Decision **ALTERNATE PROPOSED DECISION OF COMMISSIONER SANDOVAL (Mailed 8/23/2011)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of California-American Water Company (U210W) for a Certificate of Public Convenience and Necessity to Construct and Operate its Coastal Water Project to Resolve the Long-Term Water Supply Deficit in its Monterey District and to Recover All Present and Future Costs in Connection Therewith in Rates.	Application 04-09-019 (Filed September 20, 2004; Amended July 14, 2005)

DECISION REGARDING CALIFORNIA-AMERICAN WATER COMPANY'S PETITION TO MODIFY DECISION 06-12-040

1. Summary

The Commission partially grants California-American Water Company's (Cal-Am) petition to modify Decision (D.) 06-12-040 and increases the Special Request 1 Surcharge to 15% as of the date of this decision in order to allow recovery of already incurred pre-construction costs related to Cal-Am's Coastal Water Project. The Commission denies Cal-Am's request to apply its weighted cost of capital as the interest rate earned on the Coastal Water Project Memorandum Account, in which pre-construction costs are recorded. In D.10-12-016, the Commission determined that Cal-Am should earn 4.00% as the initial rate to be applied to its Allowance for Funds Used During Construction for the Cal-Am facilities portion of the Coastal Water Project, until those facilities

are moved into rate base. Given the extraordinary size of this memorandum account relative to the size of the company, given the expected long duration of the time over which the memo account balance will be financed, and given that the pre-construction costs are related to this project, it is reasonable to apply 4.00% as the interest rate to be applied to the pre-construction costs recorded in the Coastal Water Project Memorandum Account.

2. Background

California-American Water Company (Cal-Am) applied for a Certificate of Public Convenience and Necessity (CPCN) in order to provide a solution to the long-standing constraints on water supply on the Monterey Peninsula. This effort is known as the Coastal Water Project. Cal-Am is under order from the State Water Resources Control Board to cease diverting water to which it has no legal rights, determined in 1995 to be 10,730 acre feet of water per year from the Carmel River. The utility must also replace 2,975 acre feet of water per year in allocations from the Seaside Basin.[1]

The Commission certified the Final Environmental Impact Report for the Coastal Water Project and various alternative projects in Decision (D.) 09-12-017. The Commission considered Cal-Am's request for a CPCN and a proposed Settlement Agreement regarding a joint proposal by Cal-Am, the Marina Coast

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[1] The State Water Resources Control Board issued Order WR 95-10 in 1995 and Order 2009-0060 in 2009. The latter order requires Cal-Am to undertake additional measures to reduce its diversions from the Carmel River and to terminate all such diversions no later than December 31, 2016. In 2006, the Monterey County Superior Court issued a final decision regarding adjudication of water rights of various parties who use

Footnote continued on next page

Water District, the Monterey County Water Resources Agency, the Monterey Regional Water Pollution Control Agency, Surfrider Foundation, the Public Trust Alliance, and Citizens for Public Water to construct, operate, and maintain a regional desalination plant, source wells, and distribution facilities. The Commission approved the Settlement Agreement and issued a CPCN for Cal-Am in Decision (D.) 10-12-016.

On April 22, 2010, Cal-Am filed a petition to modify D.06-12-040, requesting that the Commission allow Cal-Am to recover its full, weighted average cost of capital as the interest rate applied to the Coastal Water Project Memorandum Account, rather than the 90-day commercial paper rate authorized in D.06-12-040. Cal-Am also requests that the Commission authorize an increase to the Special Request 1 Surcharge from 10% to 15%, stating that this increase will ensure all authorized pre-construction costs have been collected by the time customer bills are impacted by the costs of the Regional Project.

The Division of Ratepayer Advocates (DRA) responded on May 24, 2010, and Cal-Am replied, with the permission of the assigned Administrative Law Judge (ALJ) on June 3, 2010. DRA supports Cal-Am's request to increase its Special Request 1 Surcharge to 15%, but opposes its request to increase the interest rate applied to the memorandum account.

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groundwater from the Seaside Basin (*California American Water v. City of Seaside et al.* Case No. 66343).

D.06-12-040 addressed interim rate relief for the Coastal Water Project by adopting certain surcharges. Special Request 1 surcharge was specially designed to recover pre-construction costs and to avoid rate shock.

