



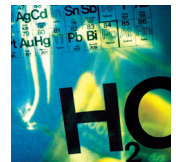
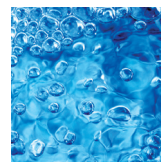
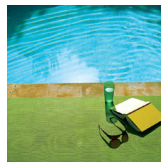
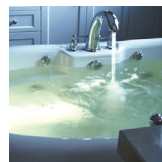
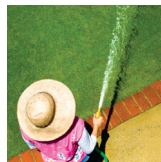
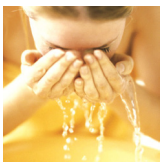
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## California Water Association Small Company Instruction Modules

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### IM-02: CONSUMER PRICE INDEX OFFSET ADVICE LETTER



## CWA ADVICE LETTER INSTRUCTION MODULE

### IM-02: CONSUMER PRICE INDEX OFFSET ADVICE LETTER

October 15, 2014

#### I.) **OBJECTIVE:**

Prepare work papers and tariff sheets to support an advice letter requesting a Consumer Price Index (CPI) Offset Rate Increase of the prior year's revenue, hereinafter referred to as a CPI Offset AL.

#### II.) **AUTHORIZING DOCUMENTS:** (with reference to applicable findings and orders)

CWA recommends that the utility obtain copies, either on-line or in hard copy form, of these documents for reference in the preparation of your CPI Offset AL.

##### 1.) **D. 92-03-093, March 31, 1982:**

- Authorized Class C and D water utilities to file an advice letter annually for "an increase in the prior year's water service **revenues** by an amount no greater than the CPI-U index" (percentage), subject to certain conditions, some of which have subsequently been amended in the documents listed below.
- Requires an earnings test (ET) so that the adjusted (increased) revenues do not result in net income in excess of the adopted Rate of Return (ROR) or Rate of Margin (ROM).

##### 2.) **Resolution W-4540, June 16, 2005:**

- Extended the authorization to file annual CPI Offset ALs to Class B utilities.

##### 3.) **GO 96-B, November 2007, last revised January 2012:**

- Established three tiers for review and disposition of advice letters. Tier 1 is "deemed approved" and is effective five days after the date of filing (or later at the utility's request), subject to correction if found substantially faulty by staff.
- Water Industry Rule 7.3.1 incorporates the wording ordered in Res. W-4664 (see below) exempting the customer notice requirement for Tier 1 ALs.
- Water Industry Rule 7.3.1(4) classifies a CPI Offset AL as a Tier 1 advice letter.

##### 4.) **Resolution W-4664, November 1, 2007:**

- Authorized filing of CPI Offset ALs without customer notice, which is an exception to GO-96 B, General Rule 4.2.
- Subsequent notice of the CPI increase is required as a billing insert.

**5.) Standard Practice U-27-W, last revised April 16, 2014:**

- Describes guidelines for the preparation and processing of CPI offset rate increase advice letters (among other topics). This Instruction Module, IM-02, further clarifies the detailed preparation procedures.
- Specifically allows partial use of the CPI increase to achieve the authorized return (net income) while avoiding overearning, as implied in D. 92-03-093.
- Except for the adjusted revenue, specifies that all other quantities used in the ET are prior year reported actuals including, at the utility's option, computed income taxes.
- Eliminates prior staff option to modify perceived "extraordinary expenses or revenues" included in the reported actuals used in the ET.

**6.) DWA Letter for 2013 CPI-U Increase, April 16, 2014:**

- Demonstrates calculation of adjusted revenue for the example ET.
- States that, for purposes of the ET, the utility may use reported state and federal income taxes or it may recalculate these taxes to reflect the higher (adjusted) revenue.

**III.) DATA REQUIRED TO PREPARE A CPI OFFSET ADVICE LETTER:**

- 1.) The utility's last GRC Resolution number and date, and whether the authorized net income was based upon ROR or ROM.
- 2.) The adopted ROR or ROM percentage authorized in the last GRC.
- 3.) The adopted revenue and adopted expenses from the last GRC.
- 4.) The prior year annual report filed by the utility and accepted by the CPUC. This document contains the reported revenue (reported REV), reported pre-income tax expenses (EXP), which include operating expenses, taxes other than income tax (payroll and property), depreciation expense, and amortization expense (if applicable), and also the calculated state and federal incomes taxes (SIT and FIT). It also reports the average rate base (RB) for the prior year.
- 5.) The current annual letter published by the Division of Water & Audits (DWA), which specifies the CPI-U increase percentage (CPI %) for the prior year. This letter will be published in April each year (previously January) after the annual report filings are due from the utilities, and specifies the maximum percentage **revenue increase** that may be requested in the CPI Offset AL in this cycle, subject to the earnings test.

