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BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U 210 W) for an Interest Rate of 8.33% for Allowance for Funds Used During Construction (AFUDC) for its San Clemente Dam Memorandum Account.	Application No. 07-02-023 (Filed February 20, 2007)

CALIFORNIA-AMERICAN WATER COMPANY'S OPENING BRIEF

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CALIFORNIA-AMERICAN WATER COMPANY'S OPENING BRIEF

I. INTRODUCTION

Pursuant to Rule 13 of the Rules of Practice and Procedure for the California Public Utilities Commission ("Commission"), California-American Water Company ("California American Water") hereby files this Opening Brief in the above-referenced proceeding. For the reasons set forth in this Opening Brief, the Commission should issue an order authorizing California American Water to set its Allowance for Funds Used During Construction (AFUDC) on its San Clemente Dam Memorandum Account at the Monterey District's current authorized rate of return.

As explained in more detail below, allowing California American Water to recover its full, weighted cost of capital as the AFUDC carrying cost (i) will benefit California American Water, as well as its customers, by providing reasonable compensation to California American Water's shareholders, while avoiding the potential error of allowing too high a return; (ii) will avoid placing California American Water at high risk on its investment and harming its financial integrity by setting the AFUDC rate below the actual cost of financing used by California American Water; (iii) will further the Commission's important policy objective of encouraging water infrastructure investment, including infrastructure necessary to protect public safety; (iv) is consistent with Commission precedent.

II. PROCEDURAL HISTORY AND SUMMARY OF POSITION

Since the 1990's, when the Department of Water Resources/Division of Safety of Dams ("DSOD") directed California American Water to evaluate the seismic safety of the San Clemente Dam, California American Water has expended significant resources to address the seismic deficiencies of the San Clemente Dam and to institute interim safety measures at the San Clemente Dam. There is no doubt that a project will have to be undertaken to comply with governmental agency mandates to address the San Clemente Dam's seismic issues. California American Water's proposed dam strengthening project and other alternatives are currently the subject of a joint Environmental Impact Report/Environmental Impact Statement (EIR/EIS) to comply with the requirements of the California Environmental Quality Act (CEQA) and the National Environmental Policy Act (NEPA). Any of the potential remedies to the San Clemente Dam seismic issues, whether earthquake reinforcement retrofit, bypass of the river feeding the dam or removal of the dam, will require California American Water to expend a substantial additional investment.

Historically this Commission has appropriately allowed all expenditures related to this project to be included in Construction Work in Progress (CWIP) with the annual carrying cost equal to the then current cost of capital to be recovered from customers in current rates. However, the most recent general rate case decision for California American Water's Monterey District, Ordering Paragraph 19 of Decision (D.) 06-11-050,[1] took the opposite position and directed California American Water to track the costs related to the proposed San Clemente Dam retrofit project in a memorandum account accruing interest at the 90-day commercial paper rate. Recognizing that the 90-day commercial paper rate is not appropriate in the long term and the fact that determination of a proper allowance for funds used during construction (AFUDC) rate was not fully addressed in the proceeding, the Commission ordered California American Water

[1] D.06-11-050, *In the Matter of the Application of California-American Water Company (U 210 W) for an order authorizing it to increase its rates for water service in its Monterey District,* 2006 Cal. PUC LEXIS 479, *167, ("D.06-11-050").

in D.06-11-050 to file an application addressing the issue of the correct AFUDC for the San Clemente Dam retrofit project costs. The Commission expressly acknowledged in D.06-11-050 that it might be appropriate to use California American Water's long-term debt and equity in calculating the AFUDC interest rate, similar to what it uses for long-term energy projects.[2]

On February 20, 2007, California American Water filed Application 07-02-023 for (i) authorization to accrue interest, or AFUDC, at 8.33 percent on its San Clemente Dam Memorandum Account and (ii) authorization to place the estimated annual average cost of construction work in progress into rate base once the project is more certain. Although California American Water initially sought authorization to place the estimated annual average cost of CWIP into rate base once the Environmental Impact Report for the San Clemente Dam Project is certified, or when some other specified milestone is reached indicating that the Project is more certain, the Assigned Commissioner and Administrative Law Judge ruled that the scope of the proceeding will not include this CWIP ratemaking request because it was premature.[3] Accordingly, this Opening Brief addresses California American Water's request to accrue AFUDC on all expenditures related to the San Clemente Dam Project at a present rate of 8.33 percent for the costs charged to its memorandum account. It should also be noted that there are portions of this project that are already used and useful, and being depreciated, but are still included in the memorandum account recovering only carry costs at a 90-day commercial paper rate, with no recovery of depreciation expense. Even if recovery of carry cost is allowed at the full rate of return , California American Water will still be under-recovering its total cost because of depreciation expense.

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[2] D.06-11-050, 2006 Cal. PUC LEXIS 479,*67.

[3] *Scoping Memo and Ruling of Assigned Commissioner and Administrative Law Judge Determining the Scope, Schedule, and Need for Hearing in This Proceeding*, issued on May 18, 2007, p. 3. The Assigned Commissioner and Administrative Law Judge directed the parties to submit briefs addressing legal and policy issues and to support any required factual assertions by a sworn declaration(s) attached to the brief.

III. CALIFORNIA AMERICAN WATER'S PROPOSAL WILL BENEFIT BOTH CUSTOMERS AND THE COMPANY.

Setting the AFUDC rate based upon the actual long-term cost of financing the San Clemente Dam Project will benefit California American Water and its customers by allowing California American Water the opportunity to earn a reasonable return at a time when it must make extensive investments into its water supply facilities and to meet regulatory requirements. Limiting the AFUDC rate to a level lower than California American Water's actual cost of the financing, as the Division of Ratepayer Advocates ("DRA") and Monterey Peninsula Water Management District ("MPWMD") have proposed, will make the investment more risky and affect the overall cost of capital of the company, thereby increasing the financing cost for all of the company's investments, or even worse, limiting California American Water's ability to secure long-term financing. Setting the AFUDC rate below the actual cost of Project financing is short-sighted because it will affect California American Water's ability to attract capital in the long-term and raise the cost of capital paid by all of California American Water's customers.

Importantly, California American Water's requested AFUDC rate recognizes that (i) California American Water must be made whole for at least the ongoing cost to finance the project; (ii) the Commission's regulatory process has already placed California American Water at a higher risk for its required remedial investments in the San Clemente Dam Project than is the case for its existing rate base; and (iii) California American Water customers may be harmed if the Commission does not provide an appropriate carrying cost for the San Clemente Dam Project investment.

A. California American Water Must be Made Whole for at Least the Ongoing Cost to Finance the Project Development and Construction.

The Commission must set California American Water's AFUDC rate on this project at a level that ensures that it is ultimately made whole for the overall cost of its investment, including at a minimum the ongoing cost to finance the project development and construction. The Commission should base the capitalized AFUDC on the actual financing costs

that California American Water would have incurred during the construction period had the Commission allowed the costs of construction as part of rate base.

California American Water's requested AFUDC rate of the current weighted average cost of capital will provide California American Water with an opportunity to earn a reasonable return on its used and useful investment, and recover its operating costs. If the Commission sets the San Clemente Dam Project AFUDC at a rate below the current cost of California American Water's capital, it will not make California American Water whole for the ongoing cost to finance this project. In other words, if the Commission denies California American Water the opportunity to at least accrue AFUDC at its authorized cost of capital (in lieu of allowing all investments in the San Clemente Dam in current rate base) and instead sets a lower AFUDC rate, then it is effectively denying California American Water the ability to earn a reasonable return on all of its other investments and full recovery of prudent expenses. As discussed below, paying California American Water only a fraction of its actual carrying costs related to the San Clemente Dam Project will increase the capital costs for California American Water and, ultimately, its customers.

