

Decision **PROPOSED DECISION OF ALJ BUSHEY (Mailed 3/6/2008)****BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

In the Matter of the Application of California-American Water Company (U210W) for an Interest Rate of 8.33% for Allowance for Funds Used During Construction (AFUDC) for its San Clemente Dam Memorandum.

Application 07-02-023
(Filed February 20, 2007)

**OPINION DETERMINING CARRYING COSTS
FOR MEMORANDUM ACCOUNT****1. Summary**

This decision retains the 90-day commercial paper rate as the carrying cost for amounts properly recorded in California-American Water Company's (Cal-Am) San Clemente Dam Memorandum Account.

2. Background

In Ordering Paragraph 19 of Decision (D.) 06-11-050, the Commission directed Cal-Am to remove the San Clemente Dam retrofit project costs from rate base and place the amount in a memorandum account for later reasonableness review. The Commission authorized the account to accrue interest at the 90-day commercial paper rate, but allowed Cal-Am the opportunity to request, by subsequent application, a different carrying cost:

The San Clemente Dam retrofit project costs shall be removed from rate base and placed in a memorandum account for later reasonableness review. The account shall accrue AFUDC [Allowance for Funds Used During Construction] at the 90-day commercial paper rate, subject to true-up, until the Commission

completes a review of the appropriate AFUDC rate for this project. Cal-Am is directed to file within 60 days an application addressing the AFUDC methodology that should be applied to the San Clemente Dam retrofit memorandum account.

On February 20, 2007, Cal-Am filed and served this application seeking Commission approval of a higher interest rate, 8.33%, which is its currently authorized cost of capital. In addition, Cal-Am asked that the memorandum account balance, with accrued interest, be moved “into rate base when the Project becomes more certain.” Cal-Am offered three alternatives for the “more certain” milestone: certification of the environmental work, obtaining final permits, or finalization of construction contracts.

The Division of Ratepayer Advocates (DRA) and the Monterey Peninsula Water Management District (MPWMD) protested this application contending that Cal-Am had not justified an interest rate higher than the 90-day commercial paper rate, and that the request for rate base treatment was beyond the scope of the application authorized by Ordering Paragraph 19. On April 16, 2007, DRA and MPWMD filed a joint motion to strike all Cal-Am testimony referencing the proposal to move project costs to rate base.

On May 11, 2007, the assigned Administrative Law Judge (ALJ) convened a prehearing conference. The applicant provided a status report on the environmental review process, and stated that the final environmental document was expected in June 2007. The applicant indicated its intent to rely on its presentation in A.05-02-012, which was prepared in late 2004, in support of its request to include the cost of construction work in progress in rate base. The applicant also did not have a specific proposal for an appropriate milestone at which to include the costs in rate base.

The ALJ and the parties addressed the need for evidentiary hearings. No party articulated a disputed issue of material fact requiring evidentiary hearings, but all agreed that numerous legal and policy issues were in dispute among the parties. A schedule for discovery and briefs, with supporting factual declarations was discussed, as well as a contingency plan for a second prehearing conference, should factual disputes emerge.

On May 18, 2007, the assigned Commissioner and ALJ issued their scoping memo and ruling for this proceeding, holding that the scope of this proceeding shall be to determine the carrying cost that should be applied to the San Clemente Dam Project memorandum account, as directed by the Commission in D.06-11-050. The scoping memo also directed that the proceeding would not include placing construction work in progress in rate base because the applicant had not yet completed its decision-making process on the appropriate alternative to pursue, and the proposed supporting data was out-of-date.

The scoping memo found that there are no identified issues of material facts in dispute among the parties and, consequently, that scheduling evidentiary hearings was not necessary. A schedule providing for briefs addressing legal and policy issues, with factual assertions supported by a sworn declarations attached to the briefs, was adopted, and the assigned ALJ was designated the principal hearing officer in this proceeding.

