

Decision 08-03-022 March 13, 2008

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

Application of California-American Water Company (U210W) to Decrease Revenues for Water Service in its Coronado District by (\$73,100) or (0.46%) in 2008, and Increase Revenues by \$266,200 or 1.67% in 2009, and \$260,900 or 1.61% in 2010.

Application 07-01-036  
(Filed January 22, 2007)

And Related Matters.

Application 07-01-037  
Application 07-01-038  
Application 07-01-039

**OPINION ADOPTING THE REVENUE REQUIREMENT FOR  
CALIFORNIA-AMERICAN WATER COMPANY'S  
CORONADO AND VILLAGE DISTRICTS**

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**OPINION ADOPTING THE REVENUE REQUIREMENT FOR  
CALIFORNIA-AMERICAN WATER COMPANY'S  
CORONADO AND VILLAGE DISTRICTS**

**1. Summary**

This decision resolves the revenue requirement phase of the general rate case (GRC) application of California-American Water Company (Cal Am) for its Coronado (Application (A.) 07-01-036) and Village (A.07-01-039) districts. A separate decision will be issued for the Larkfield and Sacramento districts. For Coronado for 2008 we adopt a revenue decrease of \$216,600 or (1.31%), which is effective from January 1, 2008. For Village for 2008, we adopt a rate increase of \$326,000 or 1.53% which is effective from January 1, 2008. The rate design portion for all four districts will be decided in Phase II of this proceeding.

Today's decision adopts the settlement between Cal Am and the Division of Ratepayer Advocates (DRA). We find the settlement is reasonable in light of the whole record, consistent with law and in the public interest.

We adopt a return on equity (ROE) of 10.15% for Cal Am's Coronado and Village districts for the three-year GRC period, or until the next GRC decision for either district is issued.

We do not grant Cal Am's request for an Infrastructure System Replacement Surcharge (ISRS). We believe that Cal Am must first develop a comprehensive asset management plan identifying the specific areas requiring capital investment to replace or improve aging infrastructure before we will implement a surcharge.

We do not implement the pilot distribution system improvement charge<sup>1</sup> (DSIC) program developed in Decision (D.) 07-08-030 for the Cal Am Los Angeles District GRC. If successful, we envision the pilot program serving as a model for other Cal Am districts and Class A water utilities. We encourage Cal Am to take the necessary steps outlined here to implement an asset management plan and apply for DSIC in its next GRC.

Finally, this decision approves Cal Am's requested regulatory expenses and employee pensions and benefits expenses.

## **2. Background**

Cal Am is a Class A water company with seven districts.<sup>2</sup> Class A water companies are regulated by the Commission pursuant to Article XII of the California Constitution and the Public Utilities Code. Specifically, Pub. Util. Code § 455.2, as implemented in the Rate Case Plan (RCP), provides for a GRC proceeding every three years.<sup>3</sup>

The Coronado District was established in 1886 for the purpose of supplying water to the residents of the area known today as the City of Coronado. American Water Works Company, Inc. (American Water) acquired

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<sup>1</sup> The ISRS and DSIC are different names for similar infrastructure improvement funding mechanism.

<sup>2</sup> A Class A water company is a privately held water company with over 10,000 service connections. Cal Am's seven districts are Coronado, Felton, Larkfield, Los Angeles, Monterey, Sacramento, and Village.

<sup>3</sup> The original RCP was adopted in D.04-06-018. On May 24, 2007, the Commission issued D.07-05-062, revising the original RCP to among other things, adopt a rate case cycle that ultimately has each utility filing its rate cases for all districts at the same time.

the company in 1966. Cal Am is a wholly owned subsidiary of American Water.<sup>4</sup> The Coronado District serves the Cities of Coronado and Imperial Beach, a portion of the City of San Diego lying south of San Diego Bay and a small area of South Chula Vista located in the County of San Diego. All of the water provided to the Coronado District's approximately 21,000 customers is purchased from the City of San Diego.

The Village Water Company was established to serve land developers in the Conejo Valley. It was acquired by Cal Am in 1967. Between 1970 and 2006 the number of customers in the Village district grew from approximately 7,200 to slightly less than 21,000 with the completion of several new developments in the area. With the increase in customers, the amount and quality of water the district was able to supply to its customers from local wells became inadequate. In 1974 the use of local well water was discontinued. Since then all water provided by the Village District has been purchased from the State Water Project.

On January 22, 2007, Cal Am filed applications for rate increases and/or decreases for its Coronado, Larkfield, Sacramento and Village districts. DRA filed a timely protest on February 21, 2007, and a prehearing conference (PHC) was held on March 23, 2007, in San Francisco. The Mark West Area Community Services Committee (Mark West) filed a Motion to Intervene on March 12, 2007. At the PHC, Mark West's Motion to Intervene was granted and the proceedings were consolidated without objection. Both DRA and Mark West objected to

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<sup>4</sup> The Coronado and Village Districts were both acquired by American Water, but for operating purposes they are part of Cal Am, a wholly owned subsidiary of American Water.

including the consolidation of the Larkfield and Sacramento districts in the scope of the proceeding.

The assigned Commissioner's and Administrative Law Judge's Scoping Memo was issued on April 11, 2007, and included the proposed consolidation of Larkfield and Sacramento. The ruling found that allowing the parties to address the issue is in the public interest, and as such, consolidation is included in the scope of this proceeding.

The Commission held four Public Participation Hearings (PPHs), one each in Thousand Oaks (Village District) and Larkfield, and two in Sacramento, on April 12, 17 and 18, 2007, respectively.<sup>5</sup> After the Scoping Memo was issued, DRA filed a Motion to bifurcate the proceeding into two phases and move the Conservation Rate Design, Purchased Water Balancing Account and Water Rate Adjustment Mechanism requests into the second phase of the proceeding. DRA sought the bifurcation because it believed it would be unable to submit its testimony in a timely fashion due to limited staff resources. There was no opposition to the motion. On May 5, 2007, an ALJ Ruling granted DRA's motion and adopted its proposed new schedule.

