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

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|---|---|
| Application of California Water Service Company (U60W) for Authority to Establish its authorized Cost of Capital for the period from January 1, 2009 through December 31, 2011. | Application 08-05-002 (Filed May 1, 2008) |
| Application of California-American Water Company (U-210-W) For an Authorized Cost of Capital for Utility Operations for 2009. | Application 08-05-003 (Filed May 1, 2008) |
| Application of Golden State Water Company for Authority to Establish Its Authorized Cost of Capital and Rate of Return for Utility Operations for 2009 – 2011. | Application 08-05-004 (Filed May 1, 2008) |

## SETTLEMENT AGREEMENT

THIS SETTLEMENT AGREEMENT, made this 20th day of February, 2009, is by and between California Water Service Company ("CWS"), California American Water Company ("California American Water"), Golden State Water Company ("Golden State"), California Water Association ("CWA"), and the California Public Utilities Commission's Division of Ratepayer Advocates ("DRA"), who are individually referred to herein as a "Party" and collectively referred to herein as the "Parties."

WHEREAS, the Parties are also parties to the three above-captioned applications before the California Public Utilities Commission ("CPUC" or "Commission"), which three applications have been consolidated into a single proceeding referred to herein as the "Water Cost of Capital Proceeding;" and

WHEREAS, the Water Cost of Capital Proceeding has been bifurcated into two separate phases, Phase 1 of which will adopt for years 2009, 2010, and 2011 separate capital structures for CWS, California American Water, and Golden State, and also adopt separate cost of capital amounts, including return on equity ("ROE") components, applicable to CWS, California American Water, and Golden State, respectively, and Phase 2 of which will consider the adoption of an adjustment mechanism that may, upon the occurrence of certain specified "triggering" events, result in changes to the adopted cost of capital for the two years between the 2009 base year and the next cost of capital proceeding for base year 2012; and

WHEREAS, in lieu of litigating the issue of an appropriate adjustment mechanism that may result in changes to the adopted cost of capital for the two years between the 2009 base year and the next cost of capital proceeding for base year 2012, the Parties desire to settle the issue of determining an appropriate adjustment mechanism;

NOW THEREFORE, in consideration of the mutual covenants and agreements hereinafter described, the Parties agree as follows:

1. Adoption of a Cost of Capital Adjustment Mechanism.

The Parties agree that the adjustment mechanism governing possible changes in the adopted cost of capital for CWS, California American Water, and Golden State for the two years between the 2009 base year and the next cost of capital proceeding for these three companies for base year 2012, should be similar to the Cost of Capital Mechanism ("CCM") adopted by the Commission in Decision No. 08-05-035 and applicable to Southern California Edison Company, San Diego Gas & Electric Company, and Pacific Gas and Electric Company, as further described and revised in Paragraph 2, below.

2. Revisions to the Cost of Capital Mechanism.

The adjustment mechanism ("Water Cost of Capital Mechanism") agreed upon by the Parties and adopted by CWS, California American Water, and Golden State is similar in design and concept to the CCM as described in Ordering Paragraphs 1 and 2 of Decision 08-05-035, except for the following revisions:

(a) Ordering Paragraph 1e. of Decision 08-05-035 shall, for purposes of the Water Cost of Capital Mechanism, be revised to read as follows:

> "1e. Index is Moody's Aa utility bonds for AA or A credit-rated utilities or higher and Moody's Baa utility bonds for BBB+ credit-rated utilities or lower."

(b) Ordering Paragraph 2a. of Decision 08-05-035 shall, for purposes of the Water Cost of Capital Mechanism, be revised to read as follows:

> "2a. ROE is adjusted by one-half of the difference between the benchmark and the Aa utility bond average for AA or A credit-rated utilities or higher and by one-half of the difference between the benchmark and the Baa utility bond average for BBB+ credit-rated utilities or lower."

A complete description of the Water Cost of Capital Mechanism is set forth in Appendix A, attached hereto and made a part hereof.

3. Application of the Water Cost of Capital Mechanism.

The Water Cost of Capital Mechanism described herein shall, upon the occurrence of certain "triggering" events specified in that Mechanism, be used to adjust the base year 2009 cost of capital adopted for CWS, California American Water, and Golden State for 2010 and 2011. Adjustments in the cost of capital would be triggered by the occurrence of certain events specified in that Mechanism. Provided the triggering events occur, adjustments in the cost of capital for each utility would be made in 2010 and 2011. While this settlement does not bind the Commission in future proceedings, the Parties agree that a similar adjustment to the cost of capital should be made following adoption of a base year cost of capital in subsequent cost of capital proceedings for CWS, California American, and Golden State. In those future cases, the Parties envision the Commission setting a base year cost of capital and adopting a similar adjustment mechanism that would be recalibrated to reflect the new cost of capital.

