Decision **PROPOSED DECISION OF ALJ LONG** (Mailed 10/21/2009)

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, 2009 through December 31, 2011.	Application 08-05-002 (Filed May 1, 2008)
And Related Matters.	Application 08-05-003 Application 08-05-004

DECISION MODIFYING DECISION 09-05-019 TO ALLOW CALIFORNIA AMERICAN WATER COMPANY TO INCLUDE A RECENT DEBT ISSUE IN THE TEMPORARY INTEREST RATE BALANCING ACCOUNT

1. Summary

California American Water Company (California American) is authorized to prospectively record in its temporary interest rate balancing account, on a monthly basis, the $88,958 difference between the forecast interest rate and the actual interest rate on $35,000,000 of debt issued on November 26, 2008. This authority begins on the effective date of this decision and terminates upon either the adoption of a new cost of capital for California American or other specific order of this Commission. This proceeding is closed.

2. Background

Decision (D.) 09-05-019 established the base year 2009 ratemaking return on common equity for California Water Service Company (California Water), California American and Golden State Water Company (Golden State). This was the first proceeding for these three companies where the sole subject was cost of capital, separated from a general rate case, pursuant to D.07-05-062, the most recent rate case plan for the class A water utilities. In response to the highly unusual problems in the 2008 financial markets, we adopted on our own motion a temporary interest rate balancing account for each company. The temporary interest rate balancing account was authorized to record any difference between the forecast incremental cost of debt included in the adopted cost of capital and the actual cost of new long term debt.

The forecast cost of debt for base year 2009 included estimated costs of debt for any debt the companies expected to issue between the time the applications were filed in May 2008 and the anticipated start of the 2009 base year. The purpose of the balancing account is to reduce the interest rate risk to both the applicants and ratepayers during the life of the adopted cost of capital.

> The temporary interest rate balancing account shall record the difference in interest expense between the actual interest cost for long-term debt for debt issued after January 1, 2009, and the interest cost included in the adopted cost of capital for debt issues in 2009 or later. This account shall include interest costs from the effective date of this decision forward and remain in effect until the next cost of capital proceeding for each company, in an appropriate venue, to end the balancing account. Any recovery shall be subject to a standard reasonableness review of the interest costs actually incurred. (D.09-05-019 at 42.)

The decision included the following findings of fact:

9. The Commission should create the temporary interest rate balancing account to record the difference in interest expense between the actual interest cost for long-term debt for debt issued after January 1, 2009, and the interest cost included in the adopted cost of capital for debt issues in 2009 or later subject to a standard reasonableness review.

10. The temporary interest rate balancing account should be effective from the date of this decision and include interest costs from the effective date forward.

California American made no comment addressing the temporary interest rate balancing account in the body of its filed opening or reply comments on the proposed decision; nor did California Water or Golden State. The California Water Association described the temporary interest rate balancing account as "acceptable," but that it should not be "institutionalized." (California Water Association Opening Comments at 9.)

3. Petition to Modify

California American's petition to modify D.09-05-019 requests that the temporary interest rate balancing account recognize the high cost of debt issued late in 2008 before the adopted base year of 2009.[1] In its May 1, 2008 application, California American estimated what it then believed was a reasonable estimate of 6.95% for its debt interest rate. (Petition at 2.) In fact, on November 26, 2008, the financing affiliate of California American issued $75 million in senior, unsecured thirty-year bonds, with an option to call in the fifth year. The interest rate was 10%. Authority to issue the debt was granted in D.08-11-025 in California American's financing application, Application 08-08-025, which did

---

[1] The petition was filed on August 3, 2009 and appeared on the Commission's Daily Calendar on August 6, 2009.

not cite a forecast interest rate. As a result of the upheaval of the financial markets, the interest rate for this financing at 10% was substantially higher than the 6.95% forecast interest rate that California American had included in its cost of capital application.

4. Response by the Division of Ratepayer Advocates

The Division of Ratepayer Advocates (DRA) filed a timely response to the petition as allowed by Rule 16.4(f). DRA objects to the petition and notes that California American did not either request to set aside submission and reopen the record for later information, or file a timely application for rehearing. DRA also points out that California American had timely knowledge in September or October of 2009, before it issued the new debt in November 2009, that its May 2009 forecast was out-of-date. Thus, DRA argues, the petition should be denied because California American failed to either timely petition to reopen the record or timely file an application for rehearing and this petition is procedurally inappropriate. (DRA Response at 6.)

A reply was filed on September 11, 2009. (Rule 16.4(g).)

