Decision 09-07-051 July 30, 2009

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of California Water Service Company (U60W) for Authority to Establish its authorized Cost of Capital for the period from January 1, 2009 through December 31, 2011.	Application 08-05-002 (Filed May 1, 2008)
And Related Matters.	Application 08-05-003 Application 08-05-004

(See Attachment B for List of Appearances.)

DECISION ADOPTING A SETTLEMENT ON AN ADJUSTMENT MECHANISM TO THE BASE YEAR 2009 COST OF CAPITAL FOR THE THREE LARGE MULTI-DISTRICT CLASS A WATER UTILITIES: CALIFORNIA WATER SERVICE COMPANY, CALIFORNIA AMERICAN WATER COMPANY, AND GOLDEN STATE WATER COMPANY

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1. Summary

This decision adopts a settlement for a subsequent years' adjustment mechanism to the base year 2009 ratemaking return on common equity for California Water Service Company, California American Water Company, and Golden State Water Company. The Commission adopted a 2009 base year cost of capital for each of the three companies in a separate phase 1 decision. In this Phase 2 decision, we also review the impact of the financial market dislocation on the 2009 base year return on equity following the February 13, 2009 evidentiary hearing and determine there are no further actions necessary at this time.

2. Water Cost of Capital Adjustment Mechanism Settlement

2.1. Summary

The applicants, California Water Service Company (California Water), California American Water Company (California American) and Golden State Water Company (Golden State), as well as the Division of Ratepayer Advocates (DRA), were advised in the scoping memo that any proposed adjustment mechanism for subsequent years to the base year's return on equity would be considered but that any proposal must be directly compared to the mechanism adopted for the major energy utilities in Decision (D.) 08-05-035.[1] Parties settled before serving any testimony and therefore there is only one proposal before the Commission. Parties made the required comparison and the proposed mechanism here is consistent with the energy mechanism. We find, as discussed below, that the mechanism is reasonable in light of the whole record, consistent with law, and in the public interest.

2.2. Proposed Settlement

The parties provided the following summary[2] describing the settlement (attached as Attachment A):

> The proposed Water Cost of Capital Mechanism provides for an automatic adjustment, up or down as the case may be, to a water utility's adopted return on equity … for 2009 (and thus, its overall rate of return on rate base for 2009) for years 2010 and 2011 only if there is a positive or negative difference of more than 100 basis points between the then current 12-month October 1 through September 30 average Moody's utility bond rates and a benchmark. For purposes of the Settlement Agreement, the initial benchmark is equal to the average interest rate of Moody's Aa utility bonds for AA or A credit-rated utilities or higher and Moody's Baa utility bonds for BBB+ credit rated utilities or lower for the period October 1, 2007 to September 30, 2008. The subsequent October 1 through September 30 average also would be based on the foregoing parameters. If the 100 basis point "deadband" is exceeded, a utility's [return on equity] will be adjusted by one-half of the difference between the benchmark and the October 1 to September 30 average. In any year where the 12-month October through September average of Moody's utility bond rates triggers an automatic [return on equity] adjustment, that average becomes the new benchmark. Appendix A to the Settlement Agreement

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[1] Scoping memo at 6–7.

[2] February 27, 2009 Motion, at 3–4.

provides three examples that illustrate how the Water Cost of Capital Mechanism would or would not change a utility's [return on equity] based on three different scenarios.

If the 100 basis point "deadband" is exceeded, an affected utility will be required to file a Tier 2 advice letter by October 15 that updates its [return on equity] and related rate adjustments to become effective on January 1 of the following year. The advice letter would also update the utility's long-term debt and preferred stock costs to reflect actual August month-end embedded costs in that year and forecasted interest rates for variable long-term debt and new long-term debt and preferred stock scheduled to be issued.[3] However, a utility's capital structure, as adopted for base year 2009, shall not be adjusted. Workpapers outlining the calculations relating to the change in [return on equity], long-term debt costs, preferred stock costs and resulting changes in rates to become effective on the following January 1 are required to accompany the advice letter.

