

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

In the Matter of the Application of CALIFORNIA WATER SERVICE COMPANY (U60W), a California corporation, for an order (1) authorizing it to increase rates for water service by \$140,558,101 or 17.1% in test year 2026, (2) authorizing it to increase rates on January 1, 2027 by \$74,162,564 or 7.7%, (3) authorizing it to increase rates on January 1, 2028 by \$83,574,190 or 8.1% in accordance with the Rate Case Plan, and (4) adopting other related rulings and relief necessary to implement the Commissions ratemaking policies.

A.24-07-003

(Filed July 8, 2024)

OPENING TESTIMONY OF

NORMAN J. KENNARD

ON BEHALF OF THE NATIONAL ASSOCIATION OF WATER COMPANIES

**ADDRESSING CALIFORNIA WATER SERVICE COMPANY'S SPECIAL REQUEST #3
AND ALLOWANCE FOR FUNDS DURING CONSTRUCTION (AFUDC) PROPOSAL**

February 11, 2025

1 **I. INTRODUCTION AND QUALIFICATIONS.**

2
3 **Q. PLEASE IDENTIFY YOUR NAME, POSITION, AND PLACE OF BUSINESS.**

4 A. My name is Norman Kennard. I am a licensed attorney in Pennsylvania and Ohio,
5 although my certification is inactive in Ohio. I am a member of the law firm of Eckert Seamans
6 Cherin & Mellott, LLC, and I am based in the Harrisburg, Pennsylvania office.

7 **Q. ON WHOSE BEHALF DO YOU OFFER THIS TESTIMONY?**

8 A. My testimony is offered on behalf of the National Association of Water Companies
9 (“NAWC”), a trade association representing the interests of water and wastewater utilities.
10 NAWC has a national profile and consists of 37 regulated utilities that provide water and related
11 services to millions of households across the country. Both in California and in other
12 jurisdictions, NAWC has been active in promoting the development of reasonable, consistent,
13 and forward-looking regulations for water ratemaking and water conservation. NAWC has
14 intervened in this proceeding, and my purpose here is to assist NAWC in providing a broader
15 perspective on specific ratemaking proposals being supported by California Water Service
16 Company (“Cal Water”) that are important to NAWC and its members. I understand that the
17 deadline for submission of testimony by “other parties,” including NAWC, is February 11, 2025,
18 so this testimony is timely.

19 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL AND WORK EXPERIENCE.**

20 A. I graduated from Hartwick College in 1974 with a Bachelor of Arts degree and from the
21 New Hampshire School of Law in 1979. During law school, I interned with the New Hampshire
22 Consumer Advocate’s Office and the National Consumer Law Center in Boston. My career has
23 been entirely focused on utility regulation, policy, and rate setting. I began my career in public
24 service in 1979, litigating public utility issues on behalf of consumers at the Pennsylvania Office

1 of Consumer Advocate. My experience in private practice spans 35 years (1983-2014, 2019-
2 present) and it has been extremely diverse, affording me a unique, multifaceted perspective. I
3 have been fortunate to have had experience across all regulated industries, in multiple forums,
4 state and federal, regulatory and legislative, as well as litigation and appellate representation.

5 I served as a Commissioner on the Pennsylvania Public Utility Commission (“PA PUC”)
6 from 2017 to 2019. During my time at the agency (2014-2019), I played key roles in many
7 important matters, including the licensure of Uber and Lyft; the PA PUC’s response to the
8 disruptive 2014 Polar Vortex, natural gas pipeline construction, electric transmission siting,
9 deregulation of local telephone service, the assertion of jurisdiction over pole attachments, and
10 the acquisition of municipal water and wastewater companies by regulated water utilities.

11 In 1983, I co-authored *A Guide to Public Utility Ratemaking for the Pennsylvania Public*
12 *Utility Commission* and then updated the *Guide* in February 2018. The 2018 edition is available
13 on the PA PUC’s website.¹ In addition, I contributed to editing the publication *Distributed*
14 *Energy Resources Rate Design and Compensation*, November 2016, which is available on the
15 National Association of Regulated Utility Commissioners (“NARUC”) website.²

16 **Q. DO YOU HAVE ANY EXPERTISE IN UTILITY RATE SETTING?**

17 A. Yes. I have been involved in numerous rate proceedings as a litigator, advisor, and
18 decision maker across all regulated industries, natural gas, electric, water and telephone from the
19 perspectives of the customer, utility, competitive supplier and regulator. During my career,
20 utility regulation has grown in sophistication and complexity from a simple rate-of-return model
21 to include various innovative ratemaking mechanisms and formulas designed to promote key
22 public policies and ensure that regulation produces the best utility incentives.

¹ See https://www.puc.pa.gov/General/publications_reports/pdf/Ratemaking_Guide2018.pdf

² See <https://pubs.naruc.org/pub/19FDF48B-AA57-5160-DBA1-BE2E9C2F7EA0>.

1 **Q. DO YOU HAVE A CURRENT SUMMARY OF YOUR WORK ON**
2 **REGULATORY POLICY ISSUES?**

3 A. Yes. My Curriculum Vitae is provided with this testimony as Exhibit 1.

4 **Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE CALIFORNIA PUBLIC**
5 **UTILITIES COMMISSION?**

6 A. Yes. I offered written testimony on similar issues in the recent rate cases for California
7 American Water Company (“Cal-Am”) and Golden State Water Company (“Golden State”),
8 docketed as A.22-07-001 and A.23-08-010, respectively. My testimony was accepted into the
9 record in those proceedings, and I am aware that both proceedings have now been resolved. In
10 addition to my testimony in California, I note that I have testified on regulatory policy issues
11 before the legislatures of Pennsylvania and Tennessee.

12 **Q. WHAT IS THE FOCUS OF YOUR TESTIMONY?**

13 A. My testimony discusses two issues. First, I address the practice known as revenue
14 “decoupling,” which Cal Water has proposed to implement through the interplay of ratemaking
15 features called the Safe Infrastructure Balancing Account (“SIBA”) and the Supply Cost
16 Balancing Account (“SCBA”). Collectively, Cal Water addresses revenue decoupling under its
17 “Special Request #3.” NAWC supports the use of revenue decoupling as a national best practice
18 that promotes water conservation, rate affordability for consumers, and operational stability for
19 water utilities. Cal Water’s proposal is designed to promote these values, and, even though I am
20 aware that the Commission has declined to adopt decoupling in recent rate cases for Cal-Am and
21 Golden State, the Commission should support decoupling based on the unique record developed
22 here. Based on the directives in the 2022 legislation identified as SB 1469, the Commission
23 “shall consider, and may authorize, the implementation of a mechanism that separates the water

1 corporation's revenues and its water sales, commonly referred to as a 'decoupling mechanism.'"³
2 Consistent with this statement, the Commission should consider Cal Water's decoupling
3 proposal and the specific advantages that provides for conservation and affordability within Cal
4 Water's service territory.

5 Second, my testimony underscores the importance of recognizing the rate base impacts of
6 construction that is in progress during the relevant test period. Cal Water has made a reasonable
7 proposal to acknowledge these impacts through the inclusion of an Allowance for Funds Used
8 During Construction ("AFUDC") ratemaking component. Cal Advocates opposes this proposal
9 based on the view that returns on rate base should not be provided on construction that is
10 incomplete or in progress during the test year. Both AFUDC and Construction Work in Progress
11 ("CWIP") are broadly accepted and well-tested ratemaking tools should be included in Cal
12 Water's ratemaking calculations, rather than Cal Advocates' one-off suggestion.

