities to a public agency likely to provide the best means of addressing the long term concerns of the local community under the unique circumstances pertaining to the Felton District;

(b) Find that such divestiture and public acquisition should be facilitated if Felton District voters approve a ballot measure providing for such acquisition;

(c) Find that, in the interim pending voter consideration of a ballot measure providing for a public acquisition of Felton District facilities, the Commission can play a vital role in reducing rate shock and facilitating the transition to a long term solution to Felton's problems;

(d) Find that granting the County of Santa Cruz's petition for modification of D.02-01-036 would provide meaningful albeit partial relief from rate shock in the Felton District and warrants further consideration by the Commission as a means of doing so;

(e) Find that a consolidation for ratemaking purposes of Cal-Am districts could, in conjunction with granting the County's petition for modification of D.02-01-036, mitigate the current high rates and potential rate shock in the Felton District;

(f) Find Cal-Am's proposed consolidation insufficient, however, to adequately mitigate the current high rates and potential future rate shock in the Felton District;

(g) Reject Cal-Am's proposal to consolidate its Felton and Monterey Districts for ratemaking purposes; and

(h) Find the alternative consolidation of the three former Citizens districts, Felton, Sacramento and Larkfield Districts to provide a better means to mitigate the current high rates and potential future rate shock in the Felton District; and

(i) Adopt a consolidation of the three former Citizens districts, Felton, Sacramento and Larkfield Districts, on an interim basis pending voter consideration of a ballot measure providing for a public acquisition of Felton District facilities.

Q. Does this conclude your testimony?

A. Yes.