Finally, the Settling Parties have agreed that the Water Cost of Capital Mechanism shall be applicable to [California Water Service Company], California American Water and Golden State for the years 2010 and 2011. While the Settling Parties agree that the Settlement Agreement in these consolidated cost of capital proceedings does not bind the Commission in future cost of capital proceedings, they agree that in such future proceedings a similar adjustment to the cost of capital should be made for the two years following adoption of a base year cost of capital, assuming that the 100 basis point deadband is exceeded. The Settling Parties also agree that the concept of the Water Cost of Capital Mechanism provided for in the Settlement Agreement should be available to the four other Class A water utility members of [California Water

[3] The proposed settlement does not specific a uniform and reliable source for interest rate forecasts. The Commission frequently relies on forecasts prepared and published by HIS Global Insight. We will therefore require the utilities to meet and confer with DRA and agree upon a standard forecast resource to be used by all companies in their filings.

Association] in their cost of capital proceedings commencing May 1, 2009.

The settling parties met the requirement to compare any proposal with the energy industry's mechanism and reported, in fact, that the two mechanisms, with some adaptation, do not materially differ:

> The Settling Parties modeled the Water Cost of Capital Mechanism after the "Cost of Capital Mechanism" adopted by the Commission for the three large energy utilities (Pacific Gas and Electric Company, Southern California Edison Company, and San Diego Gas & Electric Company) in Decision No. 08-05-035. The energy utilities' Cost of Capital Mechanism provides for automatic adjustments to an energy utility's [return on equity] for the two years following adoption of a base year cost of capital. The adjustment is based on changes to the average Moody's Aa utility bonds over a specified 12-month period, and a deadband (a range of change in interest rates that may occur without triggering a change in [return on equity]) of 100 basis points applies. With minor changes to the energy utilities' Cost of Capital Mechanism – relating to the credit rating levels of the utilities whose bonds will be used as a benchmark – the Settling Parties agreed that the Water Cost of Capital Mechanism should mirror the energy utilities' Cost of Capital Mechanism. (Motion at 4 – 5.)

2.3. Settlement Rules

Rule 12.1,[4] provides in pertinent part:

> (Rule 12.1) Proposal of Settlement
>
> (a) Parties may … propose settlements on the resolution of any material issue of law or fact or on a mutually agreeable outcome to the proceeding. Settlements need

[4] All referenced Rules are the Commission's Rules of Practice and Procedure. (http://docs.cpuc.ca.gov/published/RULES_PRAC_PROC/70731.htm)

> not be joined by all parties; however, settlements in applications must be signed by the applicant. ...
>
> The motion shall contain a statement of the factual and legal considerations adequate to advise the Commission of the scope of the settlement and of the grounds on which adoption is urged. Resolution shall be limited to the issues in that proceeding and shall not extend to substantive issues which may come before the Commission in other or future proceedings. …
>
> (b) Prior to signing any settlement, the settling parties shall convene at least one conference with notice and opportunity to participate provided to all parties for the purpose of discussing settlements in the proceeding. …
>
> (c) Settlements should ordinarily not include deadlines for Commission approval…
>
> (d) The Commission will not approve settlements, whether contested or uncontested, unless the settlement is reasonable in light of the whole record, consistent with law, and in the public interest.

In short, we must find whether the settlement comports with Rule 12.1(d), which requires a settlement to be "reasonable in light of the whole record, consistent with law, and in the public interest." We address below whether the settlement meets these three requirements.

2.4. Satisfying the Settlement Rules

As interpreted below to be consistent with the law, we find the settlement to be reasonable in light of the whole record, consistent with law, and in the public interest

2.4.1. Reasonable in Light of the Whole Record

The record consists of the proposed settlement and the motion for its adoption. We find the proposed settlement and its hypothetical examples to be sufficiently detailed to clearly describe the mechanism and its ratesetting implications. The proposal clearly intends to adapt the energy utility mechanism to the water utilities by using appropriate indices to reflect the bond ratings of the individual water company or its parent company if the cost of borrowing relies on the parent's bond rating. Because it is a joint proposal where all parties attest by their signature that they developed and agreed to the proposal, we find it reasonable in light of the whole record.