13 Paralleling NAWC's national purview and multi-jurisdictional interests, my testimony is
14 designed to place these important ratemaking issues within a broader policy context to ensure
15 that California's practices are in line with prevailing best practices. Both revenue decoupling
16 and some mechanism for acknowledging the ratemaking impacts of ongoing construction are
17 common in other states. These mechanisms are important and appropriate in this proceeding,
18 and this is particularly true given California's use of a prospective test year, which is intended to
19 be a representative snapshot of a utility's reasonable forward-looking operations.

20 **Q. WHAT MATERIALS DID YOU REVIEW IN PREPARATION FOR THIS**
21 **TESTIMONY?**

22 A. My review focused on Cal Advocates' testimony in this proceeding addressing the two
23 issues that I am discussing. Cal Advocates' testimony on revenue decoupling is sponsored by

³ SB 1469 (2022 Bradford).

1 Chris Ronco, a Cal Advocates analyst, in the testimony volume identified as “Report on
2 Production Expenses, Operations and Maintenance Expenses, and Special Request #3.” The
3 AFUDC and CWIP issue appears in the testimony of another Cal Advocates analyst, Chandrika
4 Sharma, in the volume entitled “Report and Recommendations on Plant for Bakersfield, Kern
5 River Valley, King City, Salinas, Selma, and Visalia Districts, and Rate Base.” In addition to
6 this testimony, I am familiar with Cal Water’s proposal, as presented in its Application. From
7 my prior work on this subject, I am also aware of previous Commission decisions addressing
8 revenue decoupling, including D.20-08-047 and D.21-09-047, as well as legislation directing the
9 Commission to consider decoupling, reflected in SB 1469 (Bradford 2022). Further, as I
10 mentioned previously, I am aware that the Commission declined to adopt revenue decoupling in
11 the two recent rate cases for Cal-Am and Golden State, in which I testified. The decisions
12 reaching those determinations are D.24-12-025 and D.25-01-036. I am also aware that Cal-Am
13 has filed for rehearing of its rate case decision, including on the question of whether to adopt
14 revenue decoupling, and that rehearing request remains pending. I understand that the deadline
15 for a potential request for rehearing of the Golden State decision would be in March 2025.

16 **Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

17 A. Revenue decoupling is a national best practice utilized in several other states, and it is a
18 key tool in encouraging water conservation. Likewise, decoupling fosters affordability,
19 flexibility, and self-determination for consumers by enabling the use of steep volumetric rate
20 tiers that would be too risky to pursue without a reasonable true-up mechanism to account for
21 scenarios where actual usage falls materially below revenue projections. At the same time,
22 decoupling provides greater certainty regarding cost recovery, thereby incentivizing necessary
23 investment by utilities in critical infrastructure that will ensure safe and reliable service and

1 promote efficiency going forward. Cal Water's decoupling proposal relies on two balancing
2 accounts (the SIBA and the SCBA) to identify under-collections or over-collections of the
3 utility's quantity revenues and fixed costs, respectively, and the differential between the two is
4 used to perform an appropriate annual true-up impacting base rates in the following year. This is
5 a reasonable approach and consistent with best practices.

6 Similarly, Cal Water's use of AFUDC is a reasonable approach to ensuring that the cost
7 of ongoing investments is not systematically excluded from ratemaking calculations. In any
8 given year, some work will necessarily be ongoing and not yet completed, and the AFUDC
9 element simply provides a vehicle for addressing this practical reality. Another approach to the
10 same issue is to incorporate a CWIP element in rate base. Cal Advocates' proposal that Cal
11 Water use neither AFUDC nor CWIP, despite that these ratemaking tools are commonly used
12 throughout all utility sectors in almost every state in the country, should be rejected. In addition
13 to adding unnecessary complexity, using Cal Advocates' approach will result in a revenue
14 requirement that does not align with real-world assumptions. It is not reasonable to assume that
15 there will be no projects in progress when the calendar turns from December to January, and the
16 Commission should provide some mechanism for capturing these impacts or the full cost of
17 service for Cal Water will not be reflected in the revenue requirement.

18 **Q. HOW IS YOUR TESTMONY ORGANIZED?**

19 A. First, I discuss revenue decoupling and provide support for Cal Water's proposal.
20 Second, I address the need for an appropriate recognition of the value of ongoing utility projects
21 through the well-tested and widely used ratemaking tools -- AFUDC or CWIP. In each section, I
22 respond to the perspectives put forward in Cal Advocates' testimony on these subjects.

1 **II. WATER REVENUE DECOUPLING.**

2
3 **Q. WHY IS REVENUE DECOUPLING ARISING IN CURRENT RATEMAKING**
4 **PROCEEDINGS?**

5 A. Revenue decoupling is a way of updating traditional rate-of-return ratemaking paradigms
6 to better account for the volatility and uncertainty of the current environment. Regulated utility
7 markets are characterized by essential services that require heavy fixed costs to deliver. The
8 economic theory underlying rate-of-return regulation is that utility service can be offered at
9 lower unit costs in a monopoly environment than under competition, chiefly because average
10 unit costs decrease as output increases. Through rate regulation, and an examination of costs and
11 revenues using a test year, regulators attempt to ensure that rates will remain reasonable while
12 providing an opportunity for utility cost recovery.

13 In the current environment, especially for water utilities and energy utilities, there is a
14 new emphasis on resource conservation and affordability that challenge traditional ratemaking
15 models. To achieve contemporary conservation and affordability objectives, regulators should
16 reexamine the impacts of ratemaking on throughput incentives to ensure that regulation is
17 properly tailored to produce socially optimal results. Decoupling is one of the key tools through
18 which to achieve this.

19 **Q. WHAT IS THE “THROUGHPUT INCENTIVE?”**

20 A. The “throughput incentive” refers to the incentive to encourage consumption under rate-
21 of-return regulation. Under traditional rate-of-return regulation, state public utility commissions
22 set rates and allow the utility’s revenues (and earnings) to fluctuate up or down based on
23 customers’ usage during the period between rate cases. To ensure that recovery aligns with
24 costs, the parties review historic usage and forecast the trends that affect revenues and attempt to
25 match them to the rating period.

1 In actual practice, results can differ markedly from predictions because forecasting future
2 utility usage by customers and related supply needs is difficult in a dynamic world. These
3 difficulties are particularly acute in an environment where the commodity being sold is
4 increasingly scarce, and where conditions fluctuate in inconsistent or unpredictable ways.
5 Absent a true-up mechanism, such as decoupling, a utility will either over-recover or under-
6 recover its revenue depending on usage, creating the so-called “throughput incentive”—the
7 incentive to increase sales above the level forecasted in a rate case or, at least, not decrease sales
8 below the forecasted level, even if reductions in consumption could be achieved.

9 Under traditional rate design models, utilities typically recover a fraction of their fixed
10 costs through fixed monthly customer charges and recoup the remainder through consumption-
11 based rates. That means a decline in sales can hinder a utility’s ability to recover fixed costs,
12 which can create a disincentive for utilities to promote customer efficiency. Because fixed costs
13 remain relatively stable regardless of incremental use, it is unlikely the utility can significantly
14 improve its profitability by reducing those costs. The easiest way for a utility to increase profits
15 is to increase sales, creating a powerful throughput incentive. Decoupling alleviates the
16 throughput incentive by reducing the connection between increased sales and increased revenue.⁴

17 **Q. HOW WOULD YOU CHARACTERIZE THE TRENDS AROUND THE**
18 **COUNTRY RELATED TO CONSERVATION AND DECLINING USAGE IN**
19 **THE UTILITY SECTOR?**

20 A. In recent years, we have seen increasing attention on efficiency and conservation due to
21 climate change, droughts, extreme temperatures and increasingly unpredictable weather patterns.
22 Many state legislatures through renewable portfolio standards to reduce carbon emissions from
23 the energy sector. According to information from the National Association of Regulatory Utility

⁴ National Renewable Energy Laboratory, *Clean Energy Policies in States and Communities* at 2
available here: www.nrel.gov/docs/fy10osti/46606.pdf.