On April 13, 2007, Cal Am filed Supplemental Testimony of Rodney Jordan and removed the Sutter Well and Well Number 6 from the Larkfield District application. Direct testimony was filed by DRA and Mark West on May 2, 2007. Cal Am filed its rebuttal testimony on May 21, 2007. Evidentiary hearings were held June 4-6, 2007, with Opening and Reply Briefs filed on June 28, 2007, and July 3, 2007, respectively.

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<sup>5</sup> There were two PPHs in Sacramento, one in the afternoon and one in the evening.

DRA and Cal Am filed a settlement agreement on July 6, 2007. On July 20, 2007, Mark West filed Comments on the settlement agreement. On August 20, 2007, both DRA and Cal Am filed replies to Mark West's comments on the settlement agreement.

On October 2, 2007, Cal Am filed a motion to reopen the record to accept late-filed exhibits which corrected errors in the comparison tables attached to the settlement agreement. On November 2, 2007, Cal Am filed a motion for interim rate relief. An ALJ ruling issued on November 20, 2007, granted both motions.

Parties also contacted the ALJ seeking a delay in the start of Phase II of the proceeding since settlement negotiations in the Los Angeles GRC would likely affect the rate design portion of this proceeding. The ALJ agreed to the delay and the start of Phase II is still pending a settlement in the Los Angeles case.

### **3. Settlement Agreement Between Cal Am and DRA**

Article 12 of the Commission's Rules of Practice and Procedure govern settlement agreements. According to Rule 12.1(d), prior to approval the Commission must find the settlement, whether contested or uncontested, "reasonable in light of the whole record, consistent with law, and in the public interest." Cal Am and DRA state that they have entered into the settlement agreement on the basis that the Commission's adoption not be construed as an admission or concession by any party regarding any fact or matter of law in dispute in this proceeding. They also intend that the Commission's adoption of the settlement not be construed as any statement of precedent or policy of any kind against them in any current or future proceedings. Furthermore, the

settlement is an integrated agreement, so that if the Commission rejects any portion of the settlement, each party has the right to withdraw.<sup>6</sup>

Prior to filing the settlement, an all-party settlement conference was held on May 25, 2007, and representatives of Cal Am, DRA and Mark West participated. Other meetings were held both in person and telephonically. Mark West declined to enter into the settlement agreement and therefore the settlement addresses disputed issues between DRA and Cal Am.<sup>7</sup>

### **3.1. Mark West Comments on the Settlement Agreement**

On July 20, 2007, Mark West filed comments on the settlement agreement, but Mark West's comments were related to issues involving only the Larkfield and Sacramento districts and are therefore not included here.

### **3.2. Terms of the Settlement**

The expense amounts in dispute differed from district to district. A full comparison of the parties' original and settled positions for each section is included as Attachment A.

The parties were able to reach agreement on the majority of issues in dispute in multiple ways. One reason for the disparate positions was the use of different inflation factors. If the difference between the two positions was nominal, Cal Am either agreed to adopt the lower DRA estimate or a compromise figure. Another reason for dissimilar original estimates was DRA's

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<sup>6</sup> See July 6, 2007, Motion of California American Water Company and the Division of Ratepayer Advocates for Adoption of Settlement Agreement as to Certain Issues on the Revenue Requirements, p. 4.

<sup>7</sup> *Id.*, p. 2, fn. 2.

concern with high expense years being included in the calculation and Cal Am's belief that high expense year figures were legitimate and should be included. When this occurred, the parties usually adopted a mid-point compromise amount for the settlement. Parties also reached a mid-point compromise on other issues, with the parties taking into account the actual historical expenses incurred as well as the variable nature of those expenses.

In some areas, the difference in position was due to calculation or accounting errors. Once the errors were identified and corrected, the parties agreed on the final figure or were able to adopt a settled amount. The following discussion deals with specific areas in which settlement was achieved in a manner other than those described above.

### **3.2.1. Cost of Capital**

Cal Am and DRA agree on the four districts' capital structure for the test year and both escalation years. They agree to a ratio of 58.16% debt to 41.84% equity for Test Year 2008, 58.32% debt to 41.68% equity for Escalation Year 2009, and 58.83% debt to 41.17% equity for Escalation Year 2010. The settlement uses Cal Am's projected 2007 capital structure, believing it is essentially equivalent and representative for all three years. DRA accepted Cal Am's cost of debt for 2008, 2009 and 2010, as 6.20%, 6.25% and 6.29%, respectively. We find the capital structure reasonable and in compliance with D.06-11-050, which required a return to the use of a consolidated capital structure in Cal Am's next GRC. We also find the parties' agreed upon cost of debt reasonable.

### **3.2.2. Customer Sales and Revenue**

Section 3.2 of the settlement for each district addresses Customer Sales and Revenue. The parties' initial positions essentially agreed on the customer counts, average water use, and an allowance for unaccounted-for water for each of the

four districts. However, the Village District's Unaccounted for Water calculations were corrected by DRA and the resulting figures were agreed upon by the parties. Therefore, we find this section reasonable.

### **3.2.3. Operation and Maintenance Expense**

The description of the settlement for Operations and Maintenance Expenses (O & M) appears in Section 3.3 of the settlement for each district. The specific items discussed below are O & M expense elements for the various districts that were not settled in the manner previously described.

#### **3.2.3.1. Coronado District Purchased Water**

Cal Am's original filing showed six months of actual and six months of forecasted data for 2006 without including an approved purchased water rate increase.<sup>8</sup> DRA initially accepted the original proposal. Parties subsequently decided that updated purchased water costs reflecting the increase should be used. Parties agreed on the updated figures.