#### IV.) **STEP –BY-STEP PROCEDURES:**

##### **A. Utilities with an Authorized Rate of Return (ROR) to Determine Net Income:**

A-1 First, calculate the “adjusted revenue” (adjusted REV) per the example presented in the DWA 2013 CPI-U letter: multiply the last GRC adopted revenue by the current CPI % and add this revenue increment to the prior year’s reported REV. That is:

$$\text{adjusted REV} = (\text{adopted revenue}) (\text{CPI \%}) + \text{reported REV}$$

A-2 Prepare a Summary of Earnings:

a.) Begin with the prior year adjusted REV from Step A-1;

b.) Subtract the prior year EXP (Section III. 4) from the adjusted REV. This is the “adjusted taxable income” (adjusted pre-tax income or adjusted PTI) for the prior year.

c.) Subtract the SIT and FIT reported for the prior year from the adjusted PTI in Step A-2b. This is the adjusted net income (adjusted NET) for the prior year.

Alternatively, you may calculate the “adjusted income taxes” (state and federal) based on the adjusted PTI in Step A-2b, using the utility’s applicable income tax structure. This is a little more work, but the calculated taxes will be slightly higher than the reported prior year taxes due to the increased adjusted REV; and the adjusted NET will be slightly lower resulting in a somewhat lower ROR in Step A-3 below, making the ET easier to pass.

A-3 Divide the adjusted NET from Step A-2c by the average rate base (RB) for the prior year as reported in the annual report. This is the prior year “adjusted ROR” for the utility.

A-4 Perform an earnings test for the adjusted ROR computed in Step A-3. If the adjusted ROR is equal to or less than the adopted ROR (the earnings test limit), the full amount of the CPI-U index may be applied to increase all service and commodity rates by the factor  $(1 + \text{CPI \%})$ . The new service and commodity rates include service charges, quantity rates, facilities fees, private fire protection fees, and any other service-related charges (not surcharges or reconnection fees) in your existing tariffs.

A-5 In this case, prepare and file a Tier 1 CPI Offset AL (see IM-01) requesting the amended tariffs for all service and commodity rates as described in Step A-4. Include the earnings test and other work papers with the advice letter to justify the requested increase. This completes the CPI offset filing under these conditions.

If the adjusted ROR computed in Step A-3 exceeds the authorized ROR in the utility's last GRC, (i.e. exceeds the earnings test limit), continue with the following Steps:

A-6 In this case, less than the full amount of the specified CPI-U index will be allowed to adjust service and commodity rates, and the "allowed adjusted REV" computed in the following steps will be less than the "adjusted REV" computed in Step A-1.

A-7 Begin by computing the allowed adjusted net income (allowed adjusted NET) by using the adopted ROR and the prior year's average rate base (RB):

$$\text{allowed adjusted NET} = (\text{RB}) (\text{adopted ROR}).$$

A-8 Add the reported taxes and expenses to the allowed adjusted NET to calculate the allowed adjusted REV:

$$\text{allowed adjusted REV} = \text{allowed adjusted NET} + \text{SIT} + \text{FIT} + \text{EXP}$$

where EXP is defined in Section III. 4 above.

A-9 The objective now is to compute the allowed percentage inflation-based factor that will be used to adjust rates in this CPI Offset AL. Referring to the revenue adjustment definition in Step A-1

$$\text{allowed adjusted REV} = (\text{adopted revenue}) (\text{allowed } \%) + \text{reported REV}$$

Where the adopted % is the allowed portion of the current CPI increase that may be used to increase revenue without exceeding the adopted ROR. So,

$$\text{allowed } \% = \{ \text{allowed adjusted REV} - \text{reported REV} \} / (\text{adopted revenue})$$

where the allowed adjusted REV is calculated as in Step A-8.

A-10 Multiply all service and commodity rates in your current tariffs by  $(1 + \text{adopted } \%)$  to calculate the new allowed service and commodity rates to be requested and amend your tariff sheet(s) accordingly.

A-11 Prepare and file a Tier 1 CPI Offset AL (see IM-01) requesting amended tariffs with the allowed rates determined in Step A-10. Include your work papers with the original (failed) earnings test calculation as well as the computations described in Steps A-6 through A-10 to substantiate your allowed offset request. This completes the utility's CPI offset rate request for this cycle under these limited increase conditions.