Commissioners (“NARUC”), as of 2021, 232 individual utilities were preparing to meet state 100 percent carbon-reduction requirements, 38 individual energy utilities had adopted a voluntary carbon-reduction target, while 29 utilities had adopted a voluntary 100 percent carbon-reduction target.⁵ On the water side, according to the Environmental Protection Agency (“EPA”), at least 40 states are anticipating water shortages by 2024, so the need to conserve water is critical.⁶

As a result of these dynamics, many state utility regulators are focused on finding ways to incentivize customers to reduce their water and electricity usage through conservation, more efficient home appliances, storage, and other demand side measures. These efforts have largely been successful in the water sector. In California, per capita residential water usage statewide declined 21 percent between the years 2013 and 2016 and has remained on average 16 percent below 2013 levels as of 2020.⁷

The growing focus on conservation means that utilities are facing the difficult (but necessary) task of encouraging customers to use less water and electricity while maintaining a sufficient revenue stream to assure the resiliency of their infrastructure and continue to provide safe and reliable service. This is challenging because a utility’s costs remain largely fixed, at least in the short term, even in a declining usage environment. Regardless of how much water customers use, utilities still must maintain the infrastructure necessary to provide safe and reliable service.

⁵ <https://pubs.naruc.org/pub/48902228-1866-DAAC-99FB-936FB94C528D> at 3.

⁶ <https://www.epa.gov/greeningepa/water-conservation-epa>.

⁷ <https://resources.ca.gov/-/media/CNRA-Website/Files/Initiatives/Water-Resilience/CA-Water-Supply-Strategy.pdf> at 10.

1 **Q. HOW CAN DECOUPLING HELP ALIGN UTILITY AND REGULATORY**
2 **POLICY INCENTIVES IN THE CURRENT ENVIRONMENT?**

3 A. A primary role of state utility commissions is to set, monitor, and enforce prevailing
4 policy goals, such as encouraging conservation. One of the best ways to ensure success in
5 meeting these is to align utility incentives with these goals. As Peter Bradford, Chairman of the
6 New York Public Service Commission from June 1987-January 1995, famously said: “All
7 ratemaking is incentive ratemaking. It rewards some patterns of conduct and deters others.”⁸

8 In the area of conservation, it can be difficult for a utility to encourage customers to use
9 less water and still earn sufficient revenue to operate and maintain its system. Decoupling is a
10 powerful solution to this problem because it removes the “throughput incentive” – breaking the
11 link between how much a utility sells and the revenues it collects to recover the costs of
12 providing service to customers. This ensures that a utility’s revenue from fixed costs remains at
13 the level regulators determine to be fair and reasonable, including a fair return on investment and
14 that customers pay a fair amount for services rendered.

15 Traditional regulatory mechanisms keep prices constant between rate cases, but actual
16 revenues fluctuate up or down as a function of actual sales. However, decoupling allows
17 periodic price adjustments to even out this volatility. While decoupling does not alter the
18 traditional rate case process, it creates a more flexible approach to revenue streams between rate
19 cases, and this removes the incentive for utilities to increase sales as a means of increasing
20 revenue and profits.⁹

21 In accordance with these observations, the California Legislature recognized the benefits

⁸ *Regulatory Incentives for Demand-Side Management*: Edited by Steven Nadel, Michael W. Reid, and David R. Wolcott, American Council for an Energy (Sept. 1, 1992), Introduction.

⁹ <https://www.raponline.org/wp-content/uploads/2023/09/rap-revenue-regulation-decoupling-guide-second-printing-2016-november.pdf> at 2.

1 of decoupling when it passed SB 1469, which stated that “it is the intent of the Legislature to
2 ensure that water corporations are authorized to establish revenue adjustment mechanisms that
3 provide for a full decoupling of sales and revenue in order to further incentivize water
4 conservation efforts.”¹⁰

5 **Q. WHY IS EFFECTIVELY ENCOURAGING CONSERVATION IMPORTANT**
6 **FOR CALIFORNIA?**
7

8 A. Effectively encouraging conservation and aligning Commission incentives with utility
9 incentives is especially important in California. In the past five years, the state has faced
10 unprecedented droughts, flooding, and water scarcity issues. According to the National Oceanic
11 and Atmospheric Administration (“NOAA”), 2019 and 2021 were two of the driest years in
12 history for California. California also experienced a top-10 warmest year on record in 2022.¹¹
13 While the 2022-2023 winter provided some relief, the recent catastrophic fires in Southern
14 California are a harsh reminder that climate change and drought conditions are part of the “new
15 normal.” Former Governor Brown asserted that the state needs to “make water conservation a
16 California way of life,”¹² and Governor Newsom has consistently reinforced this position.¹³

17 Water conservation in California is not only important because of supply issues, but also
18 because water conservation reduces greenhouse gas emissions, which helps to fight climate
19 change. California’s Department of Water Resources estimates that about 12 percent of
20 California’s total energy use is related to water, including pumping, treatment, and distribution.¹⁴

¹⁰<https://legiscan.com/CA/text/SB1469/id/2604410#:~:text=SB%201469%2C%20as%20amended%2C%20Bradford.%20Water%20corporations%3A%20rates.,of%20the%20water%20service%20provided%20to%20water%20users.>

¹¹<https://www.noaa.gov/news/record-drought-gripped-much-of-us-in-2022>.

¹²<https://www.library.ca.gov/wp-content/uploads/GovernmentPublications/executive-order-proclamation/39-B-37-16.pdf>.

¹³<https://resources.ca.gov/Initiatives/Building-Water-Resilience>.

¹⁴<https://water.ca.gov/Programs/All-Programs/Climate-Change-Program/Water-Energy-Nexus>.

1 Reducing the amount of water used creates a corresponding reduction in energy use. Given the
2 climate challenges facing the state, it is important for water utilities in California to have every
3 tool available to them to encourage conservation.

4 Moreover, how California manages water issues and incentivizes conservation has
5 national consequences because other states look to California as a leader on water policy issues.
6 Decoupling is one of the best ratemaking methods available to support water conservation
7 efforts, and given the extreme weather and droughts in California, this tool should be available to
8 water utilities in California, as it is for the state's electric utilities.

9 I am not aware of any rate design tool that supports conservation better than decoupling.
10 A study in the electric industry found that decoupling was more effective than state energy
11 efficiency standards, lost revenue adjustment mechanisms, and performance incentives in
12 lowering residential electricity consumption.¹⁵

13 **Q. CAN DECOUPLING PROVIDE ANY BENEFITS OTHER THAN ALIGNING**
14 **REGULATORY AND UTILITY INCENTIVES AROUND CONSERVATION?**
15

16 A. Yes, importantly, decoupling can enable the adoption of steeper tiered structures for rate
17 design than would be feasible without decoupling. I see from Cal Water's proposal that it has
18 proposed an aggressive tiered structure to accompany decoupling, and it is the security provided
19 by the decoupling "true up" that allows this structure to be considered. Without decoupling, the
20 risk of significant shortfalls based on conservation-related reductions in usage would be too
21 great, and an aggressive tiered structure would compromise utility cash flow, creating dangerous
22 shortfalls and potential requests for emergency rate relief. Decoupling evens out the range of

¹⁵ *Moving Toward Energy Efficiency: A Results-Driven Analysis of Utility- Based Energy Efficiency Policies* at 22-23 available here:
www.hks.harvard.edu/sites/default/files/degree%20programs/MPP/files/17%207%2010%20MPP_PAE_Shauna%20Theel_Andreas%20Westgaard_Moving%20Toward%20Energy%20Efficiency.pdf.

