

regulated activities and surplus real estate program. The DPD on treatment of gains on sale of properties could result in a reduction of earnings and the rate base on which the Commission determines the Company's future earnings. However, because this is only a draft that does not recommend specific actions, the Company cannot predict the final outcome of this matter. Since 1997, the Company has recorded \$10.4 million in pre-tax gains under its surplus property sale program.

In October 2001, the CPUC adopted a resolution implementing its staff's interim recommendation concerning practices and policies that enable water utilities to recover increases in purchased water, purchased power and pump taxes. These expenses are referred to as "offsetable expenses." The CPUC also directed its staff to open a proceeding to evaluate offsetable expense recovery practices and policies, and recommend permanent revisions. Historically, offset rate increases have enabled water utilities to recover increases in offsetable expenses that were not anticipated when customer rates were established and are beyond the utility's control. Future Company requests to recover offsetable expenses will be processed only if a district has filed a GRC application within its three-year rate case cycle and the district is not earning more than its authorized rate of return on a forward-looking, pro forma basis. Neither of these requirements applied to offset rate increases prior to adoption of the resolution. The Company can continue to track offsetable expenses in regulatory memorandum accounts for potential recovery subject to the CPUC's future determination of appropriate practices and policies.

During 2001, the rates charged to the Company by electric power suppliers were increased 48%. In May 2001, immediately after the CPUC authorized substantial electric rate increases for the state's two largest power companies, the Company requested authorization to recover \$5.9 million in higher power costs for 23 of its 24 regulated California districts. The CPUC's authorization allowing the Company to recover a portion of the higher power costs in four districts was not effective until September and November 2001, well after the high usage summer months. The authorization will allow recovery in four districts totaling \$2.7 million in additional annual revenue. The CPUC did not authorize any additional recovery of the higher electric costs during 2002. However, in December 2002, the CPUC did authorize the Company to file for recovery of up to \$6.4 million of electric cost increases tracked in expense-balancing accounts. In January 2003, the Company applied to the CPUC requesting authorization to recover the \$6.4 million of electric increases included in the expense-balancing accounts. A resolution regarding these advice letter filings is expected in the first half of 2003.

**Legislative Initiative.** Regulatory delays in obtaining GRC decisions have been costly to California regulated water utilities. In recent years, the Company has experienced significant revenue losses due to regulatory delays. The Company normally files its GRC applications in July. The CPUC's stated rate processing plan provides for a decision within ten months of accepting a GRC application. When decisions are not issued in a timely manner, customer rates are not increased. As a result, the Company loses revenue and does not recover costs during the period the decisions are delayed.

California Assembly Bill 2838 became effective January 1, 2003. This bill is intended to preserve the cash flow and financial ratings of regulated water utilities by providing interim rate relief based on inflation and a procedure for applying the final adopted GRC rates on a retroactive basis. In December 2002, the Company filed for protection of its 2002 GRC applications under the new law. The Commission staff rejected the application on the basis that the legislation does not apply to GRC applications submitted prior to January 1, 2003. An appeal of the Commission staff rejection has been filed with the Commission.

#### **WATER SUPPLY**

The Company's source of supply varies among its operating districts. Certain districts obtain all of their supply from wells; some districts purchase all of the supply from wholesale suppliers; and other districts obtain the supply from a combination of well and purchased sources. A small portion of the supply is from surface sources processed through three Company-owned water treatment plants. In 2003, the Company expects to complete construction of a new water treatment plant in the Bakersfield district that will increase the amount of surface water delivered to that system and reduce the amount of water pumped from wells. On average, slightly more than half of the water delivered to customers is produced from wells and surface supply, with the remainder purchased from wholesale suppliers.