Neither is there any guarantee to California American Water in the booking of an appropriate AFUDC rate, as that action only preserves the *opportunity* to earn a compensatory rate of return. By contrast, setting that accrual rate too low preemptively denies California American Water that opportunity because the shortfall that is created cannot later be made up.

As set forth in the Declaration of David P. Stephenson, the Commission can calculate the actual cost of financing using either a weighted average cost of capital, assuming all capital costs are spread evenly over all capital requirements, or issuance specific costs related directly to the cause and effect of the issuance. Here, California American Water's authorized (weighted average) cost of capital is a reasonable estimate of the lower range of California American Water's carrying cost for the San Clemente Dam Project because (1) the San Clemente Dam Project has largely been financed by the debt and equity issued by California American Water; (2) the San Clemente Dam Project is older than the current oldest debt held by California

American Water; and (3) although the San Clemente Dam Project is not a new project, California American Water has recently refinanced much of its debt. (Declaration of David P. Stephenson, ¶ 6.) California American Water is facing unprecedented levels of increased capital needs. In order to finance the San Clemente Dam Project, California American Water will have to annually borrow funds on a long-term basis and seek additional equity from stockholders and new investors in American Water Works. (Declaration of David P. Stephenson, ¶ 7.)

Setting the AFUDC interest rate at California American Water's currently authorized rate of return will provide the potential for adequate future compensation to California American Water's shareholders for the use of investment funds. At the same time, California American Water's approach avoids the potential error of allowing too high a return because the actual AFUDC carrying cost of this investment should exceed California American Water's overall weighted cost of capital.

B. The Higher Risk to this Investment Already Created by Later Reasonableness Review is Further Evidence That a Normal Rate of Return is Justified.

The fundamental risk-return tradeoff recognized by investors is that if an investment is less risky, then the investor expects a lower return; if an investment is more risky, then the investor expects a higher return. Here, the fact of ultimate reasonableness review has already made the risk of remedial investment in the San Clemente Dam higher than California American Water's overall investment in rate base. As such, the compensation investors require for bearing the risks of this investment is higher than for investments already in rate base. The more risky the investment becomes, the more it affects the overall cost of capital of the company, and thereby increases the financing cost of all of the company's investments.

Another key concept of finance theory is that the cost of capital for a large project should be specific to its own characteristics, which may be different from those of other investments a firm undertakes. (Declaration of Carl Danner, ¶ 5.) For example, a diversified company considering the purchase of a steel mill should evaluate its expected returns using a steel industry cost of capital, not that of the diversified company's existing businesses. Further, a

given investment may be more or less risky than any other investment, or than the weighted average of a firm's other investments. Since investors may ultimately be denied recovery of a portion of this investment by the Commission's regulatory process, the carrying cost to them of this investment is higher than for other rate base investments that have already been through reasonableness review and which do not bear that added risk. To be clear, California American Water is not objecting to the process of reasonableness review. The necessary implications of that process, however, should be recognized in decisions such as this one.

It would be most accurate for the Commission to adopt an AFUDC rate to reflect the actual carrying cost for the San Clemente Dam Project, which is a project-specific cost of capital reflecting the risks of the investment. However, it is difficult to identify investments of comparable risk to the San Clemente Dam Project and estimate their cost of capital to determine whether a given investment appears to offer a sufficient or acceptable return. Therefore, California American Water is not seeking a project-specific cost of capital for the San Clemente Dam Project. Rather, California American Water is seeking to earn the same overall rate of return on the accumulated San Clemente Dam Project costs as has been allowed for its other investments even though the appropriate carrying cost for this investment is higher than that for California American Water's rate base investments as a whole. Importantly, California American Water's requested AFUDC approach will not require the Commission and the parties to litigate new estimates of the cost of capital.

Even though California American Water is not seeking a rate of return on the San Clemente Dam Memorandum Account that is higher than its overall cost of capital, there are a number of particular risks that demonstrate that accruing the AFUDC rate at California American Water's overall rate of return is justified.

First, the San Clemente Dam investment is more risky because the Commission has yet to rule on the ultimate reasonableness of all of the San Clemente Dam remediation investments. In contrast, California American Water's existing rate base has already been reviewed for reasonableness, and is not subject to the same risk of partial or complete

disallowance. Accordingly, the risk of the San Clemente Dam investment must include the potential for disallowance when the Commission ultimately determines the reasonableness of California American Water's expenditures. The Declaration of Dr. Danner illustrates that the proper AFUDC carrying cost would exceed California American Water's weighted average cost of capital through the comparison of two hypothetic mutual fund investments. The first mutual fund would allow an investor to purchase a share that would represent California American Water's current rate base and whatever returns it would provide over time. The second mutual fund would allow an investor to purchase a share of California American Water's San Clemente Dam seismic improvements, which would give back the earned rate of return in the same way minus any disallowances that are ultimately ordered. Assuming that the authorized rate of return is the same for both mutual funds, the San Clemente Dam fund would be a less attractive investment because it could lose part or all of its money in a way that the first mutual fund will not. Its risk and therefore needed return is greater.

Second, the length of the financing required for the San Clemente Dam Project increases the risk of the investment. California American Water's seismic safety investments in San Clemente Dam are neither short-term nor low risk. DRA's and MPWMD's proposed 90-day commercial paper rate, which is paid by capital markets for a short-term investment of very low risk, would not compensate California American Water for the risks associated with the San Clemente Dam Project. DRA's and MPWMD's position that the Commission should apply the 90-day commercial paper rate is contradicted by D.06-11-050, in which the Commission recognized that California American Water "will need to obtain financing over several years for the project" and that the AFUDC interest rate should reflect California American Water's long-term debt and equity, similar to what is used for long-term energy projects.[4] Moreover a shortfall in carrying costs is more consequential for a lengthy project than for a brief one because the too-low return would apply for a longer time. Additionally, the Commission has already

[4] D.06-11-050, 2006 Cal.PUC LEXIS 479, *67.

subjected some of the San Clemente Dam investment to a carrying cost that is too low, at least for a brief period (although applying the appropriate carrying cost to the entire investment, as D.06-11-050 authorized and as California American Water is requesting, will address that concern).

Contrary to DRA's and MPWMD's claims, the Commission should not reduce the AFUDC rate because of the risk that customers may not receive the benefits of expenditures on a project whose ultimate outcome may be unclear. The carrying costs of a project simply are what they are regardless of DRA's and MPWMD's contentions about the project's merits. DRA's and MPWMD's approach would pre-judge the issue and impose a de facto disallowance before the Commission has even determined the reasonableness of the carrying costs, because carrying costs not booked in an AFUDC account can never be recouped later. Indeed, the disallowance will grow and compound over time. DRA and MPWMD will have ample opportunity to address their concerns about the Project during the reasonableness review. Moreover, improving the San Clemente Dam's seismic safety is also not an optional undertaking for California American Water, but rather has been required by public safety agencies for the protection of life and property.

Third, the fact that the San Clemente Dam Project is subject to AFUDC ratemaking treatment, as opposed to other ratemaking treatment such as CWIP, makes the investment riskier in that AFUDC ratemaking at times has been recognized by the capital markets as problematic. Historically, the Commission had specified CWIP treatment for this project. It was not until the most recent Monterey District rate case decision that if switched to AFUDC treatment. As set forth in the Declaration of Dr. Carl Danner, the capital markets may view investments subject to AFUDC as unusually risky because they are based on a promise or expectation of later recovery due to actions of regulatory agencies. Dr. Danner explains that utility stocks and bonds have sometimes lost market value when companies had large exposure to AFUDC, particularly in challenging regulatory environments.