#### **3.2.3.2. Village District Water Treatment – Miscellaneous**

Department of Health Services<sup>9</sup> fees for 2005 were originally classified to the wrong account. The parties agreed to a five-year average in order to mitigate the misclassification.

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<sup>8</sup> The purchased water rate increase was approved in Advice Letter 649.

<sup>9</sup> The Department of Health Services was renamed Department of Public Health on July 1, 2007.

**3.2.3.3. Village District Transmission  
and Distribution –  
Miscellaneous**

To achieve settlement, Cal Am agreed to DRA's figure reflecting a decreasing trend.

**3.2.3.4. Village District Purchased  
Water and Power**

Parties agreed that correcting the unaccounted for water figure altered the production numbers, which necessitated updating the purchased water and power costs for the district.

We find the manner in which compromise was achieved and the final settlement positions in this section reasonable.

**3.2.4. Administrative and General Expenses**

Administration and General Expenses (A&G) are addressed in Section 3.4 of the settlement for each district. By far the largest expenses in this section and the one in which the parties' positions are most disparate is employee pensions and benefits and regulatory expenses. All other elements of A&G were either agreed upon initially or settled in the course of negotiations. Employee pensions and benefits, including employee awards are not a part of the settlement and are discussed in another section of this decision. Regulatory expenses are also excluded from the settlement and discussed later.

The parties reached settlement on miscellaneous general expenses by removing charitable contributions, conservation expenses and community relations/outreach expenses.

Based on the above discussion, we find the settled items in this section reasonable.

### **3.2.5. Utility Plant in Service**

Utility Plant in Service is discussed in Section 3.5 of the settlement for each district. Following extensive exchanges of information and negotiations on the rationale for each requested plant item, Cal Am and DRA agree as set forth in Tables 1 and 2 below:

**TABLE 1: CORONADO DISTRICT UTILITY PLANT IN SERVICE (000s)**

<b>Project</b>	<b>Cal Am</b>	<b>DRA</b>	<b>Settlement</b>
Services Replacement	\$ 705.8	\$510.0	\$ 600.0 over 3 years
Meters Replacement	291.1	195.0	279.0 over 3 years
Hollister Street Main	1,580.0	1,459.0 (AL <sup>10</sup> )	1,459.0 over 3 years
Small Main Program	890.0	822.6 (AL)	809.0
Replace PRVs <sup>11</sup>	140.0	128.8	128.8
Distribution Map Automation <sup>12</sup>			102.2

**TABLE 2: VILLAGE DISTRICT UTILITY PLANT IN SERVICE (000s)**

<b><u>Project</u></b>	<b><u>Cal Am</u></b>	<b><u>DRA</u></b>	<b><u>Settlement</u></b>
Services Replacement	\$ 2400.0	\$1591.5	\$ 1995.8 over 3 yrs
Process Plant Replacement	360.0	210.0	210.0 over 3 yrs
Process Plant Additions	190.0	0.0	90.0 over 3 yrs
Lawrence Drive Facility Relocation	817.0	817.0	817.0
Shopping Center Reservoir Rehabilitation	1617.0	1617.0 (AL)	1617.0
Reservoir Improvements	4036.0	2222.0	2827.0 <sup>13</sup>

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<sup>10</sup> Advice Letter.

<sup>11</sup> Pressure Release Valves.

<sup>12</sup> The Distribution Map Automation was not properly accounted for in the Coronado rate case. A formula error omitted it from plant in service. The project was included in the direct testimony of Schubert. Exhibit 13, pp. 19-21.

Based on the explanations provided for each project, we find this portion of the settlement reasonable.

### **3.2.6. Depreciation Expense and Reserves**

Depreciation Expense and Reserves are discussed in Section 3.6 of the settlement for each district. Both Cal Am's and DRA's original depreciation calculations contained errors which were corrected for the settlement. Ultimately, DRA agreed with Cal Am's position that depreciation accruals for forecasted years 2007 through 2009 should be calculated using rates approved by the Commission in prior rate cases. We find this section of the settlement reasonable.

### **3.2.7. Special Requests**

The Special Requests are addressed in Section 3.7 of the settlement for each district. Because the special request numbering varied by district, this section will refer to the subject of the special request rather than the special request number.

#### **3.2.7.1. Infrastructure System Replacement Surcharge**

The parties were unable to reach agreement on this issue. It is discussed later.

#### **3.2.7.2. Rate Design**

This has been removed to Phase II of this proceeding.

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<sup>13</sup> This figure represents improvements to the Village District's 15 reservoirs; Moorpark, Industrial Tank I, Industrial Tank II, Las Posas Tank I, Wildwood Tank, Potrero I, Los Robles I, Los Robles II, Green Ridge, Las Posas Reservoir II, Orbis, Janns, Deer Ridge, White Stallion and Pace Reservoirs.

### **3.2.7.3. Low-Income Program**

These requests involve the Low-Income Program Tariff. Cal Am agrees to provide Low-Income Rate Assistance credit to non-profit group living facilities and migrant farm worker housing centers deemed qualified using the same criteria as that used for the California Alternative Rates for Energy program for gas and electric. Cal Am may require post-enrollment verification.

### **3.2.7.4. Full Cost Purchased Water Balancing Accounts**

This issue will be addressed in Phase II of the proceeding.

### **3.2.7.5. Conservation Balancing Account and Surcharge and Program Funding**

The Conservation Program funding is an element of the Conservation Balancing Account sought for the Village District. Coronado is only seeking conservation program funding.

The parties agree the conservation budget will be included in rates for the three-year rate case period at the maximum level allowed for Cal Am. Cal Am and DRA agree that budget estimates will not be escalated in attrition years. Parties agree the balancing account is subject to refund, Cal Am has the ability to move funds between Best Management Practices (BMP) as necessary, and Cal Am will provide all required California Urban Water Conservation Council reports to the Commission and DRA. The parties reached settlement on all the BMP expenses.