As noted above, on December 2, 2010, the Commission issued D.10-12-016, which approved the Settlement Agreement and Implementing Agreements for the Regional Project and issued a CPCN for the Cal-Am facilities. As part of that decision, the Commission adopted an initial rate of 4.00% as the Allowance for Funds Used During Construction (AFUDC) to be applied to the Cal-Am facilities and allowed this rate to be trued up to reflect actual carrying costs.[2] Following the Commission's adoption of D.10-12-016, the assigned ALJ issued a ruling providing an opportunity for parties to file and serve comments on the impact of this aspect of D.10-12-016 on Cal-Am's petition for modification. Opening comments were filed and served on January 7, 2011. Reply comments were filed and served on January 14, 2011.

3. Special Request 1 Surcharge: Recovery of Preconstruction Costs

As explained in D.06-12-040, the purpose of the Special Request 1 Surcharge is to recover the Coastal Water Project preconstruction costs that Cal-Am is tracking in the memorandum accounts approved in D.03-09-022:

> Cal-Am proposes that the Commission allow it to recover these costs (plus interest at Cal-Am's authorized rate of return) through a three-phase surcharge. Cal-Am proposes that the surcharge begin on January 1, 2007, with a 4% surcharge on customer water bills. Then, beginning

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[2] D.10-12-016 at 145.

> July 1, 2007, Cal-Am would increase the surcharge to 7%. Starting January 1, 2008, Cal-Am would increase the surcharge to 10%, which is expected to remain in place through 2014, unless the full amount is recovered sooner. At that point, Cal-Am would add any remaining uncollected preconstruction costs to the overall Coastal Water Project or alternative long-term supply solution costs.[3]

The Commission approved the Special Request 1 Surcharge in order to avoid rate shock that would accompany a very costly long-term water supply solution if the infrastructure project were included in rates at one time, but the Commission also expressed concerns about burdening the Monterey District ratepayers.[4] These ratepayers are currently responsible for the Special Request 1 Surcharge, which has been fixed at 10% since January 2008. The amortization schedule included with Cal-Am's petition demonstrates that the approximately $30 million in pre-construction costs booked to the Coastal Water Account through April of 2010 will be amortized by the end of 2014, assuming the surcharge amount is increased to 15%.[5] The proposed modification to the surcharge will allow Cal-Am to gradually increase rates to recover these costs and will avoid an additional burden when the rate increases from the Regional

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[3] D.06-12-040 at 6.

[4] The Commission also authorized the Special Request 2 Surcharge, to be implemented upon issuance of a CPCN for the Coastal Water Project. The proponents of the Settlement Agreement addressed in the CPCN decision state that the Special Request 2 Surcharge is no longer needed, because of the proposed ratemaking approach included in the Settlement Agreement. No party disputes the elimination of this particular surcharge.

[5] The illustrative amortization schedule also assumes that the AFUDC rate requested in the instant petition is granted.

Project are implemented, assuming the Commission approved that project and issued the requested CPCN.

DRA agrees with this proposed change to the surcharge amount, stating that it "acknowledges the unique nature of the water supply situation in Monterey and the fact that the Commission has previously determined Surcharge 1 to be beneficial in mitigating the potential effects of a much larger increase associated with a completed project."[6]

We concur that increasing the Special Request 1 Surcharge to 15% for the Coastal Water Project is appropriate and will ameliorate the long-term rate impacts on Monterey District ratepayers. We grant Cal-Am's request and order that, as of the effective date of this decision, the surcharge will increase to 15% and will remain at the 15% level until the full amount authorized for preconstruction costs is collected. The purpose of the increase is to ensure that all authorized preconstruction costs have been collected by the time customer bills are impacted by the costs of the long-term water supply project. We modify Ordering Paragraph 1 of D.06-12-040 accordingly.