2.4.2. Consistent With Law

The parties to the settlement are California Water, California American, Golden State, DRA and the California Water Association (Association). As noted in the motion, the Association's primary interest is that other Class A water companies may wish to have a similar mechanism when the Commission next determines their cost of capital. No settlement is binding on other parties or precedent for other proceedings (Rule 12.5), and we therefore leave to the subsequent proceeding for any other Class A companies the question of whether to adopt some form of this Water Cost of Capital Mechanism. The Association's support of the mechanism in this proceeding does mean that it is an unopposed all-party settlement. Our adoption of the Water Cost of Capital Mechanism in this decision no way presumes its adoption for any other company in a subsequent proceeding.

We note that the settlement states:

> While this Settlement does not bind the Commission in future proceedings, the Parties agree that <u>a similar adjustment to the cost of capital should be made</u> following the adoption of a base year cost of capital in subsequent cost of capital proceedings … (Settlement Agreement at 3, Emphasis added.)

We want to be clear and therefore we interpret this language as an agreement among the settling parties to propose a similar mechanism in subsequent cost of capital proceedings. It does not conflict with Rules 12.1 or 12.5 because it does not resolve the issue nor establish a precedent for future proceedings. With this interpretation, we find the proposed settlement is consistent with the law.

2.4.3. In the Public Interest

We find the settlement is in the public interest because it provides a synchronized means to adjust the return on equity to reflect significant changes in interest rates. This tends to preserve the marginal premium allowed on the return on equity (i.e., the extra amount of return) paid to equity investors compared to the interest paid to lenders as interest rates fluctuate up or down.

3. 2008 Financial Markets Dislocation

The financial markets in the United States suffered a significant and devastating upheaval beginning in late 2008 in large part due to the home mortgage lending market dislocation and other credit market problems which directly led to the failures or mergers of many long-standing financial institutions. Additionally, there has been the federal government's massive intervention: the "Emergency Economic Stabilization Act of 2008,'' H.R. 1424 (Public Law 110-343), with a stated purpose, amongst others, "to immediately provide authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States."[5] This

[5] http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h1424enr.txt.pdf

See Section 2(1); and also:

SEC. 101. PURCHASES OF TROUBLED ASSETS. (a) Offices; Authority
(1) AUTHORITY- The Secretary is authorized to establish the Troubled Asset Relief

Footnote continued on next page

followed closely on the heels of the "Housing and Economic Recovery Act of 2008" HR 3221 (Public Law 110-289).[6] The world-wide financial markets have all suffered massive losses and turmoil: it is not simply an American or Californian problem and economic recovery will not be instantaneous. We are seeing further actions now by the new President's administration early in base year 2009, including the "American Recovery and Reinvestment Act of 2009" (Public Law 111-5).[7] This act was intended to make "supplemental appropriations for job preservation and creation, infrastructure investment, energy efficiency and science, assistance to the unemployed, and State and local fiscal stabilization, for the fiscal year ending September 30, 2009, and for other purposes."

On December 17, 2008 the assigned Commissioner and Administrative Law Judge (ALJ) issued a ruling inviting the parties to offer testimony on the impacts of the financial market dislocation to the water companies, "to explore whether or not the Commission needs to take any action to enhance or ensure the water utilities' ability to attract and retain debt and equity capital sufficient to ensure safe and reliable utility service in light of activity in the financial market after completion of the Phase 1 hearings." (Ruling at 1.) Additionally, the Division of Water and Audits facilitated the appearance of an independent

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Program (or 'TARP') to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary.

[6] http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_public_laws&docid=f:publ289.110.pdf

[7] http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1enr.txt.pdf

witness. We will discuss the testimony of the three witnesses below. The ruling included this directive:

> **Specific Guidance Regarding Testimony on Financial Market Upheaval**:
>
> [W]e are primarily concerned with the ability of the utilities to attract and retain debt and equity capital sufficient to ensure safe and reliable utility service. We are also concerned with the question of whether our traditional cost of capital mechanism, including the consideration of various cost of capital models and related analysis are adequate during this period of financial instability, volatility and uncertainty and what, if any, adjustments should be made to cost of capital determinations based on traditional analyses. Finally, we wish to hear what if any specific measures should be considered as a part of our regulatory oversight for 2009 through 2011. (Ruling at 4.)