4. Adoption of Settlement By Commission.

The Parties shall use their best efforts to obtain the approval of this Settlement by the Commission and shall seek such approval in accordance with the rules governing settlements contained in Rule 12, *et seq.*, of the Commission's Rules of Practice and Procedure. Each Party shall bear its own costs and expenses in connection with seeking Commission approval of this Settlement. Should the Commission reject this Settlement, nothing contained or agreed to herein shall bind any Party with respect to any issue in any subsequent proceeding before the Commission, or any court or regulatory or legislative body of competent jurisdiction. Should the Commission reject only a part of this Settlement or impose additional requirements or conditions not set forth herein, each Party shall be free to agree to such Commission revisions or to withdraw from this Settlement.

5. Precedent for Future Cost of Capital Proceedings.

The Parties agree that this Settlement shall be applicable to the above-captioned, consolidated Cost of Capital Proceeding for CWS, California American Water and Golden State. However, because CWA is representing, in this phase of the proceeding, the interests of four other Class A water utilities who are members of CWA – San Gabriel Valley Water Company, San Jose Water Company, Suburban Water Systems, and Valencia Water Company – it is the intent of the Parties that the concept of the Water Cost of Capital Mechanism, as presented in Appendix A to this Settlement Agreement, shall be available to these other Commission-regulated water utilities for use in their cost-of-capital proceedings commencing on May 1, 2009. Such use can be as an element of direct testimony or as an element of a separate settlement in that proceeding.

6. Entire Agreement.

This Agreement constitutes the entire agreement between the Parties and supersedes all prior agreements and understanding, whether written or oral, with respect to the subject matter hereof.

7. Amendment.

This Agreement shall not be amended or revised in any way or manner unless any such amendment or revision is documented by a written document signed by duly authorized representatives of each Party.

8. Governing Law.

This Agreement is subject to and shall be construed by the laws of the State of California and the rules and regulations of the Commission.

IN CONSIDERATION OF THE FOREGOING, each Party, through its duly authorized representative, hereby executes this Settlement Agreement as of the date first written above.

CALIFORNIA WATER SERVICE COMPANY

By: Thomas Smegal

Name: THOMAS F. SMEGAL

CALIFORNIA WATER ASSOCIATION

By: John K. Hawks

Name: John K. Hawks

CALIFORNIA AMERICAN WATER COMPANY

By: D. Stephenson

Name: David P Stephenson

GOLDEN STATE WATER COMPANY

By: Keith Switzer

Name: Keith Switzer

DIVISION OF RATEPAYER ADVOCATES,
CALIFORNIA PUBLIC UTILITIES COMMISSION

By: Joseph Como

Name: JOSEPH P. COMO

Appendix A
To Settlement Agreement

## WATER COST OF CAPITAL MECHANISM

The Water Cost of Capital Mechanism governing possible changes in the adopted cost of capital for California Water Service Company (in A.08-05-002), California American Water Company (in A.08-05-003), and Golden State Water Company (in A.08-05-004)[1] for the two years between the 2009 base year and the next cost of capital applications for these three companies for base year 2012, shall operate as follows:

1. The basis for the Water Cost of Capital Mechanism shall be:

   a. The cost of capital applications for each company referenced above.

   b. The capital structure for each company shall be the one most recently authorized by the Commission for that company.

   c. The long-term debt and preferred stock cost shall be the one most recently authorized by the Commission for that company.

   d. A deadband (a range of change in interest rates that may occur without automatically triggering a change in embedded long-term debt and preferred stock costs and ROEs) is equal to plus or minus 100- basis points.

   e. Index is Moody's Aa utility bonds for AA or A credit-rated utilities or higher and Moody's Baa utility bonds for BBB+ credit-rated utilities or lower.

   f. Data source is Moody's or Mergent Bond Record.

   g. Measurement period is the average 12-month October through September period.

   h. An adjustment ratio of 50% is applied to the index as explained in Section 2, below.

2. In any year where the positive or negative difference between the current 12-month October 1 through September 30 average Moody's utility bond rates and the benchmark exceeds a trigger of 100- basis points, an automatic adjustment to the utilities' ROE shall be made as follows:

[1] Application numbers for the three consolidated, pending applications before the California Public Utilities Commission.

a. ROE is adjusted by one-half of the difference between the benchmark and the Aa utility bond average for AA or A credit-rated utilities or higher and by one-half of the difference between the benchmark and the Baa utility bond average for BBB+ credit-rated utilities or lower.

b. Long-term debt and preferred stock costs are updated to reflect actual August month-end embedded costs in that year and forecasted interest rates for variable long-term debt and new long-term debt and preferred stock scheduled to be issued.

c. Authorized capital structure is not adjusted.

d. No later than on October 15 of such year, a Tier 2 advice letter is filed that updates the ROE and related rate adjustments to become effective on January 1 of the following year.

e. In any year where the 12-month October through September average Moody's utility bond rates trigger an automatic ROE adjustment, that average becomes the new benchmark.

f. Workpapers outlining the calculations required as set forth in sub-paragraphs a., b., and e. above, shall be submitted with the advice letter to the Division of Water and Audits and shall be made available to any interested party upon request.