### **3.2.7.6. American Jobs Creation Tax Act**

The parties agree that when the actual deduction amount has been determined, Cal Am will provide DRA with the figure.

### **3.2.7.7. Balancing and Memorandum Account Balances**

The parties do not dispute these balances as they will be recovered according to Commission rules.

### **3.3. Cal Am's and DRA's Motion to Adopt the Settlement**

Based on our review of the settlement and weighing it as an integrated document, we find it reasonable in light of the whole record, consistent with the law, and in the public interest. Therefore, we grant Cal Am's and DRA's Motion, and adopt the settlement.

## **4. Issues Not Included in the Settlement**

### **4.1. Cost of Capital**

#### **4.1.1. Return on Equity**

The United States Supreme Court established the standard for setting a fair rate of return in *Bluefield, Hope* and *Duquesne*.<sup>14</sup> These decisions establish that a public utility is entitled to earn a fair return on the value of property invested to serve the public. The return should equal the return on investments in comparable companies and should be adequate to establish confidence in the financial stability of the company, maintain its credit standing, and attract necessary investment capital. Although these decisions establish the

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<sup>14</sup> *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia (Bluefield)* 262 U.S. 679, 692-693 (1923), *Federal Power Commission v. Hope Natural Gas Company (Hope)*, 320 U.S. 591, 603, (1944), and *Duquesne Light CO. v. Barasch (Duquesne)* 488 U.S. 299, 310 (1989).

constitutional standard for a fair return, determining what ROE meets that standard requires the analysis of many factors.

Cal Am's requested ROE is based on the average of two market-based financial models yielding an ROE ranging from 9.1% without a risk adjustment, to 15.7% with a risk adjustment of 3.3%.

Because Cal Am is not a publicly traded company, both Cal Am and DRA applied market-based models to the stock of similar business risk companies to determine the cost of equity for those companies. The companies are: American States Water, California Water, Aqua America, Connecticut Water, Middlesex Water, and San Jose Water Corp. Cal Am included a seventh company, Southwest Water Corp., in the group it used. Cal Am also estimated the cost of equity for two additional groups of utilities. The two groups are seven regulated gas<sup>15</sup> and seven regulated electric<sup>16</sup> utilities. Cal Am states it used the gas and electric utility estimates strictly as a reasonableness check for its water utilities calculations. Cal Am's risk component was determined by examining the risk in the cost of equity estimates compared to the risk in Cal Am's capital structure. These models provide a range of ROE estimate results.

Cal Am used the Discounted Cash Flow (DCF) model and Capital Asset Pricing Model (CAPM) in its analysis. To determine the DCF based ROE, Cal Am used the Constant Growth DCF and the Multi-Stage DCF models. The Constant Growth model assumes the company has a constant payout ratio and

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<sup>15</sup> Cascade Natural Gas, Keyspan Corp., Northwest Natural Gas, Nicor Inc., Piedmont Natural Gas, South Jersey Industries, and Southwest Gas.

<sup>16</sup> Central Vermont Public Service, Cleco Corporation, DPL Inc., Empire District Electric, Green Mountain Power, Hawaiian Electric, IDACORP, Inc., and Westar Energy.

earnings rate, and a Multi-Stage DCF model assumes investors expect near-term, non-constant growth and long-term constant growth.<sup>17</sup> The two DCF models yielded 8.9% and 9.2% results for an average 9.1% DCF method cost of equity.

The CAPM model concludes that the expected return on a risky asset is equal to the sum of the prevailing risk-free interest rate and market risk premium adjusted for the riskiness of the investment relative to the market. It assumes all investors hold efficient portfolios moving in lock step with the market and the portfolios differ only in their sensitivity to the market.<sup>18</sup> The CAPM analysis averages the results of the historical market risk premium (12.5%) and current market risk premium (12.2%) yielding an average 12.4% CAPM cost of equity. Both results shift upward when a capital structure risk adjustment is added.

DRA also used two market-based models, the DCF and Risk Premium (RP). The RP model used by DRA includes the risk investors associate with common stock and applied them to six of the comparable water utilities also used by Cal Am.<sup>19</sup> DRA's DCF analysis yields an ROE of 9.41%, and its RP analysis yields an ROE of 10.51%. DRA averages these two percentages to arrive at a recommended ROE of 9.96%. DRA opposes a risk adjustment.

DRA provided a table comparing the recommended and adopted ROE's of Class A water companies in all GRC's since 2003.<sup>20</sup> We include it here as Table 3.

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<sup>17</sup> The multi-stage DCF model uses near-term forecasts for the comparable companies and long-term forecasts of the gross domestic product from 1929 to 2005.

<sup>18</sup> Exhibit 4, p. 23.

<sup>19</sup> DRA does not include Southwest Water in its analysis.

<sup>20</sup> DRA Reply Brief, p. 5.

**Table 3: RECOMMENDED AND ADOPTED ROEs SINCE 2003**

<b>Decision No.</b>	<b>Company</b>	<b>DRA Recommended ROE</b>	<b>Company Recommended ROE</b>	<b>Adopted ROE</b>
03-02-030	Cal Am	9.97%	11.00%	10.25%
03-05-078	Suburban	9.04%	12.00%	9.84%
03-08-069	Apple Valley Rancheros	9.53%	12.00%	10.10%
03-12-039	Great Oaks	9.28%	10.95%	9.78%
04-03-039	So Cal Water	9.41%	12.45%	9.90%
04-05-023	Cal Am	9.48%	11.20%	9.79%
04-07-034	San Gabriel	9.43%	12.25%	10.10%
05-12-020	Apple Valley Rancheros	9.85%	11.60%	10.15%
06-01-025	So Cal Water	9.35%	11.30%	9.80%
07-06-024	Valencia	9.57%	11.75%	10.19%
07-08-030	Cal Am	9.69%	11.60%	10.00%
	Average	9.51%	11.65%	9.99%
Current App.	Cal Am	9.96%	11.50%	

The table indicates that for the past eleven GRCs, the adopted ROEs range from a low of 9.78% to a high of 10.25% with an average of 9.99%. DRA asserts its recommended ROE of 9.96% is consistent with the average Commission adopted ROE of 9.99% and urges the Commission to adopt it.