3.1. Summary of Findings

Based on the testimony and the argument in briefs by the parties we find that the 2009 base year cost of capital, specifically the return on equity component, is adequate without further adjustment (either higher or lower) to provide the applicants the ability to attract and retain debt and equity capital sufficient to ensure safe and reliable utility service in 2009. Elsewhere in Phase 1 we adopted a Temporary Interest Rate Balancing Account for 2009, 2010 and 2011, and in this decision we adopt the settlement agreement for a Water Cost of Capital Mechanism that provides a mechanism for an adjustment to the return on equity in 2010 and 2011 under specific circumstances. We find that there is nothing more we should do to address the financial market dislocation at this time.

3.2. Testimony

Three witnesses appeared as a panel on February 13, 2009. They were cross-examined by all active parties and also examined by the assigned

Commissioner and assigned ALJ. Following the hearing parties filed comments and replies. The Commission's Division of Water and Audits arranged for the appearance of Debra G. Coy, Senior Analyst, Water Sector, with Janney Montgomery Scott LLC; the applicants jointly sponsored[8] Susan D. Abbott, an independent consultant formerly with Moody's Investors' Service as Managing Director of the Power and Project Finance Group; and DRA sponsored J. Randall Woolridge, Professor of Finance and the Goldman, Sachs & Co. and Frank P. Smeal Endowed University Fellow in Business Administration at the University Park Campus of the Pennsylvania State University. Coy's business expertise is primarily as an equity (stock) analyst; Abbott's expertise is primarily as a bond (debt) analyst; and Woolridge's expertise includes utility cost of capital. Woolridge testified on behalf of DRA in Phase 1 addressing the base year 2009 cost of capital. Coy and Abbott did not appear in Phase 1.

3.2.1. Debra Coy

Coy made this point in testimony regarding the water utilities generally compared to other companies in 2008:

> The water utility stocks held up better than the overall markets in 2008 – down about 15% as a group, compared to a nearly 40% decline for the S&P 500. However, this decline has come during largely stable earnings, as water utilities are not as vulnerable to economic downturn as many other sectors of the economy. New customer growth has been curtailed, however, due to housing market declines, and there has been some decline in industrial water use. Generally speaking, the core residential revenue base has remained stable.

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[8] The applicants sponsored a single witness at the request of the assigned Commissioner and ALJ in the December 17, 2008 ruling.

And further:

> Given their defensive profile, water utility stocks should be attractive investments during a period of market turmoil. (Ex. SP-2 at 1.)

Additionally, Coy testified that water utilities, like everyone else, would find it a hard market to entice reluctant investors to convert their cash to investments in equity. Coy argues generically that water companies face large capital financing requirements (the utility plant growth on average exceeds the cash flow from depreciation and amortization) (Ex. SP-2 at 4), and therefore, companies are dependent on earning a reliable return on equity to attract capital. She concludes that regulators should recognize that the percentage of stock held by long-term investors who "buy and hold" has declined for water companies from around 70% – 80% to 55% - 60% and that utility regulators need to provide "additional incentives" to attract investors. (Ex. SP-2 at 7.)

3.2.2. Susan Abbott

Abbott's testimony focused on the immediate market problems with raising debt capital and the very tight market conditions for commercial paper (the archetypal short-term borrowing instruments for utilities financing balancing account under-collections and bridging financing between long-term debt and equity issuances). Although sponsored by all three applicants, Abbott did not cite to any specific instance where California Water, California American, or Golden State was specifically unable to borrow. Abbott's primary conclusion is:

> [the financial market's dislocation led to] dramatic increase in the cost of debt capital for all utilities, and especially for the smaller water utilities; the inability to issue equity in the face of a market that changes dramatically every day and therefore requires unacceptable discounts in new share prices to compensate for the

> uncertainty; and a commercial paper market that is too frequently closed to many issuers. Most importantly, the increased cost and decreased availability of debt leads to an increase in the cost of equity. (Ex. SP-1 at 2.)

Abbott therefore argues the return on equity needs to continue to be significantly above the cost of debt.