4. Interest on Memorandum Account

Cal-Am previously requested that the Commission allow it to earn its authorized rate of return on preconstruction costs rather than interest at the 90-day commercial paper rate, as ordered by the Commission in D.03-09-022. At that time, Cal-Am stated that the 90-day commercial paper rate represents only a fraction of its actual carrying costs, that its cash flow was impaired, and that

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[6] DRA's Response at 2.

there is additional perceived risk on the part of investors, because Cal-Am is currently borrowing funds to pay for the interest on the project. DRA opposed Cal-Am's request at that time, stating that the Commission had previously determined this approach was not appropriate. DRA cited D.03-09-022:

> Because the Coastal Water Project will clearly require a significant period of time for construction, distinguishing it from typical water utility construction projects, we conclude that it is not entitled to specialized CWIP ratemaking treatment offered to short duration water projects. In addition, the costs at issue here are predecessor cost to construction costs, in other words, construction work is not underway on the project and thus they are not funds used during construction. It remains unclear at this time when (or whether) any plant construction will commence. Therefore, allowing these preliminary costs to earn the utility's authorized rate of return now carries with it significant risk that the ratepayers may never receive the benefits of these expenditures. (D.03-09-022 at 21-22.)

In D.06-12-040, the Commission concluded that Cal-Am should continue to book preconstruction costs in an interest-bearing memorandum account, which would accrue interest at the 90-day short-term commercial paper rate. The Commission also determined that: "As the status of the proposed project becomes more certain (for example, if a CPCN is granted or construction is underway), we will consider modifying this ratemaking treatment upon request by Cal-Am."[7]

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[7] *Id*. at 25.

In its April 22, 2010 petition, Cal-Am argues that now is the time to adjust the AFUDC rate applied to the Coastal Water Project Memorandum Account. Among other things, the Final Environmental Impact Report is certified, several active parties in the proceeding reached a settlement agreement that provides for the financing, construction, and operation of the Regional Project, and, in Cal-Am's view, it is much more certain that the Regional Project will be approved and built. Also, Cal-Am asserts it may need to obtain a stand-alone credit rating to obtain the financing required for the Regional Project. Moreover, Cal-Am says it is funding the pre-construction costs with long-term debt and equity, so the application of the 90-day commercial paper rate deprives Cal-Am of the opportunity to recover its costs in rates.

Cal-Am states that the interest rate it requests is consistent with the methodology adopted in D.08-05-036 and affirmed in D.08-10-019, in which the Commission approved Cal-Am's authorized rate of return for AFUDC on the San Clemente Dam Memorandum Account. The Commission specifically recognized that the San Clemente Dam project was required to go forward in some form and that whatever project was eventually approved, both equity and debt investments would be required. Cal-Am also cites D.00-06-074 and D.04-03-039, in which the authorized rate of return was approved for the AFUDC on the Calipatria treatment plant project for Golden State Water Company. Cal-Am also argues that the requested modification is consistent with D.84-08-125, where the Commission authorized San Diego Gas & Electric Company to apply AFUDC on major long-term capital projects using a return on

investment based on the utility's capital structure.[8] In its January 7, 2011 comments, Cal-Am provides updated financing information and discusses the increased certainty of project construction. With respect to D.10-12-016, Cal-Am notes that the Commission's commitment to afford Cal-Am the opportunity to recover its actual carrying costs of the pipeline facilities for the Regional Project reinforces the notion that the Commission should set the AFUDC for the pre-construction costs at Cal-Am's authorized rate of return.

While DRA recognizes the AFUDC rate applied to the San Clemente Dam and the Calipatria treatment plant, DRA's May 2010 comments distinguish the methodology applied to these infrastructure projects from the appropriate treatment for Cal-Am's pre-construction costs, because the Coastal Water Project had not yet received final approval. DRA also notes that the Calipatria decision came out of a settlement agreement and had no precedential value here. In its January 7, 2011 comments, DRA states that while D.10-12-016 approves a CPCN for the proposed Regional Project, the project still must overcome several other significant regulatory/legal hurdles to begin construction. According to DRA, these hurdles are largely outside of the control of Cal-Am since it will not construct the facility other than the pipeline that will bring the product water to its service territory. Thus, DRA continues to oppose any change to the return Cal-Am will earn on its pre-construction expenses. DRA also explains that the pre-construction costs recorded in the Coastal Water Project Memorandum Account are not capital items that will eventually be recorded in rate base, but

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[8] D.84-08-125 CPUC2d at 131.

instead are costs that have been expensed. Essentially, DRA argues that not only are these costs not subject to AFUDC, but they mostly were spent in pursuing Cal-Am's original proposed project, which was since determined to be infeasible. DRA also notes that the pre-construction costs will be recovered much more quickly under the increased surcharge discussed above. As a proxy for a risk-free rate, DRA proposes the U.S. Treasury bill rate, which was 2.0% in January 2011.[9] DRA contends that allowing the weighted rate of return to be applied to these costs would circumvent ratemaking by allowing a full return on a project not yet realized.