C. Setting the San Clemente Dam Project AFUDC Rate Below the Current Cost of California American Water's Capital May Harm Customers.

DRA's and MPWMD's proposal to maintain the AFUDC rate at the 90-day commercial paper rate is short-sighted and could actually harm California American Water customers. Setting the San Clemente Dam Project AFUDC rate below the current cost of California American Water's capital may lead to a number of adverse consequences for all California American Water customers.

First, discounting the carrying costs of the San Clemente Dam Project to a level that creates a disincentive for this and other investment in California would have disastrous consequences for customers in the long run, especially in the face of huge capital investment requirements resulting from industry-wide infrastructure replacement needs. Commission action that discourages California American Water from helping to remedy the seismic risk faced by residents downstream of the Dam will have far-reaching consequences for customers.

Second, setting the AFUDC rate too low will have the unintended consequence of increasing California American Water's capital costs, which means increased rates for all customers in all of California American Water districts. If the Commission makes capital investment in California American Water's investment Project less attractive, it will unintentionally raise the cost of attracting necessary funds, and possibly constrain the availability of capital to California American Water in the future. Placing California American Water at higher risk causes a spiral effect in which the financial markets re-evaluate the costs to provide capital to California American Water, causing capital costs to go higher, thereby increasing the cost of capital for the company and all of its customers.

Third, denying California American Water an appropriate carrying cost for the San Clemente Dam Project will erode California American Water's earnings for the Monterey District and impair California American Water's ability to earn a reasonable rate of return, and therefore weaken California American Water's financial condition. Placing California American Water's financial condition at a higher risk will lead to increased financing costs for all of California American Water's investments, which will increase the revenue requirements for

which all customers are responsible. Indeed, the customer impacts of a carrying cost shortfall for a long-run investment such as the San Clemente Dam Project will be greater than for one of limited duration. Customers would plainly not benefit from an AFUDC rate that threatens to weaken the financial condition of California American Water.

IV. A NON-COMPENSATORY AFUDC RATE WILL HARM CALIFORNIA AMERICAN WATER'S FINANCIAL INTEGRITY AND ABILITY TO ATTRACT CAPITAL

DRA's and MPWMD's proposal, which would fail to set the AFUDC at a proper level, would have a staggering effect on California American Water's net income for the Monterey District. The difference between the capitalization rates amounts to approximately $4.6 million over a four-year construction period.[5] The difference is solely due to the difference in capitalized interest caused by using different capitalization rates over the remaining construction period. The annual tax effects of the different AFUDC assumptions on the net income for the Monterey District result in $255,600 for 2007, $405,000 for 2008 and $818,500 for 2009 and $1,208,800 for 2010. This means that with the annual post-tax reductions to net income the allowed return on equity of 10.10 percent would be reduced to 9.39 percent in 2007, 8.97 percent in 2008, 7.81 percent in 2009 and 6.72 percent in 2010. These reductions are illustrated in the following chart.

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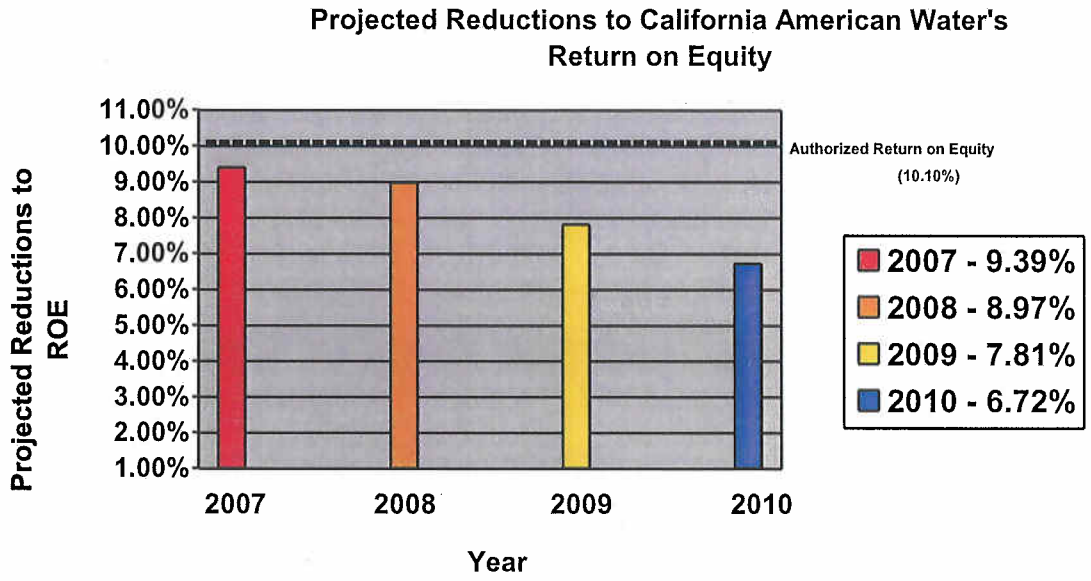
[5] Assuming a short-term interest rate of 5.2 percent versus California American Water's currently authorized rate of 8.33 percent.



The calculations for these different outcomes are set forth in the Declaration of David P. Stephenson. These are substantial reductions, all of which do nothing but place California American Water at higher risk on its investments. If the Commission does not authorize an adequate AFUDC rate for the San Clemente Dam of at least its current cost of capital, California American Water will end up with a significantly lower rate of return than what is currently authorized. The Commission must not underestimate the potential magnitude of the harm to California American Water's financial condition that will result from discounting the carrying cost that is required to service this investment.

DRA's and MPWMD's proposals to set the AFUDC rate below the actual cost of the financing used by California American Water during construction would place California American Water at higher risk on its investment just as its investment requirements are growing sharply to fulfill customer needs. This is a particularly bad time for such an action that would harm California American Water's financial integrity and ability to attract capital, in violation of the principles set forth by the U.S. Supreme Court in *Hope Natural Gas Company* and *Bluefield*

Water Works & Improvement Co.[6] According to *Hope Natural Gas Company* and *Bluefield Water Works & Improvement Co*, a utility is entitled to a return that will allow it to maintain its credit so that it continues to have access to the capital markets to raise the funds necessary for investment.[7] DRA's and MPWMD's proposed AFUDC interest rate is confiscatory and will deprive California American Water of the opportunity to earn a reasonable rate of return. Investors, realizing that an investment in California American Water does not offer a reward commensurate with its risk, would pull their money out of California American Water and invest it any number of assets that offer a fair return.

V. ALLOWING UTILITIES THE OPPORTUNITY TO RECOVER THE FULL COSTS OF THEIR INVESTMENTS IS A NECESSARY PART OF THE COMMISSION'S WATER INFRASTRUCTURE POLICY

Allowing California American Water the opportunity to recover its full, current cost of capital for this project is consistent with the Commission's important policy objective of encouraging water utilities to invest in infrastructure. The Commission's 2005 Water Action Plan provides the following: "The water infrastructure in California needs significant improvement. We will provide financial incentives and direction to encourage investment in infrastructure needed to improve water quality." [8]

The Water Action Plan specifically recognizes that the Commission should create policies and alternative financing mechanisms that actively promote the large infrastructure

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[6] *Federal Power Comm'n v. Hope Natural Gas Company*, 320 U.S. 591, 603 (1944); *Bluefield Water Works & Improvement Co. v. West Virginia Public Service Comm'n*, 262 U.S. 679, 690, 692-93 (1923). *See also Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

[7] *Hope, supra,* 320 U.S. at 603 ("From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. . . . The fixing of just and reasonable rates involves a balancing of the investor and the consumer interests. . . . By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. The return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.").