3.2.3. Randall Woolridge

Woolridge addressed the reactions of the federal government to the financial market dislocation and analyzed the impact on the stock prices of the proxy group of 10 water companies[9] used in the Phase 1 cost of capital analysis

[9] American States Water Company (parent of Golden State), Acqua America Water Company, Connecticut Water Service, Middlesex Water, San Jose Water Corp., California Water Service group, Southwest Water Company, York Water Company, Artesian Water Company, and Pennichuck Corp.

compared to the Standard & Poor's (S&P) 500.[10] Woolridge made several specific findings, the most relevant of which were:

> [T]he parent companies of the three large California water companies – California American Water Company (CAWC), California Water Service Company (CWSC), and Golden State Water Company (GSWC), have raised capital and seen their stocks, like the stocks of all water companies, perform significantly better than the overall stock market. (Ex. SP-2 at 1-2.)

Additionally:

> [Woolridge] compared the average stock price performance of [the water proxy] group relative to the price performance of the S&P 500 from July 1, 2008 until January 1, 2009. The results are provided in Exhibit JRW-5 [attachment to Ex. SP-2] ... Over the last six months of 2008, the S&P 500 declined 30.89% while the water utility stocks have increased 7.82% since July 1, 2008. In addition, during the months of September and October when the S&P 500 decreased 24.7%, the water stocks decreased only 8.3%. Moreover, over the past year, the S&P 500 was over three times as risky as the water utility stocks as measured by the coefficient of variation. As such, this evidence suggests that water utility stocks have been much less risky and have held up extremely well in the current conditions compared to the overall market. (Ex. SP-2 at 8.)

Woolridge was the only witness with specific numerical, analytical support for his conclusions. In addition to the water proxy group to S&P 500

[10] The S&P 500 is a value weighted index of the prices of 500 large capitalization common stocks actively traded in the United States. The stocks included in the S&P 500 are large publicly held companies that trade on either of the two largest American stock markets, the New York Stock Exchange and NASDAQ (National Association of Securities Dealers Automated Quotations).

comparison, Woolridge analyzed the relative volatility of the equity and debt markets (Ex. SP-2 at 6 – 7) and concluded that stock volatility had declined compared to bonds, indicating the markets had "settled somewhat compared the third quarter of 2008."

3.2.4. Commercial Paper

The applicants have used the financial market dislocation as a justification to argue for a higher regulated return on equity:

> In order for the Applicants to continue to attract the debt and equity capital necessary to fund their capital-intensive businesses, water utilities need to be able to offer investors higher returns on equity (ROE) to compensate investors for the increased risk they face during these turbulent times. (Golden State Opening Comments[11] at 2.)

Golden State alleges the applicants could not access the commercial paper market which was "closed" for a brief period.[12] However, Abbott testified that she was uncertain whether the applicants were specifically denied access or whether there was a general market dislocation:

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[11] All citations to Opening or Reply Comments refer to comments filed in response to the February 13, 2009 hearings on the financial markets dislocation issues. They are equivalent to briefs as filed in Phase 1. There are no other briefs in Phase 2 because the remaining issue was the subject of an all-party settlement.

[12] Commercial paper is a short-term negotiable instrument, usually an unsecured promissory note that calls for the payment of money at a specified date. Because it is not backed by collateral, commercial paper is usually issued by firms whose credit rating is so good that their notes are immediately accepted for trading. The notes are sold at a discount and mature in from three to six months. Commercial paper is an important source of cash for the issuing firm; it supplements bank loans and is usually payable at a lower rate of interest than the prime discount rate. The current commercial paper rate is the default interest rate used for all Commission authorized balancing and memorandum accounts.

> Q. To your knowledge, have any of the three Applicants actually been denied the ability to issue commercial paper in the last 12 months?
>
> A. I believe that I have been told that they have had difficulty accessing the commercial paper markets, yes.
>
> Q. Well, my question was denied the ability. Have they actually been unable to place commercial paper, to your knowledge?
>
> A. … I have been told that they have been unable to access the commercial paper [market].
>
> Further:
>
> Q. What conversation are you basing that on?
>
> A. Conversations I've had with the companies.
>
> Q. And they specifically indicated they were denied the ability to issue commercial paper?
>
> A. Yes.
>
> Q. Did they indicate to you whether that was directly attributable to the market generally or to them as an individual company?
>
> A. ... No, that was not indicated in the discussion about whether or not it was because the commercial paper market was closed[13] or because they were denied and somebody else was not. (TR at 442-443.)