3. Description of the San Clemente Dam Project

The San Clemente Dam was constructed in 1921 and has been operated by Cal-Am since the 1960s.¹ Due to sedimentation, the reservoir's capacity has declined from a maximum of 2,260 acre feet to 137 acre feet, and Cal-Am's only use of the dam is as a point of diversion during the winter months.

The dam requires seismic safety retrofits which are estimated to cost \$47 million. The National Oceanic and Atmospheric Administration, among other state and federal agencies, opposes the retrofit and recommend that the dam be removed. The cost estimates for removal exceed the cost of retrofit. The Lead Agencies for the environmental review of the retrofit project, the California Division of Safety of Dams and the U.S. Army Corps of Engineers, are also requiring Cal-Am to consider a bypass alternative for the dam.

As of the filing of briefs, the final decision selecting an alternative had not been issued.

4. Issue for This Proceeding

The only issue to be resolved in this decision is whether to change the carrying cost to be included on amounts recorded in the memorandum account authorized in D.06-11-050. The Commission will separately review the reasonableness of any amount Cal-Am seeks to include in revenue requirement.

5. Positions of the Parties

5.1. California-American Water Company

Cal-Am contends that it must be made whole for the ongoing cost to finance the project development and construction, and that its costs will include

¹ The ratemaking history of the dam is set out in D.06-11-050, *mimeo.*, pp. 39-45.

borrowing as well as equity from its investors. Cal-Am argues that the Commission has already recognized that Cal-Am will need to obtain financing for this project over several years. Consequently, the memorandum account should include the carrying costs based on Cal-Am's most recent authorized cost of capital, which is based on its cost of debt and equity.

Cal-Am presented a declaration stating that the full, weighted cost of capital would be the appropriate carrying cost for Cal-Am's investment in the San Clemente Dam. The declaration stated that investors expect a higher rate of return from risky investments, and that the San Clemente Dam investment is more risky than Cal-Am's overall investment in rate base such that investors would expect a rate of return higher than Cal-Am's weighted cost of capital. The declaration explained that regulators may disallow some or all of the San Clemente Dam costs which creates greater risk for recovery of the dam investment than on Cal-Am's previously-approved rate base. The declaration concluded the investors will seek higher returns for investment that will be a risk.

Cal-Am also presented a financial analysis showing that the 90-day commercial paper rate (assumed to be 5.2%) adds about \$7 million in costs to the estimated \$55 million project, and that the authorized rate of return (8.33%) would add about \$11.5 million. Cal-Am concluded that it is entitled to the \$4.6 million difference.

Cal-Am explained that setting the interest rate too low could harm customers by impacting Cal-Am's ability to attract investment. In this way, customers could end up paying higher financing costs due to the increased risk caused by insufficient return.

Cal-Am stated that the Commission's usual practice for water utility construction projects was to allow the costs for uncompleted projects to be included in the Construction Work in Progress account, which is part of rate base and thus earns the authorized rate of return. Here, however, Cal-Am noted, the Commission has reversed that usual course and removed the project from rate base, thus creating this relatively novel question of the appropriate carrying cost for construction project costs recorded in a memorandum account.

5.2. Monterey Peninsula Water Management District (MPWMD)

MPWMD stated that there is no reason for the Commission to stray from the accepted and traditional approach to determining carrying costs for water utility construction projects. The Commission has previously determined that predecessor costs² are not actually funds used during construction and should not be subject to the rate of return. Due to the significant cost, length of time in process, and continued uncertainty of whether the project will be completed, MPWMD concluded that the costs are properly treated as predecessor costs and recorded in a memorandum account with interest to accrue at the 90-day commercial paper rate.

MPWMD disputed Cal-Am's contention that the Commission's Water Action Policy supports a higher interest rate for this memorandum account. MPWMD explained that one of the objectives of the Water Action Plan is to promote investment "needed to improve water quality." The San Clemente Dam project, however, will only result in "meager" amounts of water, which would

² Planning costs incurred prior to construction.