1 potential revenue outcomes by ensuring that there is a reasonable way to recover the revenue
2 requirement that the Commission finds reasonable in a rate case, even if revenue projections turn
3 out to be significantly different from expectations. With the aggressive tiered structure that Cal
4 Water is proposing, customers will have greater ability to modulate their water usage to achieve
5 savings. This gives additional tools to low-income and low-usage consumers, consistent with
6 affordability principles.

7 By effectively promoting conservation, decoupling can also reduce utility costs and
8 customer bills over time. The Alliance for Water Efficiency has several reports documenting
9 instances, where due to revenue decoupling, water bills are markedly lower than they would have
10 been without the conservation investments that were incentivized by this same type of
11 decoupling mechanism.¹⁶ In California, a study by California Water Service demonstrates that
12 its water conservation efforts from 2008 to 2019 significantly lowered water use, which
13 decreased operating costs and in turn reduced customer bills by as much as 20 percent from what
14 they would have been without the conservation efforts.¹⁷

15 This theme – that investing in water conservation will mitigate increasing operating costs
16 in the long term – is true in my experience. In the electric sector, the savings to customers as a
17 result of efficiency, as calculated by ACEEE are impressive:

18 We estimate that not only is efficiency our third largest resource, but, more
19 importantly, it has averted the need to build the equivalent of 313 power plants
20 since 1990. We also estimate that efficiency reduced annual carbon dioxide
21 emissions, a major contributor to climate change, by 490 million tons in 2015. We
22 can see further evidence of efficiency's impact in the fact that electricity
23 consumption has flattened in recent years even as the economy has grown. What's
24 more, energy efficiency has saved consumers \$90 billion annually on electric bills.

¹⁶https://allianceforwaterefficiency.org/wp-content/uploads/2019/05/LADWP_Rates_Conservation_August_2018-ce2.pdf

¹⁷<https://www.calwater.com/docs/conservation/Economic-Value-of-Water-Efficiency-Lower-Water-Bills.pdf>.

1 For American households, this translates to average savings of \$460 per year.¹⁸
2 Conservation—both in the water and electric sectors—has been shown time and again to be the
3 lowest-cost source of supply. When less water is used, costly investments required to produce
4 additional water supplies can be deferred and potentially avoided. Water-efficient plumbing
5 products can save an average family hundreds of dollars each year. Using less water can reduce
6 the need to build or expand expensive drinking water and wastewater systems. Decoupling is a
7 necessary tool to enable utilities to make such investments in conservation, which will in turn
8 save customers money. In addition to the effectiveness of steeply tiered rates in achieving
9 conservation objectives, decoupling is simple and carries a relatively low cost to administer.

10 **Q. WHY DO YOU BELIEVE DECOUPLING IS IMPORTANT TO STABILIZE**
11 **WATER UTILITY OPERATIONS?**
12

13 An important part of utility ratemaking is predicting future usage and the issue of
14 accurate forecasting has only become more difficult with the progression of global warming and
15 unpredictable weather patterns. Infrastructure planning and decision making based on usage
16 trends is traditionally based on historical data and water availability patterns, but these data are
17 no longer a reliable guide for future conditions. Traditional utility assessment tools and
18 methodologies used for investment planning cannot accurately account for these uncertainties.¹⁹

19 Decoupling helps mitigate the uncertainty inherent in utility forecasting (and the costs
20 associated with it) by rendering utility (and intervenor party) predictions about future sales less
21 important because they are subject to true-up. This adjustment for actual results through

¹⁸ *The Greatest Energy Story That You Haven't Heard*, ACEEE Research Report, Molina and Nowak, August 19, 2016. See <https://www.aceee.org/research-report/u1604>. The quote is from the blog discussion of the findings: <https://www.aceee.org/blog/2016/08/our-new-analysis-finds-energy>.

¹⁹ *Financing a Water Secure Future* at 12, available here: https://www.oecd.org/content/dam/oecd/en/publications/reports/2022/03/financing-a-water-secure-future_27cd3a4c/a2ecb261-en.pdf.

1 decoupling more closely maintains the underlying relationship between prices and revenue
2 requirements over time. This lessens the likelihood of revenue shortfalls that can impact a
3 utility’s ability to maintain its system, as well as large-scale “rate shocks” for customers to
4 account for these revenue shortfalls in subsequent rate cases.

5 **Q. HOW HAS DECOUPLING BEEN UTILIZED IN OTHER SECTORS, SUCH AS**
6 **IN THE ELECTRIC AND GAS INDUSTRIES?**

7 A. Revenue decoupling is not a new ratemaking tool either nationally or in California.
8 California was an early adopter of decoupling in the natural gas sector.²⁰ It also implemented an
9 “Electric Revenue Adjustment Mechanism” (“ERAM”) for Pacific Gas & Electric (“PG&E”) in
10 1981, noting:

11 we find that such mechanism is essential at this time to enable PG&E a
12 reasonable opportunity to earn the authorized rate of return and also protect the
13 ratepayers from possible overestimates of expenses. Our experience in the past two
14 years has clearly shown that in times of rampant inflation and unstable interest
15 costs, it is impossible to make reasonable estimates of costs 12 to 18 months in the
16 future.²¹

17 Decoupling is now widespread in the electric sector, where it became apparent that reduced
18 consumption was much less expensive than building generation facilities, particularly in
19 vertically integrated states where utilities and their customers bear the costs of construction and
20 operation.

21 The American Council for an Energy-Efficient Economy (“ACEEE”) reported in its 2022
22 “Scorecard” that:

23 This year, 28 states offer a performance incentive for at least one major electric
24 utility, and 16 states have incentives for natural gas energy efficiency programs.
25 Some states with third party program administrators have performance incentives
26 for the administrator rather than for the utilities. Thirty-one states have addressed
27 disincentives for investment in energy efficiency for electric utilities. Of these, 14

²⁰ According to the U.S. Department of Energy, “[d]ue to natural gas supply constraints, decoupling was first introduced in 1978 in the State of California to relieve natural gas utilities of reduced revenues (D.88835),” available here: <https://www1.eere.energy.gov/manufacturing/states/pdfs/nat-gas-revenue-decoupling-final.pdf>.

²¹ See D.93887.

1 have a lost revenue adjustment mechanism and 18 have implemented decoupling,
2 with the most recent addition to the latter being New Mexico. For natural gas
3 utilities, 7 states have implemented an LRAM and 27 have a decoupling
4 mechanism.²²

5 More and more, policymakers and regulators are concluding that the conventional utility
6 ratemaking model, where profits that are tied to increasing sales, may not be in society's long-
7 term best interests.²³

8 **Q. HAS DECOUPLING RESULTED IN CONSERVATION BENEFITS IN THE**
9 **ELECTRIC SECTOR?**

10 A.' There is no doubt that decoupling has resulted in increased conservation in the electric
11 sector. In a study of six state programs, RAP found various level of positive influence of
12 revenue decoupling to achieve greater energy efficiency than would otherwise have been
13 possible, concluding that the "evidence demonstrates that revenue regulation as a strategy and a
14 mechanism to enable energy efficiency has been working well."²⁴ Specifically, in California it
15 found that:

16 Because PG&E has been decoupled in one form or another since 1984, it is very
17 difficult to determine the effect of revenue regulation on the implementation of
18 energy efficiency programs. However, PG&E has reported that incremental energy
19 efficiency savings have consistently exceeded one percent of retail sales over the
20 last ten years.²⁵

21
22 These findings are echoed in analysis undertaken by the Natural Resources Defense Council
23 ("NRDC"):

24 The states examined in this research present a variety of complementary energy
25 efficiency policies that were in place prior to and after implementing a decoupling
26 rider. Yet each of the five utilities demonstrated a significant increase in their
27 energy efficiency spending and savings after the decoupling rider was put in place.