In D.08-10-019, the Commission reiterated that "there are no explicit statutory guidelines for our decisions regarding interest rates, and we have broad flexibility in reviewing the facts of a particular situation and broad discretion to make appropriate findings of fact and conclusions of law….these factors provide a rational basis for our adopted interest rate."[10] The facts that guide us here are as follows.

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[9] DRA's Reply Comments, January 14, 2011 at 5. DRA does not refer specifically to the five-year Treasury Constant Maturity Rate, but rather to the particular rate of 2%.

[10] D.08-10-019, Footnote 9 at 4, and authority there cited; see also California Manufacturers Association v. Public Utilities Commission (1979) 24 Cal.3d 251, 258-259.)

The 90-day non-financial commercial paper rate is currently 0.18%.[11] We agree with Cal-Am that this rate is likely too low to fully compensate Cal-Am, in terms of interest earned on the Coastal Water Project Memorandum Account, when considering the investment required. However, we also agree with DRA that Cal-Am's weighted cost of capital (over 8% currently) is too generous a return at this time. While we approved the Regional Project and issued a CPCN for the Cal-Am facilities in D.10-12-016, construction is far from underway.

In adopting the AFUDC rate of 4.00% in D.10-12-016, the Commission reasoned as follows:

> While D.08-05-036 did not set policy regarding AFUDC for all long-term water projects, it is reasonable to rely on these previous determinations based upon the particular circumstances at hand and the type of financing being used to fund the project.[12] It is clear that applying the authorized rate of return was determined to be the correct approach in this type of capital project, but it is also clear that ratepayers would be protected by a reasonableness review when the project was completed.
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> Here, Cal-Am is asking for both recovery of its authorized rate of return on the AFUDC account for Cal-Am facilities, and no reasonableness review. We cannot find that it is reasonable for Cal-Am to accrue both its authorized rate of return on AFUDC and recover capital costs up to $95 million without further

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[11] Federal Reserve Statistical Release H-15, May 16, 2011, Commercial Paper, Non-financial, 3-month, Week Ending May 13th. Cal-Am states that the 90-day commercial paper rate was 0.20% as of April 22, 2010, the date the petition for modification was filed (Cal-Am April 22, 2010 Petition, Declaration of David P. Stephenson, at 4.)

[12] D.08-10-019, denying rehearing of D.08-05-036, at 8.

> reasonableness review. Assuming Cal-Am does not exceed the initial cost cap we have established today, we do not require reasonableness review of the Cal-Am facility costs before they are transferred into ratebase, and Cal-Am is essentially guaranteed recovery of these costs.
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> As DRA observes, 'Already a significant departure from the long-standing regulatory concept of 'used & useful,' Cal-Am's proposed new category of advice letters for placing project costs into rates prior to project completion would significantly mitigate almost all uncertainty and risk associated with recovery of spending on Cal Am facilities.'(footnote deleted.) We concur. Although the costs incurred will be tied up for some period of time, the ratemaking approach proposed by the Settling Parties allows the costs to be folded into rates semi-annually, as the project moves forward. This is a fair and equitable approach. Further, we find that Cal-Am should only charge and collect actual carrying costs. Under the current economic environment, we believe that the proposed AFUDC rates on the record would likely result in an under- or over-collection. Therefore, we believe that it is more appropriate to adopt an initial AFUDC rate that is more representative of current rates, and allow this rate to be trued-up to reflect actual carrying costs. Thus, we set the initial AFUDC rate at 4.00%. We direct the Settling Parties to comply with this modification and to revise the Settlement Agreement accordingly. We recognize that this is a significant modification to the Settlement Agreement, but we must ensure that ratepayers as well as shareholders are protected.[13]

Given the extraordinarily large balance that is now and will be carried in this memorandum account relative to the size of the utility, and given the long duration over which it is expected the balance will be carried, it is reasonable to

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[13] D.10-12-016 at 143-145.

apply this rate to the pre-construction costs recorded in the Coastal Water Project Memorandum Account. While we appreciate DRA's spirit of compromising in proposing the risk-free proxy of the five-year U.S. Treasury Bill Rate, currently set at 2.00%, we find that this interest rate is too low to adequately compensate Cal-Am. We set the 4.00% rate as an initial rate as we did in D.10-12-016. Because Cal-Am is at little risk of recovering its pre-construction costs, we are not inclined to adjust this rate upward from 4.00% at this time. We modify Conclusion of Law 8 in D.06-12-040 accordingly.