## **B. Utilities with an Authorized Rate of Margin (ROM) to Determine Net Income:**

B-1 Rate of Margin is defined as 1-operating ratio, where operating ratio is defined as recorded EXP plus SIT plus FIT (hereinafter Total EXP) divided by recorded REV, where all quantities are from Section III.4. The "adjusted operating ratio" is equal to Total EXP divided by the "adjusted revenue" (adjusted REV).

- B-2 To begin, compute the adjusted REV as in Step A-1: multiply the adopted revenue in the last GRC resolution by the current authorized CPI % and add this revenue increment to the prior year's reported REV. That is

$$\text{adjusted REV} = (\text{adopted revenue}) (\text{CPI \%}) + \text{reported REV}$$

- B-3 Calculate the "adjusted operating ratio" for the prior year by dividing Total EXP by the adjusted REV from step B-2.
- B-4 Calculate the "adjusted ROM," which is equal to 1- adjusted operating ratio from Step B-3.
- B-5 If the adjusted ROM in Step B-4 is equal to or less than the adopted ROM authorized in the utility's last GRC, the adjusted REV using the full CPI % passes the earnings test. Multiply all service and commodity rates including service charges, quantity rates, facilities fees, private fire protection fees, and any other service-related charges (but not surcharges or reconnection fees) in your current tariffs by the factor (1+ CPI %) to calculate the new service and commodity rates and amend your tariff sheets accordingly.
- B-6 In this case, prepare and file a Tier 1 CPI Offset AL (see IM-01) requesting the amended tariffs for all service and commodity rates, as described in Step B-5. Include all work papers and amended tariffs as attachments to the advice letter.

If the adjusted ROM from Step B-4 exceeds the adopted ROM authorized in the utility's last GRC (i.e. exceeds the earnings test limit), continue with the following Steps:

- B-7 The adjusted REV in Step B-2 must be reduced to an "allowed adjusted Rev", which is allowed adjusted REV = (adopted revenue) (allowed %) + reported REV  
where the allowed % is the allowed portion of the current CPI increase that may be used to increase revenue without exceeding the adopted ROM.
- B-8 Calculate the allowed % as follows:

$$\text{adopted ROM} = 1 - (\text{Total EXP} / \text{allowed adjusted REV})$$

So,  $\text{adopted ROM} = 1 - \text{Total EXP} / \{(\text{adopted revenue}) (\text{allowed \%}) + \text{reported REV}\}$

By rearranging the terms in this relationship, the allowed % is expressed as:

$$\text{allowed \%} = \frac{\text{Total EXP}}{(1 - \text{adopted ROM})(\text{adopted revenue})} - \frac{\text{reported REV}}{\text{adopted revenue}}$$

The first denominator on the right side of the equation above is the definition of the adopted total expense at the last GRC.

So, the formula to calculate the allowed % is simply:

$$\text{allowed \%} = \frac{\text{Total EXP}}{\text{adopted total expense}} - \frac{\text{reported REV}}{\text{adopted revenue}}$$

If the Total EXP has increased over the last adopted total expense faster than the reported REV has increased over the last adopted revenue, the allowed % will be the positive decimal number (0.0XX) difference between these two ratios. The allowed % will be smaller than the current CPI %, and the adjusted ROM will be equal to the adopted ROM. This calculated allowed % is the inflation-based increase that may be used to adjust rates for this CPI cycle.

If the reported REV has increased over the last adopted revenue faster than the Total EXP has increased over the last adopted total expense, the difference between the two ratios will be a negative number, which indicates that the utility is already over-earning relative to its adopted ROM, and no partial CPI increase is allowed.

- B-9 If the allowed % is positive, multiply all service and commodity rates in your current tariffs by the factor  $(1 + \text{allowed } \%)$  to determine the new allowed rates and amend your tariff sheets accordingly.
- B-10 Calculate the requested revenue increase resulting from application of the new allowed rates in Step B-9 using the equation presented in Step B-7. This figure will be needed in the advice letter and its cover sheet.
- B-11 Prepare and file a Tier 1 CPI Offset AL (see IM-01) requesting the amended tariffs determined in Step B-9. Include your workpapers for the original (failed) earnings test calculation, as well as the calculation of the allowed % from Step B-8 and the amended tariffs as attachments to the advice letter. This completes the utility's CPI offset rate increase request under these conditions.