“be cost prohibitive and unjustifiable by any standard of measurement.”³

MPWMD concluded that the project does not fall within the scope of the Commission’s Water Action Plan and that seismic retrofitting of the dam would not either increase or ensure water quality for the immediate area or in the California water system as a whole.

5.3. Division of Ratepayer Advocates (DRA)

DRA stated that the 90-day commercial paper rate is appropriate for the San Clemente Dam Project memorandum account. DRA disputed Cal-Am’s assertion that it will be short \$4.6 million if it is not granted relief to accrue at the higher rate because Cal-Am has not shown that the \$4.6 million is necessary to cover costs related to the San Clemente Dam Project. DRA emphasized that the scope and cost of the project are yet to be determined, and that the costs incurred so far are best categorized as pre-project.

DRA analyzed Commission precedent, especially treatment of Cal-Am’s Coastal Water Project, and concluded that the Commission has determined that highly uncertain projects with expected long construction schedules should accrue interest at the 90-day commercial paper rate, rather than the authorized rate of return. DRA also disputed Cal-Am’s contentions that the lower interest rate would cause investors to seek a higher rate of return due to the increased risk. DRA explained that investors have known about San Clemente Dam for many years and have already incorporated the risk of a reasonableness review into the stock price.

³ MWM Reply Brief at p. 9.

6. Discussion

The sole issue for today's decision is to determine the appropriate carrying cost for the accrued amounts in the San Clemente Dam memorandum account. We determine that, consistent with our precedent and sound policy, interest on the San Clemente Dam memorandum account should accrue at the 90-day commercial paper rate. When the project becomes more certain, Cal-Am may seek Commission permission to earn its authorized rate of return on the amount accrued in the memorandum account.

Consistent with our usual practice, this project was included in rate base as construction work in progress in the 2003 decision, with an amount of about \$7 million expected to be recorded in that account for this project. In the 2006 decision, the Commission removed the project amounts from the construction work in progress account because "the project is uncertain and ratepayers should not be required to fund estimated project costs until the Commission has fully reviewed a final project proposal."⁴ The Commission also authorized Cal-Am to record up to about \$24 million in expenditures for the project in a memorandum account. In doing so, the Commission denied Cal-Am current recovery of the costs pending its review of the final project proposal, but also created the question of the appropriate carrying cost for the newly-established memorandum account. We address this question in today's decision.

The Commission has previously determined that memorandum accounts for a water utility project of long duration with an uncertain outcome should accrue interest at the 90-day commercial paper rate:

⁴ D.06-11-050, *mimeo.* at p. 42.

[T]he costs at issue here are predecessor costs 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.

For these reasons, we conclude that the most appropriate manner to track these costs is for Cal-Am to establish a memorandum account to book costs associated with initial, preliminary engineering studies, environmental studies, analysis of necessary permitting requirements, and development of cost estimates for the Coastal Water Project. The memorandum account shall accrue interest at the 90-day commercial paper rate. 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 application by Cal-Am.

In the Matter of the Application of California-American Water Company 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 and to Recover All Present and Future Costs in Connection Therewith in Rates, D.03-09-022, mimeo. at pages 20-22 (emphasis added).

Cal-Am contends that this decision is not controlling due to "key differences" between the Coastal Water Project and the San Clemente Dam project. Cal-Am contends that, unlike the Coastal Water Project, it does not have a choice in remedying seismic deficiencies in the San Clemente Dam. In its opening brief, Cal-Am offered several scenarios under which the Coastal Water Project could change significantly from a utility-only project. Cal-Am also noted that, in 2006, the Commission authorized a surcharge to collect customer

contributions to the Coastal Water Project, and no such surcharge has been authorized here.