²² <https://www.aceee.org/sites/default/files/pdfs/u2206.pdf>.

²³ See *Revenue Decoupling and Regulation: A Guide to Theory and Application*, Regulatory Assistance Project ("RAP"), November 2016 (Second Printing), available here: <https://www.raponline.org/wp-content/uploads/2023/09/rap-revenue-regulation-decoupling-guide-second-printing-2016-november.pdf>.

²⁴ <https://www.raponline.org/wp-content/uploads/2023/09/rap-revenue-regulation-decoupling-guide-second-printing-2016-november.pdf>.

²⁵ *Id.*

1 Though this does not, in and of itself, demonstrate a causal connection between this
2 policy mechanism and performance, decoupling can be an effective piece of the
3 energy efficiency puzzle in a variety of regulatory environments.²⁶

4 ACEEE reported similar results to the Pennsylvania Public Utility Commission:

5 States with both EERS and decoupling achieved energy savings averaging 1.6% of
6 MWh sales in 2016. Pennsylvania and other states with EERS [energy efficiency
7 resource standards] but no decoupling saved only half as much, 0.8% of sales [in
8 2016].²⁷

9 These results were echoed in a 2017 study of 166 investor-owned electric utilities
10 operating in the U.S. from 2004-2015, that found that electric companies with decoupling were
11 associated with 3.9 percent lower residential electricity consumption per customer.²⁸ Thus, there
12 is demonstrated evidence that decoupling supports conservation in the energy sector. Given the
13 longstanding success of decoupling throughout the country on the energy side, it makes sense to
14 permit California's water utilities to have access to the same ratemaking tool so that the state can
15 realize the same conservation benefits.

16 **Q. DO OTHER STATE REGULATORY COMMISSIONS PERMIT REVENUE**
17 **DECOUPLING FOR WATER UTILITIES?**

18
19 A. Yes, many state commissions have embraced decoupling. A 2013 resolution from the
20 NARUC endorses decoupling for water utilities, noting that:

21 Alternative regulatory mechanisms can enhance the efficiency and effectiveness of
22 water and wastewater utility regulation by reducing regulatory costs, increasing
23 rates for customers, when necessary, on a more gradual basis; and providing the
24 predictability and regulatory certainty that supports the attraction of debt and equity
25 capital at reasonable costs and maintains that access at all times....⁴

²⁶ *The Evidence Is In: Decoupling Spurs Energy Efficiency Investment*, April 4, 2016, available here:
<https://www.nrdc.org/bio/samantha-williams/evidence-decoupling-spurs-energy-efficiency-investment>.
Full study published as *The Link Between Decoupling And Success In Utility-Led Energy Efficiency*,
published March 2016, available here: <http://dx.doi.org/10.1016/j.tej.2016.02.003>.

²⁷ <https://www.puc.pa.gov/pdocs/1590856.pdf>.

²⁸ *Moving Toward Energy Efficiency: A Results-Driven Analysis of Utility- Based Energy Efficiency
Policies* at 22-23, available here:
www.hks.harvard.edu/sites/default/files/degree%20programs/MPP/files/17%207%2010%20MPP_PAE_S_hauna%20Theel_Andreas%20Westgaard_Moving%20Toward%20Energy%20Efficiency.pdf.

1 A survey of other states shows the following:

- 2 • **New York** - The New York Public State Commission has permitted utilities to
3 implement a mechanism in which customer rates are subject to an “automatic adjustment
4 by way of a surcharge, or credit, based on the difference between the actual net revenues
5 (operating revenues less production costs) for the preceding rate year and the net revenue
6 target as estimated in the most recent rate case.” The difference in these two numbers is
7 then charged or credited to customers.²⁹
- 8 • **Pennsylvania** – Pennsylvania adopted revenue decoupling in Act 58. The statute defines
9 decoupling within the context of water and wastewater utilities as, “[a] rate mechanism
10 that adjusts or reconciles authorized rates or revenues for differences between sales used
11 to set rates and actual sales, which may include, but not be limited to, adjustments
12 resulting from fluctuations in the number of customers served and other adjustments
13 deemed appropriate by the commission.”³⁰
- 14 • **Rhode Island** – A Rhode Island statute carves out a revenue stabilization approach for
15 commission-regulated water suppliers. Under this provision, the supplier is permitted to
16 seek a revenue stabilization account “to ensure fiscal stability during periods when
17 revenues decline as a result of implementing water conservation programs, or due to
18 circumstances beyond the reasonable control of the water supplier, including, but not
19 limited to, the weather and drought.”³¹ This account may not exceed 10% of annual
20 operating expenses and can only be used to supplement other revenues to ensure the
21 utility’s reasonable costs are compensated.³²
- 22 • **Connecticut** - Connecticut offers statutory-based revenue adjustment mechanisms. The
23 mechanism reconciles the difference between actual revenues accrued by the water utility
24 and allowed revenues.³³
- 25 • **Indiana** - Indiana has implemented a decoupling-like mechanism in the form of its
26 System Integrity Adjustment (“SIA”). This mechanism is defined as “an amount charged
27 by an eligible utility to allow the automatic adjustment of the eligible utility’s basic rates
28 and charges to recover from or credit to customers an adjustment amount.”³⁴
- 29 • **Illinois** - The Illinois Commerce Commission has approved a tracker for the state’s

²⁹ See NYPSC Case No. 16-W-0130 (Suez Water), 2017 N.Y. PUC LEXIS 17 at *24; NYPSC Case No. 01-W-0817 (New York Water Service), 2002 N.Y. PUC LEXIS 200 at *2.

³⁰ See 66 Pa. Code § 1330.

³¹ See 39 R.I. Gen. Laws Ann. § 39-15.1-3 (c).

³² See *In Re: Pawtucket Water Supply Board General Rate Filing*, Docket No. 4171, Rhode Island Public Utilities Commission, (June 9, 2011), available here: <https://ripuc.ri.gov/sites/g/files/xkgbur841/files/eventsactions/docket/4171-PawWSB-Ord20376%286-9-11%29.pdf>.

³³ See Conn. Gen. Stat. Ann. § 16-262y(a)(1).

³⁴ See IC 8-1-31.5-9. See also *Order, Petition of CWA Authority, Inc. for Approval Pursuant to Indiana Code Section 8-1-31.5-12 to Implement a Rate Cause No. 44990 Schedule to Establish a System Integrity Adjustment*, Cause No. 44990, Indiana Utility Regulatory Commission at 5 (Dec. 28, 2017), available here: https://iurc.portal.in.gov/entity/sharepointdocumentlocation/2cf466b9-16ec-e711-81e2-1458d04e1b18/bb9c6bba-fd52-45ad-8e64-a444aef13c39?file=44990_ord_201712281337.pdf.