We review this discussion on access to commercial paper for two reasons: first to consider any linkage between commercial paper access and the authorized return on equity and, second, to consider whether there is any action

[13] Note that earlier Abbott testified: "… the debt markets were frozen in September for eleven days …" (TR at 434.)

that the Commission could take which would facilitate current access to commercial paper.

The comments filed by Golden State are stated in the third-person that "utilities" were unable to access commercial paper and that "the world as water utilities knew it changed." (Golden State Opening Comments at 1.) We have no evidence that any one of the three companies was turned away at the teller's window and told "no money for you." A higher return on equity would not directly open that teller's window for commercial paper because the market itself was not functioning at that one point in time and not because of a question of the creditworthiness of the applicants.

California Water, California American, and Golden State recover the cost of commercial paper in the interest allowance for balancing accounts and do not depend on the cost of capital – which is applied to rate base – to fund the ratemaking recovery of commercial paper costs. The recovery of interest expense for balancing accounts provides a sound regulatory mechanism to assure lenders the company can repay commercial paper.[14]

We have no other testimony in the record to suggest that commercial paper supplants long term debt or equity. Further if it does, its market rate tends to be substantially below the long term debt costs and authorized return on equity. Again, we have no evidence that this traditional relationship does not still apply. We therefore find there are no necessary actions for the Commission to assist the utilities with access to commercial paper.

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[14] Utilities also have a separate allowance for working cash in rate base. Therefore, to the extent the applicants may use commercial paper to finance daily operations any related interest cost is recovered through the working cash allowance.

3.3. Discussion

The issue before us is whether we need to take any specific action now for California Water, California American, and Golden State. None of the applicants proposed any specific action by the Commission in this phase of the proceeding (apart from the Water Cost of Capital Mechanism settlement) although they argue in their briefs that the adopted Phase 1 return on equity is too low. DRA argued more directly that the water utilities were weathering the financial market dislocation better than the stock market as a whole, and therefore we should take no other actions now. Some time has now passed since the February 13, 2009 hearing and, even though the markets have begun to stabilize, the S&P 500 index has continued to rise and fall.

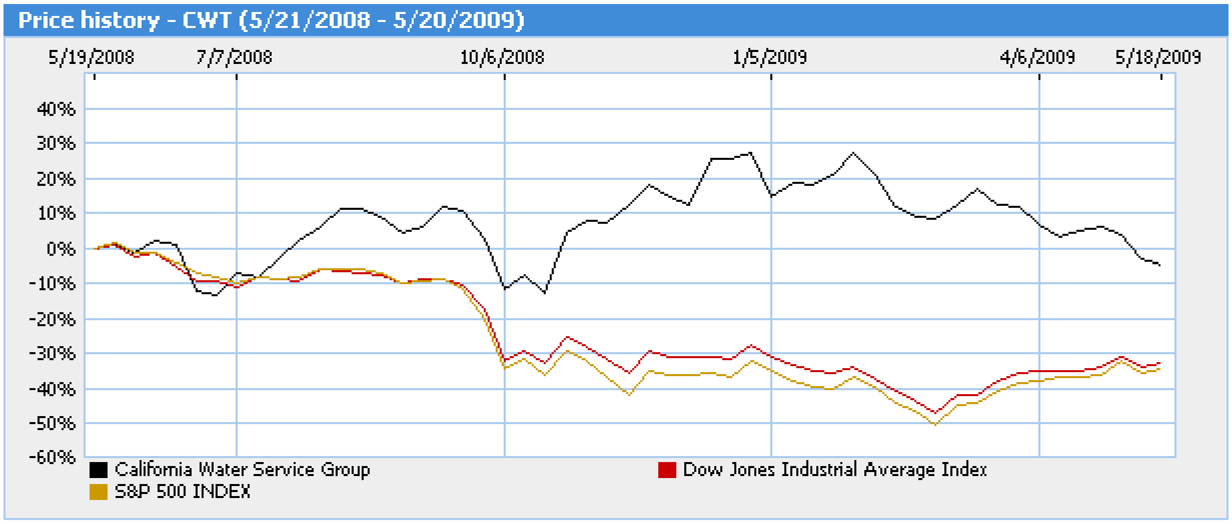
California Water's parent is publicly traded as California Water Service Group (Ticker ID CWT). The following publicly available chart shows CWT's recent trend compared to the Dow Jones Industrial Average[15] (Ticker ID DJI) and the Standard and Poor's 500[16] (S&P 500) Ticker ID GSPC). The chart shows that