5. Discussion

We will address the petition's request to recover the significant difference in interest cost for earlier debt issued in 2008 as a matter of fairness and do not need to address whether there are material impacts on earnings or rates.[2] We

[2] We use "significant" in this section to mean "important enough to merit attention" (Oxford English Dictionary http://www.askoxford.com/concise_oed/significant?view=uk) and not to necessarily mean "material" in the technical language of financial reporting and disclosure. "Materiality is not a simple calculation. Rather it is a determination of what will vs. what will not affect the decision of a knowledgeable investor given a specific set of circumstances related to the fair presentation of a company's financial statements and

Footnote continued on next page

take note of DRA's procedural objections, but do not believe they limit our discretion to consider a petition to modify, even if it may be an untimely one.

The temporary interest rate balancing account adopted in D.09-05-019 allows the companies to record the difference in interest expense between the actual interest cost for long-term debt for debt issued after January 1, 2009, and the interest cost included in the adopted cost of capital for debt issues in 2009 (or later, if there is no adjustment pursuant to the Water Cost of Capital Adjustment Mechanism discussed below). The account included interest costs for debt issued from the effective date of the decision forward and was to remain in effect until the next cost of capital proceeding for each company, which would end the balancing account and address its balance. (D.09-05-019 at 42.) For California American, the account did not include the debt issued late in 2008 at the unexpectedly high rate of 10%. That debt was, however, included in the 2009 embedded cost of debt based on the information and 6.95% forecast available when the filing was made in May of 2008. No party asked for, and no party was allowed, to update the forecast cost of debt or capital structure after the May 1, 2008 filing.

California American did not know that the base year 2009 cost of capital proposed decision would include a new temporary interest rate balancing account before it was mailed for public review and comment, on December 19, 2008. California American asserts now that such knowledge may have affected

---

disclosures concerning existing or future debt and equity instruments." (Journal of Accountancy May 2005. http://www.journalofaccountancy.com/Issues/2005/May/TheNewImportanceOfMateriality.htm.)

the management decision to issue debt before the cost of capital decision was adopted. (Petition at 4.) California American did refer to this debt issue in its opening comments on the proposed decision:

> "Indeed, based upon its most recent financing, California American Water had to borrow long-term debt at a 10% coupon rate. In light of this and other factors, the Commission should revisit the 10.2% return on equity in Phase 2 of this proceeding." (Opening Comments at 13.)

Thus, at the time, California American cited its most recent high cost debt, not to change the weighted cost of debt included in base year 2009, but only as an argument to "revisit" the authorized return on equity in phase 2.

There is a significant cost difference, $1,067,500 per year, for California American when the actual cost at 10% is compared to the 2008 forecast cost of 6.95%, which is embedded in the adopted 2009 base year cost of capital.

Difference Between Forecast and Actual Interest Expense		
Principal	$35,000,000	$35,000,000
Annual Interest Rate	6.95%	10%
Annual Interest Expense	$2,432,500	$3,500,000
Annual Difference		$1,067,500
Monthly Difference (Divide by 12)		$88,958

The authorized return on equity was the primary focal point for all parties in the proceeding, although there were also issues surrounding capital structure and cost of debt. Thus, the proposed decision's discussion and the parties' comments were mainly directed at the most appropriate return on equity.

The final decision, besides adopting a return on equity of 10.2% for all three applicants, made a significant ratemaking adjustment when it adopted equity ratios lower than those proposed for two companies, California Water and

Golden State. The final decision imputed a forecast of 8.5% cost for the debt to replace a portion of the equity proposed by applicants. This adjustment was made to address the relatively high equity ratios requested by those companies. (D.09-05-019 at 8 – 13.)

The temporary interest rate balancing account was a ratemaking adjustment adopted in the final decision to further protect ratepayers as well as shareholders from the impacts of potentially large changes in debt costs (up or down). The question now is whether, as a matter of fairness, we should recognize for California American the unexpected increase in new debt costs first incurred in the window of time between filing the application and the adoption of D.09-05-019.

The overarching purpose of D.09-05-019 was to adopt a reasonable cost of capital which would allow the utilities an opportunity to earn a fair return. The decision recognized, and addressed, the financial market's dislocation in late 2008 and early 2009.[3] Therefore, we find that it is reasonable to adjust for the significant market impacts suffered by California American in late 2008 and allow the company to include the difference between the forecast 6.95% and 10% in the temporary interest rate balancing account. This provision will allow California American to prospectively recover the shortfall between the forecast interest rate and the actual interest rate. No further correction to the 2009 cost of capital is necessary.

---

[3] "We take note of the financial markets' dislocation and therefore consider whether there are any extenuating circumstances of sufficient importance to warrant a departure form our normal procedures." (D.09-05-019 at 2.)

