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

Application of California Water Service Company (U60W) for Authority to Establish its Authorized Cost of Capital for the period from January 1, 2012 through December 31, 2014.

Application 11-05-001  
(Filed May 2, 2011)

And Related Matters.

Application 11-05-002  
Application 11-05-003  
Application 11-05-004

**ADMINISTRATIVE LAW JUDGE'S RULING ORDERING HEARINGS  
BEFORE CONSIDERATION OF MOTION TO ADOPT SETTLEMENT**

**Summary**

The four largest Class A water companies doing business in California and the Commission's Division of Ratepayer Advocates (DRA) (collectively, Parties) have entered into a proposed settlement agreement (Agreement) for which they seek Commission approval. The applicants are California Water Service Company (Cal Water or CWS), San Jose Water Company (San Jose or SJW), California-American Water Company (California-American Water or CAW) and Golden State Water Company (Golden State or GSW) (collectively, the Applicants). Table I sets out the main financial terms of the Agreement.

**Table I**  
**Financial Terms of Proposed Settlement Agreement**

<b>Company</b>	<b>Cost of Equity</b>	<b>Cost of Debt</b>	<b>Capital Structure</b>	<b>Rate of Return</b>
CWS	9.99%	6.24%	46.6% debt, 53.4% equity	8.24%
CAW	9.99%	6.63%	47.0% debt, 53.0% equity	8.41%
GSW	9.99%	6.99%	45.0% debt, 55.0% equity	8.64%
SJW	9.99%	6.68%	48.65% debt, 51.35% equity	8.38%

For reasons discussed in detail below in order to fully consider if the proposed settlement is in the public interest, I seek additional record development. I determine the best way to achieve this is to proceed to evidentiary hearings regarding costs of capital for the Applicants.

### **Background**

Decisions (D.) 07-05-062 and D.10-10-035 directed Cal Water, San Jose, California-American Water, and Golden State to submit by May 1, 2011, applications for authorized costs of capital for their water utility operations for the period from January 1, 2012, to December 31, 2014. Cal Water, San Jose, California-American Water, and Golden State each submitted a separate application (collectively, Applications), supported by direct testimony. Golden State amended its application on July 27, 2011. The Applications were consolidated by ruling of Chief Administrative Law Judge (ALJ) Karen V. Clopton on May 20, 2011. On August 31, 2011, DRA served testimony in response to the Applications. DRA's testimony contested many of the positions taken by each Applicant. Cal Water, San Jose, California-American Water, and Golden State each served rebuttal testimony on September 21, 2011.

The Parties began settlement discussions in October 2011. At the opening of evidentiary hearings on October 17, 2011, the Parties informed the presiding ALJ that they had reached an agreement in principle concerning all issues related to the Applications. The ALJ suspended the evidentiary hearings to give the parties time to complete the settlement. Pursuant to Rule 12.1(b) of the Commission's Rules of Practice and Procedure, the Parties held a noticed settlement conference on October 26, 2011. Having conducted discovery, negotiated in person, and analyzed their respective interests, the Parties entered into the Agreement. In view of these developments, the ALJ cancelled the evidentiary hearings.

### **Discussion**

The Agreement assigns the same cost of equity (9.99%) to all four water companies. This uniform cost of equity is a compromise between the Applicants' proposed costs of equity which range from 11.25% to 11.50%, and DRA's proposed costs of equity which range from 8.75% to 9.00%. All parties submitted pre-filed testimony supporting their individual proposed costs of equity.

Although a cost of equity of approximately 10% might have been appropriate a few years ago, it is unclear given the combination of Commission policies with current economic conditions if that return is too high today. First, the Commission has, by the adoption of the Water Cost of Capital Mechanism (WCCM), effectively insulated these companies against loss of income resulting from water conservation practices adopted by consumers. Second, the Commission has mitigated other financial risks by adopting the Water Rate Adjustment Mechanism (WRAM) and other policies that allow the companies to capture and recover in future rates differences between estimated and actual costs of service.

At the same time, the interest rate on long-term U.S. Treasury obligations has fallen to its lowest level in generations. This represents the “risk free” rate of return. As the parties’ experts indicate, standard rate-making practice calculates the “equity premium” as the difference between the “risk-free” rate of return and the rate of return necessary to attract investor capital in sufficient amounts to meet the companies’ needs. A cost of equity of approximately 10% when the “risk-free” rate of return is less than 3%, implies an equity premium in excess of 7%. This equity premium level is historically unprecedented and the Commission does not have enough record before it to determine if it is reasonable and in the public interest, especially when considering the extremely low levels of risk that result from the Commission’s adoption of the WCCM, the WRAM and other policies.

For the foregoing reasons, it is reasonable to hold evidentiary hearings in order to develop a record to more fully consider the proposed settlement. This ruling directs the applicants to present their evidence at hearings and to supplement their previously filed testimony with additional testimony that directly addresses the questions raised in this ruling regarding the return on equity as well as the other components of the overall rate of return. Accordingly,

**IT IS RULED** that:

1. Before considering the proposed settlement among California Water Service Company, California-American Water Company, Golden State Water Company, San Jose Water Company and the Commission’s Division of Ratepayer Advocates, additional record development is needed.
2. Evidentiary hearings on the consolidated applications of the water companies will be held January 23-25, 2012.

3. Each of the applicants shall supplement its previously filed testimony with additional testimony regarding a just and reasonable return on equity in light of (a) the current risk-free rate of return, (b) the Water Cost of Capital Mechanism, (c) the Water Rate Adjustment Mechanism, and (d) other applicable Commission policies that insulate the applicant from financial risk.

4. Such supplemental testimony shall address changes, if any, in the applicant's previously filed testimony regarding its capital structure, cost of debt and overall rate of return.

5. Applicants' supplemental testimony shall be served on the service list no later than January 3, 2012, with copies to the assigned Commissioner and the assigned Administrative Law Judge.

6. Responsive testimony of the Division of Ratepayer Advocates to the supplemental testimony shall be served on the service list no later than January 13, 2012, with copies to the assigned Commissioner and the assigned Administrative Law Judge.

7. Rebuttal testimony from the Applicants shall be served on the service list no later than January 18, 2012 with copies to the assigned Commissioner and the assigned Administrative Law Judge

Dated November 28, 2011, at San Francisco, California.

/s/ KARL J. BEMESDERFER  
Karl J. Bemesderfer  
Administrative Law Judge