Cal Am includes VS growth (also call SV growth) in its calculations. VS growth represents the company's dividend growth rate through the sale of stock. Cal Am claims the VS growth rate is required when the company is not expected to issue new shares at prices equal to book value.<sup>21</sup> DRA argues that the VS

<sup>21</sup> Exhibit 4, Tab 11, p. 18.

growth rate is unnecessary in calculating sustainable growth because DRA's results are the average of DCF and RP models. The DCF model uses both current and future stock prices and therefore captures the effects of the higher stock prices.<sup>22</sup>

Another factor considered in setting the ROE are interest rate trends. Cal Am estimated the risk-free interest rate to be 5.0%. This estimate is based upon an average of intermediate-term U.S. Treasury security constant maturity rates published by the Federal Reserve.<sup>23</sup> DRA used Data Resources Inc. (DRI) forecasts for years 2008 - 2010, 10-year and 30-year Treasury bill rates of 5.28% and 5.53%, respectively.<sup>24</sup> We have relied on DRI forecasts in the past, most recently in D.07-08-030 where DRI's forecast for 2007 - 2009 was 5.2% for 10-year Treasury bills and 5.41% for 30-year Treasury bills.

DRA provides an assessment of Cal Am's total risk by the Standard and Poors (S&P) rating agency.<sup>25</sup> S&P evaluates a company's risk in order to assign a credit rating which is a direct measure of its ability to attract capital. Cal Am's parent company American Water Capital Company is rated A- by S&P. Ratings of AAA through BBB are considered investment grade.

As a result of our examination of the parties financial models, interest rates, authorized ROEs for other companies and credit worthiness of Cal Am, we find an ROE of 10.15% is fair and reasonable.

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<sup>22</sup> Exhibit 29, Tables 2-2 & 2-5.

<sup>23</sup> [www.federalreserve.gov](http://www.federalreserve.gov).

<sup>24</sup> Exhibit 29, Table 2-6.

<sup>25</sup> DRA Opening Brief, pp. 9-10.

Cal Am is seeking a 3.3% leverage adjustment to account for increased risk. A company's total risk is a combination of the business and financial risk it faces. Business risk relates to the uncertainty in estimating a company's future operating income. Uncertainty regarding the weather and possible contamination that could affect water supply are business risks. Cal Water is a regulated utility and therefore part of its business risk is regulatory risk. The Commission has implemented a variety of measures to reduce the regulatory risk of water companies. Those measures include Balancing Accounts for purchased water and power, and pump taxes. Memorandum Accounts are another means used to reduce risk and protect earnings from regulatory lag. There are Memorandum Accounts for Safe Drinking Water Act compliance, catastrophic events, water quality, and Construction Work in Progress (CWIP).

The level of regulatory risk eliminated by Memorandum and Balancing Accounts was the subject of extensive Cal Am cross examination of DRA's witness Willis. The DRA testimony asserts that the Commission has virtually eliminated regulatory risk.<sup>26</sup> Ultimately, the DRA witness allowed that some regulatory risk was beyond the Commission's power to eliminate.<sup>27</sup>

Financial risk is determined by the amount of debt in the capital structure. Usually, the bigger the debt in the capital structure, the more financial risk there is. Cal Am states that its capital structure has significantly more debt and therefore reflects greater financial risk than that of the sample water utilities. It asserts that any estimate of the cost of equity relying on market data for the

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<sup>26</sup> Exhibit 29, pp. 3 -1.

<sup>27</sup> RT pp. 262 - 74.

sample water utilities must be adjusted to reflect the financial risk associated with Cal Am's capital structure if it is to constitute a fair rate of return in this proceeding.<sup>28</sup> It requests an additional 3.3% to account for the company's financial risk in order to attract investors.

Although DRA agrees that water companies with highly leveraged capital structures are higher risk and in some circumstances a leverage adder may be reasonable, DRA asserts no adjustment is necessary here. DRA points out that Cal Am's parent company enjoys a credit rating of A- and issues Cal Am's debt securities.

We do not grant Cal Am's request for a leverage adjustment of 3.3%. The debt to equity ratio, although higher than the comparable water companies, does not adversely affect the S&P credit rating of its parent company. Further, since Cal Am's parent company issues its debt securities, its debt to equity ratio is something wholly within Cal Am's control. Finally, Cal Am has offered no evidence that its high debt to equity ratio has hindered its ability to attract investors. Similarly it has provided only one instance where the Commission has denied recovery of costs through Memorandum and Balancing Accounts.<sup>29</sup>

Finally, in D.06-11-050 we denied a leverage adjustment, finding that Cal Am was no riskier than comparable water companies and that Cal Am shareholders are rewarded for the lower equity ratio through the amortization of the Citizen's acquisition premium. Also, in the merger proceeding Cal Am claimed ratepayers would benefit from the savings on cost of capital, specifically

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<sup>28</sup> Exhibit 4, p. 31.

<sup>29</sup> In D.03-09-022, the Commission denied Cal Am's request for Construction Work In Progress (CWIP) on its Coastal Water Project desalination plant.

from increased leverage. In D.07-08-030, we found the reasons for denying a leverage adjustment in D.06-11-050 still applicable and we continue to do so.