1 utilities to act as a revenue stabilization device. The Volume Balancing Adjustment
2 (“VBA”) Rider adjusts customer prices in a way that holds utility revenues at a constant,
3 despite volatility in customer consumption.³⁵

- 4 • **Maine** – The Maine Public Utilities Commission is authorized to adopt a “rate-
5 adjustment mechanism to decouple water utility revenues from water utility sales through
6 revenue reconciliation when changes in sales are due to a change in the number of
7 customers or a change in the volume of consumption.”³⁶ The statute permits adjustments
8 to “rate of return” to account for any changes to utilities’ risk profiles from adopting
9 decoupling, but these considerations do not undermine the validity of decoupling as a
10 practice.
- 11 • **Nevada** – A decoupling mechanism proposal must meet the minimum requirements of
12 NRS 704.329.³⁷ A deferred water service adjustment rate mechanism was adopted for
13 Great Basin Water Co. by stipulation.³⁸

14 **Q. DID YOU CONSIDER CAL ADVOCATES’ TESTIMONY SUGGESTING THAT**
15 **OTHER STATES PRACTICES ARE NOT INFORMATIVE OF HOW**
16 **CALIFORNIA SHOULD APPROACH THE DECOUPLING ISSUE?**

17
18 A. Yes, I considered Cal Advocates testimony on this, but I do not believe that Cal
19 Advocates’ distinctions are well founded. The bottom line is that all of these states have
20 recognized conservation as a priority and have adopted decoupling as ratemaking tool that is
21 effective in helping them achieve this policy goal. This determination made by other states
22 regarding decoupling is relevant here, regardless of the specific distinctions as to how these other
23 states have implemented decoupling or what test periods provide the starting point for
24 decoupling.

25 Cal Advocates’ objections are premised largely on the notion that other states rely, in
26 whole or in part, on historical test years.³⁹ This does not diminish the benefits of decoupling – or

³⁵ See Ill. Comm. Comm’n, Docket No. 16-0093 (Illinois-American Water) at 72; Ill Comm. Comm’n, Docket No. 17-1106 (Util. Servs. Of Illinois) at 52.

³⁶ Me. Rev. Stat. tit. 35-A, § 6102-A(1).

³⁷ NAC § 704.63385.

³⁸ *Application of Great Basin Water Co., Spanish Springs Division, filed under Advice Letter No. 11, to revise Water Tariff No. 1-W to implement the deferred water service adjustment rate mechanism relating to the Order issued in Docket No. 18-11014*, 2023 NEV. PUC LEXIS 36, *1.

³⁹ See Ronco Testimony at 3-9 to 3-12.

1 the recognition by these states that decoupling is an important tool to help achieve their
2 conservation goals. Whether the basis of a utility revenue requirement is grounded in past,
3 recorded financials or based on a projection of costs for a future test year, utility rate designs are
4 inherently forward-looking in that they take effect on a date certain and apply thereafter until
5 further modification. In this context, the advantages of decoupling are the same regardless of
6 whether the underlying basis for the projections is historical or prospective in nature. Once the
7 rate design takes effect, there is the same potential for the revenue assumptions to be divergent
8 from actual experience, irrespective of how the rates and revenue expectation were developed.
9 Cal Advocates' attempts to distinguish other states' decoupling efforts are unavailing—I do not
10 think there is any reason to view California's ratemaking framework differently than the
11 approaches in these other states from a decoupling perspective.

12 **Q. DOES CAL ADVOCATES PRESENT ANY VALID REASON NOT TO ADOPT**
13 **CAL WATER'S DECOUPLING PROPOSAL?**

14 A. In my view, no. Once the Commission adopts a revenue requirement and finds it
15 reasonable, it should not be controversial to provide a vehicle to ensure that the rate design
16 achieves the intended cost recovery. Decoupling does not create new profit opportunities for
17 utilities; it only ensures that the fixed costs of service are recoverable even as revenues fluctuate.
18 Cal Advocates suggests that decoupling “protect[s] Cal Water from the risk of properly
19 forecasting for sales,”⁴⁰ but this characterization ignores the broader context of the ratemaking
20 process. All parties in rate proceedings contribute to the development of reasonable forecasts,
21 and the Commission adopts the figures it believes will reflect the circumstances in the future test
22 year. Revenue decoupling does not undermine these forecasting efforts, but it provides a vehicle
23 to respond to unforeseen fluctuations in revenue expectations. Fluctuations are hard to predict

⁴⁰ See *Ronco Testimony* at 3-4.

1 and are heavily influenced by drought events and the associated reductions in supply as
2 consumers react to conservation imperatives. It is true that Cal Water’s decoupling proposal
3 would “allow rate increases outside of the GRC process,” but it also allows for *rate decreases*, if
4 expenses are lower than expected or revenues are higher than expected.⁴¹ Furthermore, these
5 timely adjustments maintain close alignment between rates and the Commission-adopted revenue
6 requirements. Since the starting point of these adjustments is a revenue requirement that the
7 Commission has adopted as reasonable, it is not true that the Cal Water’s decoupling proposal
8 “lack[s] transparency.”⁴²

9 **Q. DO CAL ADVOCATES’ COMPARISONS TO THE FEATURES OF A**
10 **“COMPETITIVE MARKET” UNDERMINE CAL WATER’S DECOUPLING**
11 **PROPOSAL?**
12

13 A. No. Cal Advocates references that in a “a competitive market, a business would be
14 unable to guarantee its revenue forecast by billing customers for the difference between
15 actual sales and authorized (forecasted) revenue [or] retroactively recover revenue from
16 customers.”⁴³ This statement only underscores the need for decoupling. In a non-regulated
17 competitive market, firms can readily change their prices to react to changing circumstances;
18 water utilities cannot. Water utilities can only charge the rates that the Commission approves, so
19 as forecasts begin to deviate from reality, there is no remedy between rate cases absent a
20 decoupling mechanism. This is exactly why the traditional ratemaking model should be
21 supplemented with a full decoupling mechanism. Without it, utilities are exposed to
22 unreasonable financial risks to which they cannot readily respond.

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Ronco Testimony* at 3-5.

1 **Q. IS THE “M-WRAM” OR “CPAM” OPTION IDENTIFIED IN CAL**
2 **ADVOCATES’ TESTIMONY SUFFICIENT TO ADDRESS THE CONCERNS**
3 **YOU HAVE RAISED ABOUT VOLATILITY IN WATER USAGE AND**
4 **ASSOCIATED REVENUES?**

5
6 A. No. Although the Commission has adopted “M-WRAM” or, what Cal Advocates now
7 calls “CART”⁴⁴ in the most recent Class A rate cases,⁴⁵ these measures are not sufficient to
8 respond to the volatility of weather conditions because they do not sever the “throughput”
9 incentive. As Cal Advocates correctly explains, the “M-WRAM allows the utility to recover the
10 revenue difference between what it actually recovered under a conservation rate design, such as
11 tiered rate structure, and what it would have recovered under a single quantity rate.”⁴⁶ This is
12 not a decoupling mechanism—it just substitutes one set of volumetric rates for another, without
13 reducing the incentive to encourage consumption. Therefore, the M-WRAM is not tailored to
14 promote conservation and it likewise provides insufficient protection against revenue shortfalls
15 where actual conditions fail to match forecasts through the traditional rate-of-return model.