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To illustrate how the Water Cost of Capital Mechanism operates, the following three scenarios are offered as examples.

**WATER COST OF CAPITAL MECHANISM**

**IMPACT BASED ON THREE SCENARIOS**

**BASE CAPITAL STRUCTURE OF AN A-Rated Utility**

| | **Ratio** | **Cost** | **Weighted Cost** |
|---|---|---|---|
| Long-Term Debt | 43.00% | 6.40% | 2.75% |
| Preferred Stock | 9.00% | 6.10% | 0.55% |
| Common Equity | 48.00% | 11.50% | 5.52% |
| **Return on Rate Base** | | | **8.82%** |

**BASIC ASSUMPTIONS**

1. A planned long term debt issuance at month-end August of the second year would not change the capital structure but would reduce the August 6.40% embedded rate to 6.30%.
2. No change in preferred stock ratio or cost.
3. No change in common equity ratio.
4. Initial benchmark interest rate of Moody's Aa utility bonds was 6.50%
5. Trigger is 100-basis points between the benchmark interest rate and twelve-month actual October through September Moody's Aa utility bond rate.

**SCENARIO #1**

**Assumption:** New actual October through September Moody's average Aa utility bonds was 6.80%.

**Result:**

1. Difference between the new benchmark (6.80%) and the initial benchmark (6.50%) is only 30-basis points. This is less than the trigger of 100-basis points.
2. Therefore, there is **no change.**
    a. Long-term debt remains 6.40% for purpose of calculating a return on rate base.
    b. No change in preferred stock rate of 6.10%.
    c. No change in common equity return of 11.50%.
    d. Authorized return on rate base remains 8.82%.

**SCENARIO #2**

**Assumption:** New actual October through September average Moody's Aa utility bonds was 5.00%.

**Results:**

1. Difference between the 6.50% initial benchmark and 5.00% average 12-month Moody's Aa utility bonds new benchmark was 150-basis points, or 50-basis points higher than the 100-basis point deadband, triggers an adjustment.
2. Long-term debt cost is adjusted to 6.30% from 6.40%.
3. No change to preferred stock ratio or cost.
4. A downward 75-basis point change (half of the 100-basis point deadband and half of the 50-basis points that exceeded the 100-basis point deadband) in the 11.50% cost of common equity.
5. New authorized return on common equity is 10.75%.
6. New authorized rate of return on rate base is 8.42%.
7. New Benchmark is 5.00%.

**Trigger Impact:** The overall authorized return on rate base would **decrease** 40-basis points to 8.42% from 8.82% as shown below.

| | **Ratio** | **Cost** | **Wtd.Cost** |
|---|---|---|---|
| Long-Term Debt | 43.00% | 6.30% | 2.71% |
| Preferred Stock | 9.00% | 6.10% | 0.55% |
| Common Equity | 48.00% | 10.75% | 5.16% |
| **Return on Rate Base** | | | **8.42%** |

**SCENARIO #3**

**Assumption** – New actual October through September average Moody's Aa utility bonds was 8.00%.

**Results** –

1. Difference between the 6.50% initial benchmark and 8.00% average twelve-month Moody's Aa utility bonds new benchmark was 150-basis points, or 50-basis points higher than the 100-basis point deadband, triggers an adjustment.
2. Long term debt cost is adjusted to 6.30% from 6.40%.
3. No change to preferred stock ratio or cost.
4. An upward 75-basis point change (half of the 100-basis point deadband and half of the 50-basis points that exceeded the 100-basis point deadband) in the 11.50% cost of common equity.
5. New authorized return on common equity is 12.25%.
6. New authorized rate of return on rate base is 9.14%.
7. New benchmark is 8.00%

**Trigger Impact:** The overall authorized return on rate base would **increase** 32-basis points to 9.14% from 8.82% as shown below.

**Ratio Cost**

| | | | |
|---|---|---|---|
| Long Term Debt | 43.00% | 6.30% | 2.71% |
| Preferred Stock | 9.00% | 6.10% | .55% |
| Common Equity | 48.00% | 12.25% | 5.88% |
| **Return on Rate Base** | | | **9.14%** |