To summarize, we deny Cal Am's request for a leverage adjustment. We find its capital structure reasonable since its parent company still enjoys an A-minus rating and there is no evidence it has been unable to attract investors. We also find an ROE of 10.15% falls within the range of the financial models calculated by the parties, is consistent with the ROEs adopted in other proceedings, is comparable to the returns on investments of like companies, and comports with Cal Am's creditworthiness. The 10.15% ROE is fair and reasonable because it is adequate to assure confidence in the company's financial health, maintain its credit standing, and attract capital investment. This ROE will be effective for the term of this rate case, updated in the upcoming Cost of Capital proceeding and implemented under the existing rate making mechanisms.

#### **4.2. Infrastructure Replacement System Surcharge**

Cal Am seeks implementation of an ISRS. An ISRS produces revenue to offset costs associated with replacement or repair of non-revenue generating capital projects such as mains, pumping equipment, water treatment equipment, meters and hydrants as well as other fixed costs.<sup>30</sup>

Cal Am believes an ISRS will address regulatory lag which results in earnings attrition because the current rate case process only provides for annual rate adjustments, regardless of when the projects are completed. Cal Am

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<sup>30</sup> Exhibit 3, p. 4.

contends the current use of balancing accounts to offset earnings attrition may not result in complete recovery.

The recovery mechanism Cal Am proposes is a surcharge, capped at 10% over three years, applied to the Commission authorized service and volume prices portion of customers' bills. It would be calculated quarterly utilizing actual costs for completed projects placed into operation. An advice letter detailing the calculations would be filed with a 15-day Water Division review period before the surcharge becomes effective. Cal Am claims the 15-day review period is adequate since the surcharge calculations will be based on a process to record capital expenditures that has been in place for many years and is familiar to staff.<sup>31</sup>

Cal Am discusses the 5%-capped surcharge mechanism utilized in Pennsylvania. It distinguishes the Pennsylvania example from the higher 10% sought in this case because Pennsylvania rate cases may occur with greater frequency and the surcharges are therefore rolled into rate base sooner. It asserts that in California, the Cal Am surcharge will be in effect for three years before being reset and therefore actually results in an annual surcharge only slightly higher than 3%.

Cal Am lists the customer safeguards of its proposal such as price caps, audits, resetting the price cap to zero, and customer notification processes.<sup>32</sup> Cal Am asserts that a more predictable revenue stream will allow it to spread costs more evenly between GRCs and minimize some rate shock produced by the

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<sup>31</sup> Exhibit 3, Tab 4, p. 10.

<sup>32</sup> *Id.*, p. 15.

current GRC process.<sup>33</sup> The company also lists the reasons alternative regulation such as an ISRS is vital to Cal Am's operation. The reasons include identifying a revenue stream for capital improvement, greater planning flexibility, providing specific customer information regarding capital expenditure funding, offsetting capital expenditure revenue loss due to conservation efforts, and improved offsetting of earning attrition over current processes.<sup>34</sup>

DRA opposes Cal Am's request for an ISRS. It asserts that Cal Am's application did not identify, inventory or quantify the age or condition of specific plant infrastructure warranting an ISRS.<sup>35</sup> Without identifying the specific projects, DRA characterizes the ISRS as an "automatic rate adjustment" for capital investment and believes without specific project information, it is premature to consider such a funding mechanism.

DRA lists the steps it considers necessary to develop a sufficient plan, such as a multiple year forecast quantifying the number of wells, water treatment plants, distribution mains, services and other facilities that may fall under an ISRS; criteria used to determine when facilities will need replacement; estimates or forecasts identifying the level of capital investment planned; and the effect of national security or drinking water standards on infrastructure replacement.<sup>36</sup>

DRA describes the mechanism based on depreciation rates used by other utilities to replace infrastructure. That mechanism utilizes a straightforward calculation of the depreciation rate and a replacement rate that eventually

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<sup>33</sup> *Id.*, p. 19.

<sup>34</sup> *Id.*, p. 16.

<sup>35</sup> Exhibit 25, pp. 11-16.

<sup>36</sup> *Id.*

replaces 100% of the system. Cal Am provided no system replacement rate for its ISRS proposal. Although DRA supports Cal Am's intent to develop a replacement plan, it believes adopting an alternative ratemaking mechanism prior to the development of a plan is unwise.

DRA questions Cal Am's claim of the benefits of a reliable revenue stream, believing it is no more accurate or predictable than traditional ratemaking. The current regulatory framework includes the ISRS-eligible project in rate base and the revenue stream is created there. In fact, DRA claims the current regulatory framework is more predictable since Cal Am will know what its base rates will be for three years, rather than having to wait until a project is completed to trigger a surcharge.

DRA dismisses Cal Am's claims that the ISRS reduces base rates or that an ISRS is needed to assure customers that a portion of their bill is being used for infrastructure replacement. DRA disagrees with Cal Am's claim of a rate base reduction. DRA asserts that although factually true in the short term, under Cal Am's proposal customers will start seeing the first of multiple and increasing surcharges as soon as the second quarter of a GRC cycle. DRA points out that only one customer voiced concern about system replacement and that concern highlighted Cal Am's lack of a replacement plan, not lack of identified funding.

DRA contends that Cal Am's ISRS proposal results in less regulatory oversight and therefore more risks than safeguards to ratepayers. First, DRA disputes Cal Am's claim that a 10% cap is less than other states' caps due to the longer GRC cycle in California. DRA counters that the Pennsylvania (PA) DSIC surcharge of 5% is actually less because PA utilities file rate cases every two years making the annual surcharge 2½% rather than 3.33% for a rate cap of 10%

over three years. DRA further claims the 10% cap is based on a comfort level within the company rather than estimated capital project costs.

Similarly, DRA finds the 15-day review period problematic. DRA contends the 15-day review period is insufficient to ensure proper Water Division staff review of advice letters involving substantial sums.