5.1. Prospective Ratemaking

The Commission cannot authorize the recovery of costs already incurred by the applicants:

> It is a well established tenet of the Commission that ratemaking is done on a prospective basis. The Commission's practice is not to authorize increased utility rates to account for previously incurred expenses, unless, before the utility incurs those expenses, the Commission has authorized the utility to book those expenses into a memorandum or balancing account for possible future recovery in rates. This practice is consistent with the rule against retroactive ratemaking. This impacts not only rate recovery for operational expenses, but also rate recovery for ownership costs, such as depreciation expense and return on investment. (43 CPUC 2d 596 (1992) at 600.)

Therefore, we will only authorize the recovery of incremental interest costs incurred after the effective date of this decision for the $35,000,000 in long term debt issued in November, 2008. This will still allow California American to record in its temporary interest rate balancing account the $88,958 monthly difference until the Commission adopts a new cost of capital or the Water Cost of Capital Adjustment Mechanism is triggered so that the actual costs for the November 26, 2008 debt issue are included in the embedded cost of debt.

5.2. Water Cost of Capital Adjustment Mechanism

In D.09-07-051 the Commission adopted a Water Cost of Capital Adjustment Mechanism. In Section 2(b) of the settlement the parties agreed that, if the trigger mechanism is met, then the long-term debt costs are adjusted to actual as of August of the current year.[4] Thus, if triggered, the 2010 cost of capital would be updated using recorded data as of August 2009. The mechanism is also applied for 2011. Any adjustment to the cost of capital for 2010 or 2011 would terminate any further recording of an under-or over-collection of interest costs in the temporary interest rate balancing account pursuant to this decision.

6. Assignment of Proceeding

John A. Bohn is the assigned Commissioner and Douglas M. Long is the assigned Administrative Law Judge (ALJ) in this proceeding.

7. Comments on Proposed Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. No comments were filed.

Findings of Fact

1. California American issued debt in November 2008 at a cost substantially higher than was forecast in its May 1, 2008 cost of capital application.

2. The Commission first considered a temporary interest rate balancing account in a proposed decision mailed for comment on December 18, 2008. Parties had no prior knowledge of the Commission's proposal prior to the public comment period for the proposed decision.

---

[4] Long-term debt and preferred stock costs are updated to reflect actual August month-end embedded costs in that year …" http://docs.cpuc.ca.gov/published/Graphics/105148.PDF (D.09-07-051, Attachment A, Appendix A at 2.)

3. The purpose of the temporary interest rate balancing account adopted in D.09-05-019 was to offset forecast error risks to stockholders and ratepayers caused by the late 2008 and early 2009 financial markets' dislocation.

4. Recording the $88,958 on a monthly basis in the temporary interest rate balancing account will compensate California American for the difference between its forecast of 6.95% and the actual 10% cost for $35,000,000 in long term debt issued on November 26, 2008.

5. The accrual of any difference will stop whenever there is an adjustment triggered by the Water Cost of Capital Adjustment Mechanism adopted in D.09-07-051 for either 2010 or 2011, or when a new cost of capital is adopted by the Commission.

Conclusions of Law

1. The Commission had the authority to adopt the temporary interest rate balancing account in D.09-05-019 to protect ratepayers and shareholders from unpredictable swings in interest rate costs following the late 2008 and early 2009 financial markets' upheaval.

2. The Commission has the authority to consider an untimely filing that addresses fairness issues.

3. The Commission has the authority to authorize California American to prospectively record the $88,958 monthly difference between the forecast interest costs and the actual interest costs for the November 26, 2008 issuance of $35,000,000 in debt in the temporary interest rate balancing account only after the effective of this decision and continuing until the cost of capital is changed in a subsequent proceeding or by the Water Cost of Capital Adjustment Mechanism adopted in D.09-07-051.

4. This order should be effective immediately.

5. This proceeding should be closed.

O R D E R

IT IS ORDERED that:

1. California American Water Company is authorized to prospectively record in its temporary interest rate balancing account, on a monthly basis, the $88,958 difference between the forecast interest rate and the actual interest rate on $35,000,000 of debt issued on November 26, 2008. This authority begins on the effective date of this decision and terminates upon either the adoption of a new cost of capital for California American Water Company or any adjustment to cost of capital pursuant to the Water Cost of Capital Adjustment Mechanism adopted in Decision 09-07-051. California American Water Company must file a Tier 1 advice letter to modify the description of the temporary interest rate balancing account in its preliminary statement, consistent with this order.

2. Application (A.) 08-05-002, A.08-05-003, and A.08-05-004 are closed.

This order is effective today.

Dated ______________________________, at San Francisco, California.