[8] Water Action Plan, p. 4.

investment that is needed industry-wide in California. Maintaining the current disincentive for investment caused by an inadequate AFUDC return is contrary to supporting those needed investments. Shortchanging the carrying cost of a project will create a disincentive for investment that will ultimately harm California American Water and all its customers. While the Commission will determine as a result of this proceeding an AFUDC carrying cost only for one substantial project for California American Water, the outcome will send a closely-watched signal to the water industry about the Commission's willingness to compensate utilities for the expense of investments necessary to the welfare of customers. California American Water supports the Water Action Plan and its beneficial goals, and encourages the Commission to continue to do the same by supporting the actual cost of the investments those goals require.

A. The Commission Should Encourage Investments to Protect Public Safety by Permitting Compensatory Carrying Costs.

Allowing California American Water to recover its full, current cost of capital for funds subject to AFUDC treatment will send an important signal to the industry that the Commission continues to value and encourage investments to protect public safety. It will also show that the Commission supports the safety-related actions of other governmental authorities by permitting a compensatory carrying cost for funds needed to carry out the mandates of the DSOD. Indeed, the Commission should support California American Water's efforts to address risks to life and property from seismic hazards as it would any other public health or safety concern that requires investment.

The Commission must not create a disincentive for California American Water to make such investments, particularly when the project involves complicated matters that necessarily will take time to resolve in California's environmental review and governmental approval process. By way of example, DRA's and MPWMD's proposal to maintain the status quo (of a 90-day commercial paper rate applied to AFUDC balances) would send a discouraging signal for investments in major capital projects. Investors, realizing that an investment in California American Water may not offer a reward commensurate with its risk, and in

accordance with the most fundamental investment principles, would pull their money out of California American Water and invest it in any number of assets that offer a fair return.

As set forth in the Declaration of F. Mark Schubert, California American Water does not have the choice of ignoring the San Clemente Dam seismic safety issues in order to avoid related capital expenditures. Despite the fact that California American Water has acted responsibly to comply with the mandates, the environmental review has been delayed due to complications to the environmental review process that are outside California American Water's control. Given the significant expenses and delays of the Project, and the effect of those delays on corresponding carrying costs on California American Water, it is even more important that the Commission recognize that a shortfall in carrying costs will discourage future water utility investment by California American Water and other utilities regulated by the Commission.

VI. CALIFORNIA AMERICAN WATER'S REQUESTED AFUDC RATE OF 8.33 PERCENT IS CONSISTENT WITH COMMISSION PRECEDENT.

Given that the Commission has typically not provided AFUDC treatment on water construction projects, the AFUDC interest rate calculation as it applies to water utilities is a relatively novel issue.[9] However, California American Water's requested AFUDC rate is consistent with precedent in which the Commission has authorized energy utilities to accrue AFUDC for major long-term capital projects at rates that reflect the overall cost of capital.[10] In D.84-08-125, the Commission explained that the "basic concept underlying the AFUDC rate formulae [is to] provid[e] a return on investment based on the utility's capital structure similar to

[9] Instead of authorizing AFUDC, the Commission has historically allowed water utilities to recover the financing costs by placing the estimated average cost of CWIP into rate base. Here, the Commission reversed that treatment by ruling that California American Water should no longer be allowed to recover the current financing costs for the San Clemente Dam Project from customers as part of rate base, but should only be allowed to accrue AFUDC.

[10] D.84-08-125, *Application of SAN DIEGO GAS & ELECTRIC COMPANY for authority to include the Southwest Powerlink as a specified major addition under its Major Additions Adjustment Clause (MAAC) and to increase its Major Additions Adjustment Billing Factor (MAABF) and decrease its Annual Major Additions Rate (AMAR) upon operation of the Southwest Powerlink*, 1984 Cal. PUC LEXIS 1309, **12-13.

the overall rate of return derivation."[11] Simply put, the Commission has calculated the AFUDC rate to reflect the expected source of funds used to finance the Project.

Here, the San Clemente Dam Project is a long-term, major capital project that may take a number of years before it becomes operational. Consistent with Commission precedent and as discussed above in the record of this case, the appropriate AFUDC carrying cost is California American Water's overall rate of return authorized for the Monterey District.

While the Commission has allowed water utilities to accrue capitalized interest based upon a short-term borrowing rate for short-term deferred items, the Commission recognized in D.06-11-050 that a short-term borrowing rate would be inadequate to compensate California American Water for the carrying cost of the San Clemente Dam Project, which is a long-term investment project. As explained above, consistent with prior Commission decisions, California American Water's AFUDC should be capitalized to ensure that the utility ultimately has the opportunity to be made whole for the overall cost of the investment.

DRA and MPWMD incorrectly claim that prior Commission decisions somehow require the Commission to adopt the commercial paper rate for California American Water's San Clemente Dam memorandum account. First, in D.00-03-053, a case cited by DRA, the Commission adopted the settled position between California American Water, DRA (its predecessor), MPWMD, and the US Department of Defense and Federal Executive Agencies, which cannot be used as justification or precedent for reducing California American Water's requested AFUDC in this case. As the Commission is aware, "[u]nless the Commission expressly provides otherwise, … adoption [of a settlement agreement] does not constitute approval of, or precedent regarding, any principle or issue in … any future proceeding. (See Rule 12.5 of the Commission's Rules of Practice and Procedure.)

Second, D.03-09-022, a case cited by DRA and MPWMD, was a case-specific determination of the ratemaking treatment for a particular project, not a rulemaking or

[11] *Id.* at *15.

determination of policy for all water company investments.[12] In deciding how California American Water's Coastal Water Project should be treated, the Commission opted not to provide either CWIP or AFUDC as the utility's cost of capital because physical construction had not begun.[13] The distinction in D.03-09-022 between short- and long-term projects is not relevant to determining the appropriate AFUDC rate that should apply to the San Clemente Dam. Moreover, the Commission has explicitly recognized that the circumstances surrounding the San Clemente Dam Project are different from those of the Coastal Water Project. In D.06-11-050, the Commission explained that the San Clemente Dam Project will require financing over several years and that similar to energy projects, it may be more appropriate to use an AFUDC interest rate that reflects the long-term debt and equity.[14] As discussed above, the San Clemente Dam circumstances warrant an AFUDC rate of California American Water's current authorized rate of return.

Third, DRA wrongly cites to D.94-06-033 in support of its proposal that the 90-day commercial paper rate is appropriate. The underlying Order Instituting Investigation (also called the Risk OII) was issued nearly seventeen years ago to consider whether financial and operating risks faced by water utilities that are under Commission jurisdiction warrant changes in regulatory policies. At the time, the water projects in question were short-term and low risk. Neither the Commission nor the parties to the Risk OII contemplated the sheer size and magnitude of long-term capital projects such as the San Clemente Dam Project, which are significantly more costly and risky than the short-term projects historically undertaken by water utilities. By way of example, the largest water capital project identified in the Risk OII involved

[12] D.03-09-022, *Application of California-American Water Company (U 210 W) for a Certificate that the Present and Future Public Convenience and Necessity Requires Applicant to Construct and Operate the 24,000 acre foot Carmel River Dam and Reservoir in its Monterey Division*, 1997 Cal. PUC LEXIS 1279.

[13] Id. at *32.

[14] D.06-11-050, 2006 Cal. PUC LEXIS 479,*67.

borrowing capital from the bond markets to drill seven new wells.[15] In the many years since the time the Commission issued the Risk OII, the Commission has made many changes to the policies affecting investor-owned water utilities. This decision is irrelevant to the Commission's determination of the AFUDC interest rate at issue in this proceeding.

Finally, D.94-06-033, D.00-03-053 and D.03-09-022 were all available to the Commission (and considered by the Commission) when it issued D.06-11-050 and ordered California American Water to file the Application that is the subject of this proceeding. Clearly, the Commission does not consider these decisions to have addressed the issue.

