STATE OF CALIFORNIA

Edmund G. Brown Jr, *Governor*

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

March 1, 2011

RE: Rates of Return and Rates of Margin for Class C and Class D Water Utilities

TO: COMMISSION

By this memorandum, the Division of Water and Audits (DWA) updates its recommended Rates of Return and Rates of Margin for Class C and D water utilities.[1] These updates have been calculated in accordance with Resolution W-4524, which revised the Standard Practice that addresses how the rate of return and rate of margin are calculated for Class C and D water utilities.

DWA considered a number of factors in determining the rates of return. DWA assessed the movement in actual and forecasted interest rates over the last year's (lower actual rates that are forecast to recover to near recent historical). In addition, DWA took into account the high operational risks faced by Class C and Class D water utilities and the constant level of authorized rates of return for Class A water utilities in 2010 over 2009 (average of 8.94% and 8.51%, respectively).

In determining the rates of margin for Class C and D water utilities, DWA considered the Class B water utilities most recent authorized average rates of return of 10.36%, their most recent authorized equivalent average rate of margin of 20.63%, and the recommended rates of return for Class C and D water utilities, as calculated.

For 2011, DWA recommends that the following rates of return and rates of margin be used for Class C and Class D water utilities informal general rate cases (supporting documentation is attached):

	Rates of Return (ROR)	**Rates of Margin**
Class C	**11.25% to 12.25%**	**23.40%**
Class D	**12.00% to 13.00%**	**24.89%**

If you have any questions regarding the Rates of Return or Rates of Margin recommendations, please contact Raymond Yin of the Division of Water and Audits at (415) 703-1818, or ryy@cpuc.ca.gov.

Sincerely,

Rami Kahlon, Director
Division of Water and Audits

Kayode Kajopaiye, Chief
Utility Audit, Finance, & Compliance Branch

Attachment

[1] As required by D.92-03-093, in Phase I of I.90-11-033 (Water Risk OII).

CALCULATION OF CLASS C & D WATER COMPANY[2] RATES OF RETURN (ROR) & RATES OF MARGIN (ROM)[3]

- Rates are calculated using both return-on-ratebase and rate of margin methods.
- The method that produces the higher result is used.
- ROR is set at a level above or below the recommended ranges, if warranted.
- Where little or no rate base exists, the ROM is used.
- The ROM is applied to Operating Expenses to determine the estimated dollar return, which is then compared with the average dollar ROR on rate base.
- Calculations are based on the assumption that there is a comparable relationship between authorized Class B ROR and ROM and Class C and D ROR and ROM.
- Class C and D water operations, finances, and risks are more similar to those of the Class B water companies, than with Class A water utilities.

Data Used in Determining the Rates of Return and Rates of Margin for Class C and Class D Water Utilities

Year	Recommended ROR Range		Actual Interest Rates from the Federal Reserve U.S. Treasuries			
	Class C Water	Class D Water	90-Day	1-Year	5-Year	30-Year
2009	12.00% - 13.00%	12.75% - 13.75%	0.15%	0.47%	2.20%	4.08%
2010	11.25% - 12.25%	12.00% - 13.00%	0.14%	0.32%	1.93%	4.25%
2011 (As of 02/2011)			0.15%	0.27%	1.99%	4.52%
			Forecast Interest Rates from IHS Global Insight			
Forecast for 2012 (As of 02/2011)			1.47%	1.72%	2.73%	4.68%

Calculation of Rate of Margin ("ROM")	Inputs	ROM	
		Class C	Class D
Average Class B Rate of Margin ("ROM")	20.63%		
Average Class B Rate of Return ("ROR")	10.36%		
Average Class C ROR	11.75%		
Average Class D ROR	12.50%		
Average Class C ROM = Average Class B ROM * (Average Class C ROR/Average Class B ROR)		23.40%	
Average Class D ROM = Average Class B ROM * (Average Class D ROR/Average Class B ROR)			24.89%

[2] Class C water utilities have 501 to 2,000 customers; Class D water utilities have 500 or less customers.
[3] Pursuant to D.92-03-093, Ordering Paragraph 8 and Resolution W-4524.