Cal Am has argued that no regulatory oversight would be lost under its ISRS proposal; it would merely occur after project completion rather than prior to implementation. DRA maintains that after the fact disallowance is politically unpopular and once a project has been completed, there is no room for Cal Am to alter its position. DRA claims it becomes an “all or nothing” proposition eliminating the flexibility inherent in the current system. As an example, DRA cites the proposed settlement in this GRC which resulted in an overall 34% reduction in the revenue requirement sought by Cal Am.<sup>37</sup>

Both Cal Am and DRA cite portions of the National Association of Regulatory Utility Commissioners’ (NARUC) February 25, 1999, resolution in support of their respective positions. Cal Am claims the resolution endorses the use of DSIC to tackle the job of replacing water system infrastructure. DRA quotes the NARUC resolution’s many other “policies and mechanisms” to “help ensure sustainable practices in promoting needed capital investment and cost-effective rates.”<sup>38</sup> DRA points out that the Commission currently utilizes nearly all the policies or mechanisms identified by the NARUC Resolution.

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<sup>37</sup> The average is calculated using all four districts in the GRC. DRA Opening Brief, p. 23, Table 2.

<sup>38</sup> Exhibit 43, p. 1.

The Commission adopted the Water Action Plan on December 15, 2005. The Plan includes six key principles: safe water; high quality water; highly reliable water supplies; efficient use of water; reasonable rates and viable utilities. One of the six objectives adopted to meet the principles was to promote water infrastructure investment. The Water Action Plan recognizes the need for a regulatory process that ensures companies develop long-term plans regarding aging infrastructure, includes plan review, and provides the necessary funding.

Cal Am's witness refers to the need for infrastructure replacement plans and the folly of waiting for all plant to fail or be near failure. The witness calls it "a disaster waiting to happen."<sup>39</sup> We agree it is a prudent course of action, however, Cal Am has not provided an actual plan beyond seeking a 10% surcharge. Further, Cal Am has not provided any evidence that the Coronado or Village districts' infrastructure are currently at or near the failure point.

As envisioned by the Water Action Plan, an infrastructure replacement plan is inherently beneficial to both ratepayers and water utilities. It assures customers there is a plan for long-term, reliable delivery of high quality water for a known price and provides the water utilities with a clearly defined revenue stream for infrastructure replacement costs. Unfortunately, Cal Am's proposal consists mainly of establishing a revenue stream via a surcharge. Cal Am has not identified capital project costs or a long-term replacement strategy providing the essential link to the requested 10% surcharge. Cal Am believes the ISRS will allow it to determine the amount of funds available for capital projects and this will aid the company in determining what projects should be undertaken.

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<sup>39</sup> *Id.*, p. 20.

Conversely, we believe a strong asset management strategy identifies needed capital improvements first, and then determines the revenue necessary to complete the projects. Therefore, we do not adopt Cal Am's ISRS proposal.

In D.07-08-030, we implemented a pilot DSIC program for Cal Am's Los Angeles District. The program provides Cal Am with the desired revenue stream, yet contains multiple safeguards to ensure the Commission retains regulatory oversight. This pilot program is intended to send a strong signal regarding our commitment to long-term capital asset management planning, including the development of infrastructure replacement strategies.

We will not implement the pilot DSIC program in the Coronado and Village districts at this time. We adopted the pilot program with the intention that if successful in meeting our Water Action Plan objectives, a similar surcharge mechanism could be considered for other Cal Am districts and other Class A water utilities. In the absence of evidence establishing urgency or financial need, we believe the current regulatory structure is sufficient. It will provide the necessary regulatory oversight and revenue for capital projects in the Coronado and Village districts until we can determine the success of our pilot DSIC program. The pilot program will be fully reviewed in the next Los Angeles District GRC.

We are committed to providing incentives for water utilities to more efficiently fund infrastructure investment. To that end, we encourage Cal Am to use the time until its next GRC to refine its asset management plan to include information such as:

- A multiple-year forecast indentifying the number, age and condition of wells, water treatment plants, distribution mains and other infrastructure components;
- Criteria for a long-range replacement strategy;

- Forecasts of the level of capital investment needed;
- Impacts of national security on drinking water standards and infrastructure, and;
- The necessary funding mechanism.

#### **4.3. Administrative and General Expense**

Cal Am and DRA reached agreement on all aspects of Administrative and General expense except those discussed below.

#### **4.4. Employee Pensions and Benefits**

The issue in dispute is health care premium costs. The primary difference between the parties' health care premium cost estimates is the use of different inflation factors. Cal Am estimated Group Health Insurance costs using an escalation factor of 8% for 2007 and an increase of 9% for 2008 based on historical trends in health care premiums.<sup>40</sup> DRA calculated the health insurance costs using the CPI-U for group insurance, citing D.04-06-018 as the basis for that calculation. Cal Am contends that DRA has mistakenly concluded that health insurance premiums are categorized as insurance and therefore linked to the CPI-U, rather than as pension and benefits under the Commission's Uniform System of Accounts and linked to the Labor factor.<sup>41</sup>

Under cross-examination, DRA's witness Greene was asked to examine historical data based on the Coronado District's cost of health insurance. After examining the Coronado District's costs and percentage increases from 2002

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<sup>40</sup> Sacramento District Exhibits A-D & F, Final Application, Ch. 6.

<sup>41</sup> Cal Am Opening Brief, p. 44.

through 2006, DRA's witness stated that he was "wrong in using the CPI-U numbers."<sup>42</sup>

We agree. The historical data more accurately reflects the actual costs the company has incurred for its employees' health insurance premiums and is the appropriate way to calculate future expenses for that item.