VII. CONCLUSION

Allowing California American Water to recover its full, weighted cost of capital as the AFUDC carrying cost (i) will benefit California American Water, as well as its customers, by providing reasonable compensation to California American Water's shareholders, while avoiding the potential error of allowing too high a return; (ii) will avoid placing California American Water at high risk on its investment and harming its financial integrity by setting the AFUDC rate below the actual cost of financing used by California American Water; (iii) will further the Commission's important policy objective of encouraging water infrastructure investment, including infrastructure necessary to protect public safety; (iv) is consistent with Commission precedent. The Commission should authorize California American Water to set its AFUDC on its San Clemente Dam Memorandum Account at the Monterey District's current authorized rate of return.

[15] D.94-06-033, *Investigation on the Commission's own motion into the financial and operational risks of Commission regulated water utilities, and whether current ratemaking procedures and policies require revisions*, 1994 Cal. PUC LEXIS 428 *80 (stating that "The utility's witness could not recall an earlier time when San Gabriel had required that degree of capital infusion, nor could he foresee a specific event in the future that would require capital expenses of this magnitude.").

Dated: August 13, 2007

STEEFEL, LEVITT & WEISS
A Professional Corporation

By: _____
Lori Anne Dolqueist
Attorneys for Applicant
California-American Water Company

Exhibit A

Declaration of Dr. Carl Danner

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U 210 W) for an Interest Rate of 8.33% for Allowance for Funds Used During Construction (AFUDC) for its San Clemente Dam Memorandum Account.	Application No. 07-02-023 (Filed February 20, 2007)

DECLARATION OF DR. CARL DANNER IN SUPPORT OF CALIFORNIA-AMERICAN WATER COMPANY'S OPENING BRIEF

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Attorneys for Applicant
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Date: August 13, 2007

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U 210 W) for an Interest Rate of 8.33% for Allowance for Funds Used During Construction (AFUDC) for its San Clemente Dam Memorandum Account.	Application No. 07-02-023 (Filed February 20, 2007)

DECLARATION OF DR. CARL DANNER IN SUPPORT OF CALIFORNIA-AMERICAN WATER COMPANY'S OPENING BRIEF

I, Dr. Carl Danner, declare:

1. I have personal knowledge of the facts and opinions set forth herein and could and would competently testify thereto if called upon to do so.

2. I was an Advisor and Chief of Staff to Commissioner (and Commission President) G. Mitchell Wilk during his tenure at the California Public Utilities Commission (Commission). Since leaving the Commission, I have provided consulting services to various clients on regulation and policy issues. I hold a Masters and Ph.D. in Public Policy from Harvard University, where my dissertation addressed the strategic management of telecommunications regulatory reform. At Harvard I served as Head Teaching Assistant for graduate courses in microeconomics, econometrics and managerial economics. I hold an AB degree from Stanford University, where I graduated with distinction in both economics and political science. My experience includes researching and teaching regulation, advising regulators, testifying in regulatory proceedings, and advising clients on regulatory issues. My resume is attached as Exhibit 1.

3. I was retained by California-American Water Company (California American Water), a party to this proceeding, to evaluate, from a regulatory policy standpoint, how the Commission should set an appropriate rate of return for its investments in the seismic safety of San Clemente Dam that are subject to allowance for funds used during construction (AFUDC)

ratemaking. I was also asked to consider the investment implications of the Commission's use of AFUDC ratemaking for water utilities in the current environment facing those companies. Based upon my review of this case and my expertise on regulation and policy issues before the Commission, I believe that it is appropriate for California American Water to use a full cost of capital (including equity and debt) for the carrying cost of financing the San Clemente Dam Project through AFUDC. Even though the actual AFUDC carrying cost should exceed California American Water's overall weighted cost of capital, I recommend the latter figure because the use of a current overall cost of capital is an improvement over the present situation, is straightforward to calculate, will not overcompensate California American Water and is generally consistent with Commission practice.

4. The purpose of this declaration is to explain the basis for my opinion that the full, weighted cost of capital would be an appropriate AFUDC carrying cost for California American Water's remedial investment in the San Clemente Dam.

5. As an initial matter, it is my understanding that parties to this proceeding have proposed that the 90-day commercial paper rate is an appropriate carrying cost for California American Water's remedial investment in the San Clemente Dam. The 90-day commercial paper rate is in no way an appropriate carrying cost for California American Water's San Clemente Dam investment for a variety of reasons that include some noted by the Commission in D.06-11-050. The proper carrying cost is a project-specific cost of capital reflecting the risks of this investment, which include the potential for disallowance when the Commission ultimately determines the reasonableness of California American Water's expenditures.

6. Under finance theory, if an investment is less risky, the investor expects a lower return and if an investment is more risky, the investor expects a higher return. At this stage, the regulatory process makes the San Clemente Dam Project investment more risky than California American Water's overall investment in rate base, and as a result, the actual carrying cost for the San Clemente Dam Project should be higher than the carrying cost for California American Water's rate base.

7. The reason for this elevated risk is that the Commission has yet to rule on the ultimate reasonableness of San Clemente Dam remediation investments to date, as well as those that will occur in the future. The Commission may disallow recovery on a portion of those investments. It is my understanding that it has been argued in this proceeding that California American Water should be denied any recovery of these funds. Neither is there any potential for capital gain that might offset this regulatory risk. The Commission has already subjected some of the San Clemente Dam investment to a carrying cost that is too low, at least for a brief period (although the upcoming Commission decision can remedy that). A less-than-compensatory carrying cost on the San Clemente Dam Project makes the investment less attractive to investors.

8. By contrast, California American Water's existing rate base has already been reviewed for reasonableness, and is not subject to the same risk of partial or complete disallowance. For this regulatory reason, that rate base is thus less risky than are remedial investments in San Clemente Dam. Therefore, the cost of capital for California American Water's existing rate base investments should be lower than for remedial investments in San Clemente Dam.

9. To illustrate these principles of risks and carrying costs, I compare two hypothetical mutual fund investments to see which is more attractive. The first mutual fund would allow an investor to purchase a share of the current rate base of California American Water. In exchange for a dollar, an investor could buy one share of California American Water's current rate base and whatever returns it would provide over time. The second mutual fund would allow an investor to purchase a share of California American Water's San Clemente Dam seismic improvements. That mutual fund will pay out in the same way, giving back the earned rate of return plus allowed depreciation, but minus any disallowance that is ultimately ordered. If the two mutual funds are equally attractive, then they are of equal risk since each earns the same rate of return. However, assuming that the authorized rate of return is the same for both

mutual funds, the first mutual fund is more attractive because the second mutual fund could lose part or all of its money in a way (disallowance) that the first fund will not.[1] Since the San Clemente Dam fund would be less attractive, its risk and therefore needed return (or carrying cost) is greater. This illustrates again that the actual AFUDC carrying cost should exceed California American Water's weighted average cost of capital.

10. Investors have recognized investments subject to AFUDC as unusually risky. For example, in the 1980s many electric utilities had substantial investments in nuclear power plants that were accounted for through AFUDC. Such accounts are considered "regulatory assets" since they are based on a promise or expectation of later recovery due to actions of regulatory agencies. In many instances those investments were not fully recovered because of regulatory disallowances. During that time, Wall Street investment analysts came to evaluate the "quality" of a utility's earnings as an important factor in rating or evaluating its equity and securities.[2] Evidence shows that utility stocks and bonds sometimes also lost market value when companies had large exposures to AFUDC, particularly in challenging regulatory environments.