Reviewing Cal-Am's Director of Engineering's declaration, included with its opening brief, shows that the outcome for the San Clemente Dam project is far from certain. Cal-Am, and the appropriate state and federal agencies, are actively considering four alternatives to the dam strengthening option: dam notching, dam removal, river bypass (Carmel River reroute and dam removal), and no project.⁵ The Director of Engineering's declaration also states that Cal-Am is exploring the possibility of selling the surrounding property to a private environmental group to facilitate dam removal, and is seeking financial assistance from governmental and private entities.

The Director of Engineering's declaration shows that it remains unclear at this time what ultimate project Cal-Am may undertake to address seismic deficiencies at the San Clemente Dam, and what share of any associated costs ratepayers may be called upon to contribute.

Based on these facts, we conclude that the San Clemente Dam project, at this point in time, has substantially the same legal and regulatory status as the Coastal Water Project did in 2003.⁶ Both projects are of long duration with an uncertain outcome. The potential outcomes include options with significantly varying impacts on ratepayers.

⁵ Declaration of F. Mark Schubert, para. 15, *attached to Cal-Am's Opening Brief*, filed August 13, 2007.

⁶ We do not consider the 2006 surcharge relevant to our analysis of the rationale adopted in the 2003 decision.

Like the Coastal Water Project in 2003, it remains unclear at this time when (or whether) any plant construction will meet our standards for inclusion in rate base. Pending such a demonstration, the San Clemente Dam costs should continue to be recorded in the memorandum account and accrue carrying costs at the 90-day commercial paper rate. No party has put forward a persuasive argument to treat the San Clemente Dam project differently from the Coastal Water Project and we see no reason to deviate from our recent precedent.

Therefore, we conclude that amounts properly recorded in the San Clemente Dam memorandum account should accrue carrying costs at the 90-day commercial paper rate. As with the Coastal Water Project, we will consider modifying this ratemaking treatment when the project becomes more certain, and upon fully supported application by Cal-Am.

7. Need for Hearings

As there are no disputed issues of material fact necessary to resolve the motions, no evidentiary hearings are necessary.

8. 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 Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were filed on March 26, 2008, and reply comments were filed on April 1, 2008. Cal-Am contended that the San Clemente Dam project was more certain than the Coastal Water Project because the dam must be retrofitted, unlike the Coastal Water Project, which is optional. DRA replied that the Monterey District's dire water shortage requires action by Cal-Am, and the Coastal Water Project is the most likely means to address the supply issues, thus making it analogous to the San Clemente Dam Project.

We have reviewed the comments and reply comments, all of which substantially reargue positions taken in the briefs, and have made no significant changes to the proposed decision.

9. Assignment of Proceeding

Michael R. Peevey is the assigned Commissioner and Maribeth A. Bushey is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. Cal-Am and the involved state and federal agencies have not determined which alternative project will be implemented to address seismic deficiencies in the San Clemente Dam.
2. The San Clemente Dam project and the Coast Water Project, as of 2003, have substantially the same legal and regulatory status.
3. There are no disputed issues of material fact which require evidentiary hearing for resolution.

Conclusions of Law

1. The Commission previously determined that the 90-day commercial paper rate is the appropriate carrying cost for a memorandum account where costs associated with a long-term and uncertain water project are recorded.
2. No party has presented a persuasive rationale for deviating from our precedent in D.03-09-022.
3. Cal-Am should record carrying costs equal to the 90-day commercial paper rate on all amounts properly recorded in its San Clemente Dam project memorandum account, pending further order of this Commission.

4. The Commission shall review the reasonableness of all amounts recorded in the San Clemente Dam project memorandum account prior to any amount being included in revenue requirement or rate base.
5. Hearings are not necessary.
6. This proceeding should be closed.

O R D E R

IT IS ORDERED that:

1. California-American Water Company shall include in its San Clemente Dam Memorandum Account carrying costs equivalent to the rate earned on prime, 90-day commercial paper as reported in Federal Reserve Statistical Release H-15 on all amounts properly recorded in the account.
2. Application 07-02-023 is closed.

This order is effective today.

Dated _____, at San Francisco, California.