16 **Q. WHY IS IT IMPORTANT FOR UTILITIES TO MAINTAIN FINANCIAL**
17 **HEALTH IN A DECLINING USAGE ENVIRONMENT?**
18

19 A. Water utilities must be as concerned about revenue flows as they are about water flows.
20 Without financial viability, a water utility cannot meet its mission of delivering safe and reliable
21 water cost-effectively. As the Alliance for Water Efficiency pointed out in its report *Building*
22 *Better Water Rates for an Uncertain World*, utilities must generate sufficient revenue to provide
23 safe and affordable water services to customers while also covering the costs of providing that

⁴⁴ “CPAM” appears to stand for the “Conservation Pricing Adjustment Mechanism,” but Cal Advocates also uses the term “Conservation Adjustment for Rate Tiers,” or “CART.” See *Ronco Testimony* at 3-1, 3-4.

⁴⁵ See D.24-12-025 at 40-43; D.25-01-036 at 70-74. The term “M-WRAM” stands for “Monterey-Style Water Revenue Adjustment Mechanism,” referring to the origins of this alternative true-up mechanism in Monterey, California.

⁴⁶ *Ronco Testimony* at 3-2 to 3-3.

1 water service.⁴⁷ At a minimum, utility rates should be sufficient to generate revenue to support
2 operations, maintain and develop infrastructure, and preserve the financial integrity of systems.

3 The financial health of a utility is also important so that it can attract capital and maintain
4 financial health. Private capital and commercial finance play an important role to bridge the
5 financing gap in the water sector discussed previously, but capital attraction is a very competitive
6 business. From the investors' point of view, a main criterion is the creditworthiness of the
7 borrower, which depends on the ability to recover costs and to service their debt obligations. It
8 is therefore essential for utilities to maintain a predictable revenue stream.⁴⁸ Thus, ideally, utility
9 revenue should be maintained at a level that will continue to attract capital while also allowing
10 the utility to promote conservation.

11 This is particularly important in the water sector because water utilities require more
12 capital invested per dollar of revenue than any other regulated industry. To complicate the
13 economics further, thus making it more difficult to attract capital, the water industry has the
14 lowest depreciation rates. These characteristics negatively influence the industry's ability to
15 attract capital because low depreciation rates and long recovery periods are viewed negatively by
16 capital market analysts.

17 If utilities do not generate sufficient revenue because of declining usage or other
18 unanticipated factors, some utilities may elect to postpone repairs, replacements, and
19 rehabilitation expenditures to keep current operating costs and corresponding service charges as
20 low as possible. This approach is particularly enticing in today's environment where operation

⁴⁷https://allianceforwaterefficiency.org/wp-content/uploads/2014/08/AWE_Building-Better-Water-Rates-Uncertain-World_Final.pdf at 11.

⁴⁸ *Financing a Water Secure Future*, OECD at 15, available here:
https://www.oecd.org/content/dam/oecd/en/publications/reports/2022/03/financing-a-water-secure-future_27cd3a4c/a2ecb261-en.pdf.

1 and maintenance (“O&M”) costs for water utilities are growing and outpacing available
2 funding.⁴⁹ Water utilities only have limited resources and must prioritize certain improvements
3 and de-prioritize others based on available resources. As such, it may take a water system longer
4 to make necessary improvements if the company has declining usage resulting from
5 conservation, while continuing to experience the same demands to replace and maintain
6 infrastructure. However, deferring capital expenditures invariably results in higher operating
7 costs in the short run and higher construction costs in the long run, ultimately necessitating
8 higher rates for customers. And if these critical infrastructure investments are deferred
9 indefinitely, this results in unreliable and unsafe drinking water.

10 Thus, it is essential for water utilities to remain financially healthy to continue to have
11 sufficient capital to invest in their systems. A safe and reliable water system is a system that
12 benefits customers. The American Society of Civil Engineers has found that more reliable water
13 services would help U.S. households avoid up to \$7.7 billion in cumulative medical costs over 20
14 years, \$2.6 trillion in cumulative losses incurred from service disruptions and overflows, and
15 \$1.4 trillion in cumulative disposable income loss.⁵⁰

16 **III. RECOGNITION OF ONGOING CONSTRUCTION PROJECTS IN**
17 **RATEMAKING METRICS.**

18 **Q. WHAT IS YOUR UNDERSTANDING OF CAL ADVOCATES’ POSITION**
19 **REGARDING THE TREATMENT OF CAL WATER’S PROJECTS THAT ARE**
20 **IN PROGRESS BUT NOT COMPLETED DURING THE TEST YEAR?**
21

22 A. Cal Advocates proposes to reject Cal Water’s use of AFUDC, and opposes the inclusion
23 of ongoing projects in rate base through a CWIP component.⁵¹ Instead, Cal Advocates proposes

⁴⁹ *The Economic Benefits of Investing in Water Infrastructure: How a Failure to Act Would Affect the US Economic Recovery*, American Society of Civil Engineers, available here:
https://uswateralliance.org/wp-content/uploads/2023/09/VOW-Economic-Paper_1.pdf.

⁵⁰ *Id.* at 30.

⁵¹ See *Sharma Testimony* at 7-2, 7-3, 7-9 to 7-16.

1 to utilize an “Interest During Construction” or “IDC” rate, which provides only a return on the
2 “current cost of short-term debt” for ongoing projects. This approach is inconsistent with the
3 two well-settled and widely used approaches of either AFUDC or CWIP. Creating a new
4 approach solely for Cal Water seems unnecessarily complicated and risky. Not to mention Cal
5 Advocates approach fails to recognize the practical reality of utility construction and provides
6 incomplete compensation for the financial impacts of work that is necessary to support Cal
7 Water’s system but which is not fully completed at the end of the test year.

8 **Q. HOW DO OTHER STATES APPROACH THIS ISSUE?**

9 Historically, regulators have generally excluded construction projects from rate base,
10 citing the “used and useful” rule to require that the plant must be online and in service (or very
11 soon to be) before inclusion in rate base. Since interest and dividends must be paid during
12 construction, whether funded by ratepayers or not, these costs are refinanced. The utility borrows
13 more money and/or sells more stock to pay interest on previously incurred debt and dividends on
14 outstanding stock. Therefore, the utility must not only pay the cost of purchasing and installing
15 the bricks and mortar comprising the plant but must also pay capital costs.

16 Recognizing, however, that the construction financing is a real and unavoidable cash
17 expense, regulators have established an accounting category called AFUDC that is designed to
18 reflect these financing costs on a deferred basis. Thus, today, regulators in most states allow
19 utilities to capitalize AFUDC for future recovery. This is considered critical for utilities because
20 their business is capital-intensive, and it often takes lots of money and time to build large
21 facilities. Since typical utility regulation does not allow the utility to put the cost of a new facility
22 into rates until it is in service, AFUDC offers a way for the utility to recover its pre-operational
23 financing costs.

1 The delay in recovery of costs and capital expenditures can cause significant pressure on
2 the utility's financial metrics, including its credit metrics and rating. If the key issue causing a
3 delay in recovery is infrastructure investments, the inclusion of CWIP in the rate base, which
4 allows for a return on these funds while construction is ongoing, can complement a future test
5 year. When utilities are involved in construction of large projects, large balances in CWIP
6 accounts can result in serious cash flow issues and including CWIP in rate base provides the
7 regulated utility with a return on a portion of its investment during the construction period
8 helping ease this financial strain.

9 Both AFUDC and CWIP are well-settled and widely used ratemaking tools implemented
10 by state commissions across the country.⁵² AFUDC and CWIP are best practices in the utility
11 sector and part of the guidelines in Federal Energy Regulatory Commission's Uniform System of
12 Accounts (FERC USOA).⁵³ Thus, Cal Advocates suggestion to deviate from one of these proven
13 regulatory practices seems unnecessary and unduly complicated.