11. For example, Loudder, Khurana and Boatsman examined 109 energy utilities from 1984-93 to understand whether regulatory assets were effectively singled out by financial markets in determining the value of utility common stock:

> *Our results suggest that market participants assess the probability that regulators will ultimately allow the full recovery of the regulatory assets and adjust for the uncertainty of reported regulatory assets, rather than assuming 100 percent of the maximum possible recovery of regulatory assets in the rate base.*[3]

---

[1] The comparison is even clearer between investing in a San Clemente Dam mutual fund, versus investing in 90-day commercial paper at the same interest rate. The latter would be a far more attractive investment and therefore far less risky, indicating once again that the 90-day commercial paper rate is too low for a proper AFUDC carrying cost.

[2] The carrying cost that is credited to ADFUC balances factors into a utility's reported quarterly earnings. The greater the proportion of AFUDC returns in earnings, the lower is their quality.

[3] Loudder, Martha L., Khurana, Inder K. and James R. Boatsman. "Market Valuation of Regulatory Assets in Public Utility Firms," The Accounting Review (vol. 71, no. 3, July 1996), pages 357-373.

Rating agencies also considered earnings quality in assigning investment risk ratings to energy utility preferred stocks. Rao and Moyer found that utility exposures to AFUDC led to reduced ratings and potentially harmful ratepayer impacts among 49 preferred stocks during the 1978-81 period:

> "*From a regulatory perspective, the results indicate that ratings are affected adversely by low quality earnings. To the extent that low earnings quality leads to lower bond and preferred stock ratings (and thus higher capital costs), the impact is not favorable to ratepayers, ceteris paribus.*"[4]

12. Although I am not equating seismic upgrades to San Clemente Dam with the riskiness of investing in a nuclear power plant in the 1970s, the capital markets have recognized AFUDC ratemaking treatment as problematic at times. This can raise the cost of capital paid by customers, and certainly reflects a greater carrying cost than a 90-day commercial paper interest rate.

I declare under penalty of perjury under the laws of the state of California that the foregoing is true and correct to the best of my knowledge and belief. Executed this 13th day of August, 2007, at San Francisco, California.

Dr. Carl Danner

[4] Rao, Ramesh, and R. Charles Meyer. "Rating Agency Responsiveness to Changes in the Economic Environment Facing Electric Utilities," Quarterly Journal of Business and Economics (winter, 1990), pages 86-101.

Exhibit B

Declaration of F. Mark Schubert

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U 210 W) for an Interest Rate of 8.33% for Allowance for Funds Used During Construction (AFUDC) for its San Clemente Dam Memorandum Account.	Application No. 07-02-023 (Filed February 20, 2007)

DECLARATION OF F. MARK SCHUBERT IN SUPPORT OF CALIFORNIA-AMERICAN WATER COMPANY'S OPENING BRIEF

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California-American Water Company

Date: August 13, 2007

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U 210 W) for an Interest Rate of 8.33% for Allowance for Funds Used During Construction (AFUDC) for its San Clemente Dam Memorandum Account.	Application No. 07-02-023 (Filed February 20, 2007)

DECLARATION OF F. MARK SCHUBERT IN SUPPORT OF CALIFORNIA-AMERICAN WATER COMPANY'S OPENING BRIEF

I, F. Mark Schubert, declare:

1. I am the Director of Engineering for the Western Region of the American Water Works Service Company ("American Water"). The Western Region is comprised of water and wastewater utility subsidiaries located in Arizona, California, Hawaii, New Mexico and Texas, including California American Water. My business address is 303 H Street, Suite 250, Chula Vista, CA 91910.

2. My responsibilities as Director of Engineering include: managing all engineering projects and capital planning activities on a regional basis; supervising asset planning, engineering design and construction management on a regional basis; supervising engineering colleagues in three separate offices; providing rate case support and testimony as an expert witness on capital project planning in California, Hawaii and New Mexico; providing liaison contact for federal, state and local regulatory agencies on a regional basis to ensure compliance with all state and federal regulations; and supervising developer plan/engineering review activities..

3. I have been with American Water for nearly twenty years. After working in engineering positions at R. W. Beck and Associates and Economic and Engineering Services, Inc., in 1987 I joined the System Engineering Department of American Water as a Senior Planning Engineer in Voorhees, New Jersey. My duties included the development of

comprehensive planning studies for several subsidiary operating water companies of American Water Works Company, Inc. In 1989, I assumed the position of Assistant Director - Rate Studies, which involved preparing reports and studies in the areas of cost of service, depreciation and rate design for these same water companies. In 1994, I was promoted to the position of Director - Regulatory Studies for New Jersey-American Water Company ("NJAWC") in Haddon Heights, New Jersey. In 1995, I assumed the responsibilities of Director - Business Development for NJAWC. In 2000, I returned to the System Engineering Department of the Service Company in Voorhees, New Jersey as a Senior Planning Engineer. My responsibilities included overseeing the capital planning and engineering activities of the Western Region on an interim basis. In November 2001, I was promoted to the position of Director of Engineering for the Western Region and assumed these responsibilities on a permanent basis.

4. In 2004, I joined RBF Consulting as a Senior Project Manager, where I was primarily responsible for preparing strategic master plans and helping to implement capital improvement projects for various clients of RBF Consulting. In addition, I was responsible for assisting private utility clients on rate case applications due to my extensive experience dealing with Public Utilities Commissions in the states of California, Hawaii and New Mexico. I then rejoined American Water in January 2006 as a Regulatory Engineering Manager in the rates and regulatory planning department. I was named Director of Engineering for American Water for the Western Region in June 2007.

5. I am a registered professional engineer (Civil) in the Commonwealth of Massachusetts and the States of California, Hawaii, Idaho, New Jersey, New Mexico, Oregon and Washington. I am a member of the American Water Works Association and the American Society of Civil Engineers.

6. California American Water is undertaking the seismic safety project under orders of the Department of Water Resources/ Division of Safety of Dams ("DSOD"). California American Water's proposed dam strengthening and project alternatives are currently the subject of a joint Environmental Impact Report/Environmental Impact Statement (EIR/EIS) to comply

with the requirements of the California Environmental Quality Act (CEQA) and the National Environmental Policy Act (NEPA).

7. The San Clemente Dam is located on the Carmel River in Monterey. California American Water has served the Monterey Peninsula since it acquired properties from California Water and Telephone Company in 1966. California American Water provides potable water to its customers in the Cities of Monterey, Seaside, Carmel-by-the-Sea, Sand City, Pacific Grove, Del Rey Oaks and certain unincorporated areas of Monterey County.

8. The San Clemente Dam was constructed in 1921. At the time of construction, little was known about building for earthquake safety. The San Clemente Dam impounds a reservoir and serves as a surface water diversion. The reservoir initially had a storage capacity of 1,425 acre feet. Over the years, due to natural stream processes and disturbances in the watershed, more than 2.4 million cubic yards of sediment have accumulated behind the dam.

9. At the request of the California DSOD, California American Water retained consultants in the early 1990's to evaluate the seismic safety of the San Clemente Dam. The studies concluded that the San Clemente Dam had some deficiencies, specifically in its structural integrity to withstand the forces of a Maximum Credible Earthquake (MCE). The dam could suffer structural damage during an MCE and from the Probable Maximum Flood (PMF) event; water could overtop the dam and possibly erode the downstream abutment area. It should be noted that the seismic safety work would need to be completed even if the sediment had not accumulated behind the San Clemente Dam.

10. The consultants recommended remediation of the structure to prevent failure of the dam under these extreme loading conditions. California DSOD directed California American Water to proceed with remediation and to bring the San Clemente Dam into compliance with current seismic safety standards so that the dam can withstand the load from an MCE and safely pass the PMF. After studying several alternatives, California American Water proceeded to design a downstream concrete buttress. California DSOD reviewed the design and found it satisfactory with respect to dam safety. Preparation of the environmental impact report was done

in parallel with the remediation design. California American Water has been acting responsibly to comply with other governmental agencies' mandates. Two draft environmental EIRs that analyzed various options for strengthening the dam were previously circulated in 1998 and 2000. The delay in the environmental review was outside of California American Water's control.