5. Comments on Proposed Decision

The alternate proposed decision of Commissioner Catherine J.K. Sandoval 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. Cal-Am filed and served timely comments. No party filed reply comments. We have carefully reviewed the comments, but make no adjustments to the decision.

6. Assignment of Proceeding

Michael R. Peevey is the assigned Commissioner and Angela K. Minkin is the assigned ALJ in this proceeding.

Findings of Fact

1. For purposes of mitigating the rate impact of the Coastal Water Project, the Commission authorized a Special Request 1 Surcharge to recover preconstruction costs. The Special Request 1 Surcharge is currently set at 10%.

2. Cal-Am's request to adjust the Special Request 1 Surcharge to 15% is unopposed.

3. Increasing the Special Request 1 Surcharge to 15% for the Coastal Water Project is appropriate and will ameliorate the long-term rate impacts on Monterey District Ratepayers.

4. Cal-Am's request to increase the interest rate applied to the Coastal Water Project Memorandum Account from the 90-day commercial paper rate approved in D.06-12-040 to its weighted average rate of return is excessive.

5. The current 90-day commercial paper rate is 0.18%. This is likely too low to fully compensate Cal-Am, in terms of interest earned on the Coastal Water Project Memorandum Account, when considering the investment required.

Conclusions of Law

1. It is reasonable to modify Ordering Paragraph 1 of D.06-12-040 to increase Special Request 1 Surcharge to 15%, because the increase will help reduce overall rate shock.

2. The Commission has broad flexibility to review the facts of a particular situation and to exercise its ratesetting discretion accordingly.

3. Cal-Am's request to be allowed to earn its authorized rate of return on preconstruction costs booked in its memorandum account should be denied in light of the many uncertainties regarding the ultimate realization of the project.

4. It is reasonable to apply 4.00%, the rate adopted as the initial AFUDC rate applied to Cal-Am's carrying costs related to the Cal-Am facilities constructed in the Regional Project adopted in D.10-12-016, as the interest rate applied to the pre-construction costs recorded in the Coastal Water Project Memorandum Account, and it is reasonable to modify Conclusion of Law 8 in D.06-12-040 accordingly.

5. Given the current economic environment, it is reasonable to establish 4.00% as the interest rate to be applied to the Coastal Water Project Memorandum Account.

6. Today's decision should be made effective immediately.

O R D E R

IT IS ORDERED that:

1. The Petition for Modification of Decision 06-12-040 by California-American Water Company, is granted to the extent that Special Request 1 Surcharge is increased to 15% until the full amount authorized for preconstruction costs is collected.

2. Ordering Paragraph 1 of Decision 06-12-040 is modified as follows:

> California-American Water Company is authorized to implement the proposed Special Request 1 Surcharge commencing January 1, 2007. Initially, the surcharge shall be 4%, then beginning July 1, 2007, shall increase to 7%. Beginning January 1, 2008, the surcharge will increase to 10%. <u>As of (the effective date of this decision) the Special Request 1 Surcharge shall increase to 15% and shall remain at the 15%</u> level until the full amount authorized for preconstruction costs is collected.

3. Except to the extent granted in Ordering Paragraphs 2 and 5, the Petition for Modification of Decision 06-12-040 filed by California-American Water Company is denied.

4. The interest rate applied to the Coastal Water Project Memorandum Account shall be 4.00%.

5. Conclusion of Law 8 of Decision 06-12-040 is modified as follows:

Cal-Am's request to be allowed to earn its authorized rate of return on preconstruction costs booked in its memorandum account should

be denied for the reason that it remains unclear at this time when ~~(or whether)~~ any plant construction will commence. All preconstruction costs should be booked in an interest bearing memorandum account and accrue interest ~~at the 90-day short term commercial paper rate~~ set at the rate of 4.00% .

6. Application 04-09-019 remains open.

This order is effective today.

Dated _____, at San Francisco, California.