14 **Q. WHY IS CAL ADVOCATES' "IDC" APPROACH INSUFFICIENT?**

15 A. The "IDC" percentage is computed using short-term debt rates, without considering the
16 full return that a utility would need to derive on its investments to reflect the risks of tying up
17 capital in long-term water system improvement projects. The rate base determinations in this
18 rate case will impact rates for several years beyond the test year, and, in any given year, some
19 projects will necessarily be "in progress." As time goes on, those projects will be completed and

⁵² The following states permit CWIP for all utilities: Oregon, New Mexico, Iowa, Arizona, Florida, Wisconsin, Illinois, Indiana, Ohio, Kentucky, Tennessee, North Carolina, South Carolina, West Virginia, Pennsylvania, and Delaware. The following states permit CWIP for electric and gas utilities: Vermont, Mississippi, Alabama, Oklahoma, Colorado, Nebraska, Wyoming, North Dakota, Utah (note that a majority of these states have very few investor-owned water utilities). The following states permit CWIP for only water utilities: Texas, New York, and New Jersey.

⁵³ <https://www.ecfr.gov/current/title-18/chapter-I/subchapter-B/part-35/subpart-B/section-35.13>
<https://www.ecfr.gov/current/title-18/chapter-I/subchapter-B/part-35/subpart-C/section-35.25>

1 put in service, but absent the application of AFUDC (or, in the alternative, the inclusion of those
2 investments in rate base through a CWIP component), a portion of the utility's reasonable
3 investments will not generate a reasonable rate of return. While Cal Advocates claims that no
4 profit should be included on these investments until they are completed, there is no analytical
5 reason to treat them differently than projects that are closed and in service. In both cases, the
6 utility has tied up capital that is being used to support the water system, and that reality should be
7 reflected in the revenue requirement.

8 **Q. DO YOU AGREE WITH CAL ADVOCATES' ANALOGIES TO THE**
9 **DYNAMICS OF COMPETITIVE MARKETS IN DISCUSSING ITS "IDC"**
10 **PROPOSAL?**

11 A. No. As I mentioned in my discussion of decoupling, references to competitive market
12 dynamics are misplaced in the context of a utility that cannot change its rates except upon
13 Commission approval through the rate case process. Cal Advocates asserts that "[i]n a
14 competitive environment, a business would generally be unable to collect profit on a capital
15 investment that provides no service to customers."⁵⁴ This invocation of competitive market
16 dynamics overlooks the reality that non-regulated competitive businesses are not subject to rate-
17 of-return regulation, and their projects are not specifically linked to returns on capital
18 investments. By contrast, regulated water utilities' profitability is linked to returns on
19 investment by virtue of their regulatory status. Cal Advocates' analogy to a hotel deriving
20 "profit while it is under construction" is also inapt because Cal Water's construction projects do
21 not involve the creation of entirely new water systems—they are improvements to a longstanding
22 water system that has been in place for many years. In that sense, the proper analogy would be
23 to a hotel that already exists and which is adding a new "wing." A hotel in that situation would

⁵⁴ See *Sharma Testimony* at 7-7.

1 absolutely have the opportunity to adjust its rates to reflect the financial impact of the ongoing
2 construction. Again, Cal Water cannot take such steps without Commission approval, but for
3 Cal Water to parallel the more accurate hotel expansion example, some recognition in revenue
4 requirement must be made for the ongoing capital investments, even if projects do not happen to
5 be completed by the last date of a test year.

6 The future viability of the water industry needs effective and efficient regulatory policy
7 that put private capital to work meeting a substantial share of the future infrastructure needs. The
8 cost of the large future infrastructure investments will be viewed by financial markets in terms of
9 their risk. The level of risk depends, in large part, on whether regulators allow recovery of the
10 costs of prudent investments once they are incurred. AFUDC and CWIP are two well tested
11 policies that allow facilitate this, to the benefit of both the customer and the utility.

12 **IV. CONCLUSION.**

13 **Q. WOULD YOU PLEASE SUMMARIZE YOUR TESTIMONY?**

14 A. Decoupling is a prevailing best practice and aligns with California's urgent need to
15 respond to volatile weather patterns, climate change, and drought conditions. Cal Water has
16 made a reasonable decoupling proposal and its should be adopted. Likewise, Cal Water's
17 AFUDC proposal is reasonable because it appropriately reflects the impacts of capital
18 investments on projects that are in progress from year to year.

19 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

20 A. Yes. I reserve the right to file additional testimony as allowed and circumstances
21 warrant.

Exhibit 1

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Overview

Norman concentrates in the areas of utilities, telecommunications, water/waste water, energy and administrative litigation.

Immediately prior to joining the firm, Norman served as a Commissioner at the Pennsylvania Public Utility Commission. During his time at the agency (2014-2019), he played key roles in many important cases, including the licensure of Uber and Lyft; the Commission's response to the disruptive 2014 Polar Vortex, natural gas pipeline construction, electric transmission siting, deregulation of local telephone service, the PUC's assertion of jurisdiction over pole attachments and the acquisition of municipal water and wastewater companies.

Norm's long career in private practice encompasses thirty plus years (1983-2014, 2019- present) has been extremely diverse, affording him unique, multifaceted perspectives on the issues. He has covered consumer and utility issues in the gas, water, electric, water/wastewater and telephone sectors. He has experience across all regulated industries, in multiple forums, state and federal, regulatory and legislative, as well as litigation and appellate representation. His clients have ranged from rural electric companies to local exchange telephone companies to industrial customers to electric generators to natural gas producers to gas distribution companies to national trucking companies. During this time, he was heavily involved in shaping the successful implementation of the Pennsylvania natural gas transportation reforms (the precursor to the Natural Gas Choice Act), the Chapter 30 broadband infrastructure renewal legislation, and the negotiation of Public Utility Regulatory Policies Act and power generation contracts.

Norm began his career in public service, litigating public utility issues on behalf of consumers at the Pennsylvania Office of Consumer Advocate (1979-1981).

Interests

- USCG Licensed Captain. Extensive blue water boat delivery to Caribbean. Owner of S/V Elysium in Annapolis MD.
- Other interests include reading history, world travel, and wine collection.
- Married to Anne Kennard for 30 years with two adult daughters, Lauren and Sara.

Practice Groups

Utilities

Water/Wastewater

Energy

Telecommunications

Education

J.D., New Hampshire School of Law, 1979

B.A., Hartwick College, 1974

State Bar Admissions

Pennsylvania and Ohio

Professional Affiliations

PA Bar Association, Public Utility Practice Section

Publications

- *A Guide to Public Utility Ratemaking*, February 2018, Co-author, Copyright PAPUC, http://www.puc.pa.gov/General/publications_reports/pdf/Ratemaking_Guide2018.pdf
- *Distributed Energy Resources Rate Design and Compensation*, November 2016, Contributing Editor, Copyright NARUC, <https://www.naruc.org/rate-design/>

Recent Speaking Engagements

- PA Chamber Energy and Environmental Forum, Speaker, May 23, 2018.
- Pennsylvania Telephone Association, Speaker, “Perspectives from the PUC,” July 10, 2018.
- PUC CLE, Presenter, “Practicing Before the PUC”, July 23, 2018.
- PA House Broadband Committee, Testimony, September 25, 2018.
- NAWC Annual Meeting, Panelist on Water Valuation Issues, San Antonio, TX, October 2018.
- NARUC Winter Meeting 2019, Moderator of Water/Wastewater Fair Value Panel, Washington, DC, February 2019.
- NARUC Utility Rate School, Presenter, “Legal Arts,” San Diego, CA, May, 2019.
- PA Senate Technology Committee, Testimony on Broadband Deployment Challenges, August 7, 2019.