11. In July 2000, the National Oceanic and Atmospheric Administration ("NOAA") Fisheries promulgated new rules under Section 4(d) of the Federal Endangered Species Act (ESA) prohibiting "take" of the threatened South Central California Coast ("SCCC") steelhead trout, which spend important parts of their lifecycle in coastal rivers, including the Carmel River. Near the same time, NOAA adopted a national policy to advocate the removal of old dams that are a barrier to fish passage. NOAA also decided that, of all the Coastal streams in the SCCC area, the Carmel River has the conditions most likely to help species recover. These issues complicated the EIR process.

12. In 2001, NOAA Fisheries advised California DSOD that the alternative of dam removal should be studied in much greater detail. NOAA Fisheries insisted that the best way to render the dam seismically safe is to completely remove it and required detailed and expensive studies of sediment transport in the Carmel River as the means of sediment disposal. NOAA believes that removal of the dam should be pursued because it will remove the barrier to fish passage. The primary impediment to dam removal is dealing with the impounded sediment in a manner that will avoid adverse impacts to human health and safety, property and the environment. In addition, the cost of removing the dam may be more expensive than retrofitting the dam. The controversy over this issue and opposition by environmental agencies has resulted in significant delays in addressing the San Clemente dam seismic issues.

13. At California DSOD's direction, California American Water performed the requested sediment transport modeling. The additional modeling confirmed the earlier analysis, that releasing all of the sediment into the Carmel River would cause significant changes in the downstream riverbed and floodplain. In early 2004, California DSOD and California American Water entered into a Memorandum of Understanding to reinstate the environmental review

process, and agreed that an EIS should be included with the U.S. Army Corps of Engineers (USACOE) as the federal lead agency. It was also agreed that the alternatives would be given the same level of environmental review as the proposed strengthening project. DSOD and USACOE issued a joint Draft EIR/EIS in September 2006 that evaluates the potential environmental effects of the proposed strengthening project and alternatives. The EIR/EIS has not yet been certified.

14. In late 2002, due to the delays in completing the EIR, the California DSOD ordered California American Water to institute interim safety measures at San Clemente Dam, as well as reducing the level of water in the reservoir. Lowering the reservoir would adversely affect the California red-legged frog and the steelhead trout because it would prevent the fish ladder from operating during the key migratory times of the year for steelhead trout and reduces habitat in the reservoir for the California red-legged frogs. Since the Spring of 2003, reservoir drawdowns were implemented. Mitigation for the California red-legged frog and steelhead trout occupying the reservoir during the annual drawdown included rescues and translocation of the California red-legged frog and steelhead trout. The drawdowns will be required each year until a permanent seismic safety project for the San Clemente Dam is implemented.

15. The EIR/EIS analyzed in detail four alternatives to the dam strengthening option, which include: dam notching, dam removal, river bypass (Carmel River reroute and dam removal), and no project. Although the project under review is known as the San Clemente Dam Seismic Safety Project, one of the alternatives currently being considered is total removal. California American Water is currently exploring the possible sale of the surrounding property to the California Coastal Conservancy for the removal of the San Clemente Dam. In an effort to make the project more cost-effective, California American Water is pursuing financial support from governmental agencies and interested non-governmental entities.

16. With the exception of the "no project" alternative, each alternative is expected to take a minimum of three to five years for California American Water to complete. Regardless of which alternative is chosen for the San Clemente Dam, California American Water will be

required to provide mitigation measures to protect the California red-legged frog and steelhead trout during construction, and potentially for an indefinite time thereafter.

17. It is my understanding that California DSOD will certify the EIR/EIS when it is completed. Under NEPA, USACOE will not issue a Record of Decision until its permit process is completed. Of course, the timing of the certification of the EIR/EIS and issuance of Record of Decision is not within the control of California American Water.

I declare under penalty of perjury under the laws of the state of California that the foregoing is true and correct to the best of my knowledge and belief. Executed this 13th day of August, 2007, at Chula Vista, California.

F. Mark Schubert

Exhibit C

Declaration of David P. Stephenson

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U 210 W) for an Interest Rate of 8.33% for Allowance for Funds Used During Construction (AFUDC) for its San Clemente Dam Memorandum Account.	Application No. 07-02-023 (Filed February 20, 2007)

DECLARATION OF DAVID P. STEPHENSON IN SUPPORT OF CALIFORNIA-AMERICAN WATER COMPANY'S OPENING BRIEF

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Date: August 13, 2007

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U 210 W) for an Interest Rate of 8.33% for Allowance for Funds Used During Construction (AFUDC) for its San Clemente Dam Memorandum Account.	Application No. 07-02-023 (Filed February 20, 2007)

DECLARATION OF DAVID P. STEPHENSON IN SUPPORT OF CALIFORNIA-AMERICAN WATER COMPANY'S OPENING BRIEF

I, David P. Stephenson, declare:

1. I am employed by American Water Works Service Company (Service Company) as a Manager of Rate Regulation for the Western Region of American Water and my business address is 4701 Beloit Drive, Sacramento, CA 95838.

2. In my current position, I am responsible for preparing, filing and processing all requests for rate adjustment, financing, acquisition or any other application before the state public utility regulatory agencies in the states of California and Hawaii in the Western Region.

3. I received a Bachelor of Science in Business Administration, with an emphasis in Accounting from San Diego State University. Additionally, I have attended and instructed at various seminars on different aspects of the water industry, including the Biannual Utility Rate Seminar sponsored by the National Association of Water Companies (NAWC) to educate members of the National Association of Regulatory Utility Commissioners (NARUC) and their staff about regulated water utilities.

4. I have been employed by the American Water Works System since 1978. The various positions I have held with the Company are: Accountant - 1978; Accounting Superintendent for the Los Angeles Region - 1981; Assistant Director of Accounting for the Western Region - 1983; Assistant Director of Rates and Revenues for the Western Region - 1984; Director of Rates and Revenues for the Western Region – 1986; Manager Rate Regulation

for Hawaii, California and New Mexico – 2005; Manager Rate Regulation for California and Hawaii - 2007.

5. The purpose of this declaration is to provide the basis for my opinion that California American Water should be allowed to accrue allowance for funds used during construction (AFUDC) for the San Clemente Dam Project at the current cost of capital of 8.33 percent, the authorized rate of return for the Monterey District.

6. To determine the actual cost of financing we can either use a weighted average cost of capital, assuming all capital costs are spread evenly over all the capital requirements, or we can use issuance specific costs related directly to cause and effect of the issuance. In determining that the current weighted average cost of capital carrying cost is an appropriate AFUDC for the San Clemente Dam Project, I considered a number of factors that suggest that the project has been financed by equity and many of the debt issuances of California American Water. First, this is a project that has been going on for a long period of time. Second, the current oldest debt of California American Water is not as old as length of time this project has been ongoing. Third, most of the debt of California American Water has just been refinanced.

7. In addition, it has never been more evident than it is today that the industry and California American Water demand a huge amount of capital. To finance this level of capital investment, I anticipate that California American Water will need to annually borrow funds on a long-term basis as well as seek additional equity from stockholders and new investors in American Water Works. I expect that California American Water will continue to meet its capital needs through issuing new debt and equity.