#### **4.5. Regulatory Expense**

DRA asserts that Cal Am's estimates for regulatory expense are excessive, although it acknowledges that considerable regulatory expense is involved in GRC proceedings. One of DRA's primary objections to the expense estimates involve the regulatory expense for 2008, a year it asserts Cal Am will not have any regulatory expenses.<sup>43</sup>

Cal Am contends that its costs are based on the actual expenses incurred in preparing for this rate case, as well as the costs for its most recent GRCs in other districts. Cal Am regulatory expense estimates used the actual prior costs for outside consultants, legal assistance, witness training, company labor and expenses and management level expenses. Cal Am goes on to point out that the new Rate Case Plan had not been issued at the time this application was filed and this proceeding has been bifurcated to address rate design in a second phase, two events that add significantly to its regulatory expense. Neither of these expenses was anticipated nor included in the original filing.<sup>44</sup>

While Cal Am's requested regulatory expenses are higher than previous years, there is some justification for the increases as actual historical expenses are

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<sup>42</sup> RT, p. 406: 24-25.

<sup>43</sup> Exhibits 25, p. 4-5, Exhibit 26, p. 4-5, Exhibit 27, p. 4-4 & Exhibit 28, p. 4-4.

the basis for the estimates. Also, at DRA's request, this proceeding was bifurcated, requiring additional time and attendant expense on Cal Am's part to prepare for a second phase of the proceeding that will extend into 2008.

We will adopt Cal Am's regulatory expense figures because they do not include the now-known 2008 expense associated with the bifurcation of this proceeding.

## **5. Comments on Proposed Decision**

The proposed decision of the Administrative Law Judge 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 Rule of Practice and Procedure. Comments were filed by DRA and Cal Am on March 3, 2008, and reply comments were filed by DRA on March 10, 2008.

DRA's comments support the proposed decision and identify two typographical errors.

Cal Am's comments focus on the ROE. Cal Am feels the 10.15% ROE is too low and the lack of a leverage adjustment fails to acknowledge its increased financial risk.

The development of an ROE requires that many factors be taken into consideration. The financial model is only one of those factors. There is no "correct" financial model. Rather, there are many models whose results are different based on the proxies used. Our analysis of the parties' positions and development of the ROE took all factors into consideration.

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<sup>44</sup> Cal Am Opening Brief, p. 46.

Our discussion of the ROE acknowledges the increased risk in Cal Am's high debt to equity ratio. However, our discussion also notes that the debt to equity ratio is wholly within Cal Am's control since its parent company issues Cal Am's debt securities. Cal Am fails to demonstrate that it has been unable to attract investors due to its higher debt to equity ratio.

We deleted a section of the ROE discussion dealing with over-earning by Cal Am, but it does not change our adopted ROE. We made other minor changes to the proposed decision based on DRA's comments.

## **6. Assignment of Proceeding**

John A. Bohn is the assigned Commissioner and Linda A. Rochester is the assigned Administrative Law Judge in this proceeding.

## **Findings of Fact**

1. This decision resolves the revenue requirement phase of Cal Am's GRC application for its Coronado and Village districts.
2. On July 6, 2007, Cal Am and DRA filed a partial settlement of the revenue requirement issues.
3. The debt to equity ratio contained in the settlement of 58.16% to 41.84% for Test Year 2008, 58.32% to 41.68% for Escalation Year 2009 and 58.83% to 41.17% for Escalation Year 2010 is reasonable.
4. The cost of debt contained in the settlement for 2008, 2009 and 2010, of 6.20%, 6.25% and 6.29%, respectively, is reasonable.
5. We find the Operation and Maintenance section of the settlement reasonable.
6. The Administration and General Expenses section of the settlement is reasonable.
7. The Utility Plant in Service section of the settlement is reasonable.

8. We find the Depreciation and Expense Reserves section of the settlement reasonable.

9. The Special Requests section of the settlement is reasonable.

10. The settlement viewed as an integrated agreement is reasonable in light of the whole record, consist with the law and in the public interest.

11. A Return on Equity of 10.15% is reasonable based on the record and is commensurate with return on investments in comparable companies and sufficient to (a) assure confidence in the financial integrity of Cal Am , (b) maintain its credit and (c) attract necessary capital investment.

12. A leverage adjustment to the ROE for increased financial risk is not warranted.

13. Although development of a long-term infrastructure replacement strategy is essential to ensuring reliable, high quality service and water, Cal Am has not justified its request for an ISRS absent a plan identifying the capital projects it will fund.

14. Cal Am's proposed ISRS reduces the ratepayer safeguards of our existing regulatory structure.

15. Our existing regulatory structure is adequate for the Coronado and Village districts.

16. Cal Am's employee pension and benefit expenses relating to health care premiums are reasonably based on historical expenses and appropriately use a labor inflation factor.

17. Cal Am's employee pension and benefits expense related to employee awards is appropriately charged to ratepayers.

18. Cal Am's regulatory expense is reasonable.

19. This proceeding remains open for the Phase II Rate Design.

**Conclusions of Law**

1. The settlement agreement filed by Cal Am and DRA is reasonable in light of the whole record, consistent with the law, in the public interest and should be adopted.
2. The settlement should not be construed as precedent or policy of any kind in this or future proceedings.
3. An ROE of 10.15% is reasonable in light of the whole record, consistent with the law, in the public interest and should be adopted.
4. Cal Am's figures for employee pensions and benefits expenses and regulatory expenses are reasonable in light of the whole record, consistent with the law, in the public interest and should be adopted.

**O R D E R**

**IT IS ORDERED** that:

1. The Motion of California American Water Company and the Division of Ratepayer Advocates for adoption of the settlement agreements as to certain issues on the revenue requirements for Coronado and Village districts filed on July 6, 2007, and attached as Attachment A, is granted.
2. The Coronado and Village districts' revenue requirement tables, attached as Attachment B, are adopted.
3. This proceeding remains open for Phase II, the rate design phase.

This order is effective today.

Dated March 13, 2008, at San Francisco, California.

MICHAEL R. PEEVEY  
President  
DIAN M. GRUENEICH

JOHN A. BOHN  
RACHELLE B. CHONG  
TIMOTHY ALAN SIMON  
Commissioners

[D0803022 Attachment A](#)

[D0803022 Attachment A](#)

[D0803022 Attachment B](#)