8. I developed a spreadsheet, which is attached hereto as Exhibit 1, which shows the problem of discounting the AFUDC interest rate for the project on the earnings of the Monterey District. This spreadsheet shows the impacts of different AFUDC rates for this project on the ability of the Monterey District to earn a reasonable rate of return. In the first column, I have noted the total estimated project cost in each year, along with its total through completion. In the second column, entitled 90-Day Commercial Paper Rate, I have calculated AFUDC to be added

to the project based on an estimated short-term 90-day commercial paper rate of 5.2%. In the third column, entitled Full AFUDC Rate, I have calculated AFUDC at the current approved cost of capital for the Monterey District of 8.33% as determined in D.06-11-050. In all of the columns I have used the same estimated annual construction expenditures as estimated in California American Water's five-year financial plan. The only other assumption I used to determine the AFUDC is a plant weighting factor of 50%, which is reasonable for an ongoing project such as this project.

9. In Column 1 of the spreadsheet contained in Exhibit 1, shows the project costs. In Column 2, I have calculated the interest at the short-term interest rate of 5.2 percent over the projected remaining construction period of four years, which amounts to over $7 million. Assuming the Monterey District current cost of capital of 8.33 percent over the remaining projected four-year construction period, the projected interest for the project is about $11.6 million. Assuming a short-term interest rate of 5.2 percent versus California American Water's currently authorized rate of 8.33 percent, the impact on the net income of the Monterey District in capitalized interest over the remaining four year construction period is about $4.6 million.

10. The annual tax effects of the different AFUDC assumptions on the net income of the Monterey District are shown at the bottom of Exhibit 1 and are as follows:

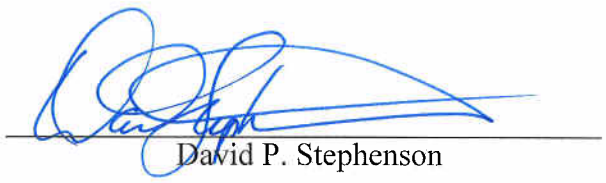
2007	$ 255,600
2008	$ 405,000
2009	$ 818,500
2010	$ 1,208,800

11. Based on the current 2007 rate base authorized in D.06-11-050 of $82,445,700, the annual post-tax reductions to net income as shown above cause the allowed rate of return on equity of 10.10% to be reduced to 9.39% in 2007, 8.97% in 2008, 7.81% in 2009 and 6.72% in 2010. These are substantial reductions. As a result of these reductions, California American Water will be at a much higher risk on its investments.

12. Placing a company at higher risk typically causes a spiral affect in which, as the company is placed at higher risk, the markets re-evaluate the costs of providing funds to the company, causing funding rates to go higher, thereby increasing the cost of capital for the company and its customers. As the cost of capital increases, and the AFUDC method is not changed, the effect of using a 90-day short-term rate increases risk and, then again the cost of capital increases. This tends to have a spiral effect. Discounting the carrying cost for the San Clemente Dam Project AFUDC will have a negative impact on California American Water's finances and increase its risk.

13. The Commission must provide the company with an opportunity to earn a reasonable return on its used and useful investment, and recover prudently incurred operating costs. I am concerned that if the Commission denies California American Water the opportunity to at least accrue AFUDC at its authorized cost of capital (in lieu of allowing all investments in the San Clemente Dam in current rate base) and instead sets a lower AFUDC rate, or none at all, then it will deny California American Water the opportunity to earn a reasonable return on its investment.

I declare under penalty of perjury under the laws of the state of California that the foregoing is true and correct to the best of my knowledge and belief. Executed this 13th day of August, 2007, at San Francisco California.



David P. Stephenson

CALIFORNIA AMERICAN WATER COMPANY
MONTEREY DISTRICT
SAN CLEMENTE DAM PROJECT

AFUDC FILING AS ORDERED BY D.06-11-050

CALCULATION OF IMPACT OF VARIOUS AFUDC TREATMENTS

ITEM	Accumulated Annual Project Costs	90-day Commercial Rate	Full AFUDC Rate
2007 Beginning Authorized Balance	$12,564,940	$12,564,940	$12,564,940
2007 Expenditures	$2,554,000	$2,554,000	$2,554,000
2007 Weighted Average Balance	$13,841,940	$13,841,940	$13,841,940
2007 Ending Balance pre Interest	$15,118,940	$15,118,940	$15,118,940
Interest Rate	0.00%	5.20%	8.33%
Interest	$0	$719,781	$1,153,034
Total Ending Balance	$15,118,940	$15,838,721	$16,271,974
2008 Beginning Balance	$15,118,940	$15,838,721	$16,271,974
2008 Expenditures	$9,880,000	$9,880,000	$9,880,000
2008 Weighted Average Balance	$20,058,940	$20,778,721	$21,211,974
2008 Ending Balance	$24,998,940	$25,718,721	$26,151,974
Interest Rate	0.00%	5.20%	8.33%
Interest	$0	$1,080,493	$1,766,957
Total Ending Balance	$24,998,940	$26,799,214	$27,918,931
2009 Beginning Balance	$24,998,940	$26,799,214	$27,918,931
2009 Expenditures	$29,089,000	$29,089,000	$29,089,000
2009 Weighted Average Balance	$39,543,440	$41,343,714	$42,463,431
2009 Ending Balance	$54,087,940	$55,888,214	$57,007,931
Interest Rate	0.00%	5.20%	8.33%
Interest	$0	$2,149,873	$3,537,204
Total Ending Balance	$54,087,940	$58,038,087	$60,545,135
2010 Beginning Balance	$54,087,940	$58,038,087	$60,545,135
2010 Expenditures	$1,499,509	$1,499,509	$1,499,509
2010 Weighted Average Balance	$54,837,695	$58,787,842	$61,294,890
2010 Ending Balance	$55,587,449	$59,537,596	$62,044,644
Interest Rate	0.00%	5.20%	8.33%
Interest	$0	$3,056,968	$5,105,864
Total Ending Balance	$55,587,449	$62,594,564	$67,150,508
TOTAL INTEREST	$0	$7,007,115	$11,563,059
Difference Between No Interest		$7,007,115	$11,563,059
Difference Between 90 Day Rate			$4,555,944

Calculation of Monterey Net Income Impact

Monterey 2007 Rate Base			$82,445,700
Authorized Return			8.33%
Operating Income			$6,867,700
Weighted Cost of Equity	Authorized Return	10.10%	4.38%
Equity Return			$3,611,100

Equity Loss Calculation		Interest Difference	Tax Effected @41% Taxes	Net Return on Equity
	2007	$433,253	$255,600	9.39%
	2008	$686,464	$405,000	8.97%
	2009	$1,387,331	$818,500	7.81%
	2010	$2,048,896	$1,208,800	6.72%

EXHIBIT 1

PROOF OF SERVICE

I, Michelle Chavez, declare as follows:

I am employed in the City and County of San Francisco, California. I am over the age of eighteen years, and not a party to the within cause; my business address is STEEFEL, LEVITT & WEISS, One Embarcadero Center, 30th Floor, San Francisco, California 94111-3719. On August 13, 2007, I served the within:

California-American Water Company's Opening Brief

on the interested parties in this action by placing a true copy thereof in a sealed envelope, addressed as follows:

Please see attached Service List

☒ **(BY PUC E-MAIL SERVICE)** By transmitting such document electronically from Steefel, Levitt & Weiss, San Francisco, California, to the electronic mail addresses listed above. I am readily familiar with the practice of Steefel, Levitt & Weiss for transmitting documents by electronic mail, said practice being that in the ordinary course of business, such electronic mail is transmitted immediately after such document has been tendered for filing. Said practice also complies with Rule 1.10(b) of the Public Utilities Commission of the State of California and all protocols described therein.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on August 13, 2007 at San Francisco, California.

/s/Michelle Chavez

Michelle Chavez

VIA PUC E-MAIL SERVICE:

(LAST UPDATED MAY 16, 2007)

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