[15] The DJI is one of several stock market indices, created by nineteenth-century Wall Street Journal editor and Dow Jones & Company co-founder Charles Dow. It is an index that shows how certain stocks have traded. Dow compiled the index to gauge the performance of the industrial sector of the American stock market. The average is computed from the stock prices of 30 of the largest and most widely held public companies in the United States. The "industrial" portion of the name is largely historical—many of the 30 modern components have little to do with traditional heavy industry. The average is price-weighted.

[16] The S&P 500 is a value weighted index published since 1957 of the prices of 500 large-capitalization common stocks actively traded in the United States. The stocks included in the S&P 500 are those of large publicly held companies that trade on either of the two largest American stock markets, the New York Stock Exchange and NASDAQ. Almost all of the stocks included in the index are among the 500 American stocks with the largest market capitalizations.

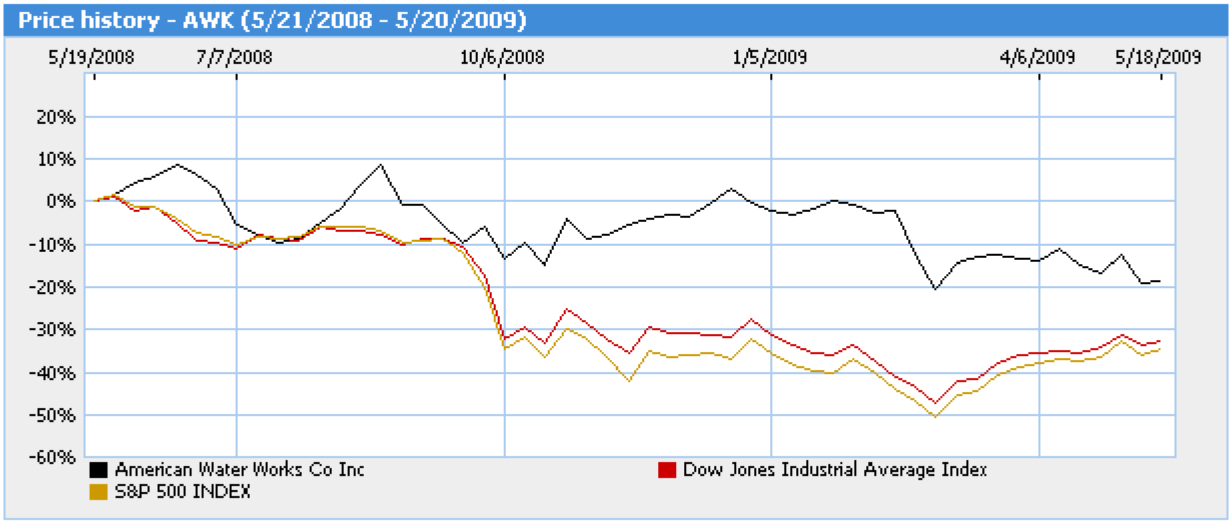
over a recent 12-month period, the market price for California Water Service Group suffered a significantly smaller loss in value. For example, by May of 2009 the chart shows that California Water Service Group had lost value only for short periods of time, whereas both the Dow Jones Industrial Average and the Standard and Poor's 500 had lost up to 50% of their value and by May 2009.has still lost over 30% in value.[17]

[17]http://moneycentral.msn.com/investor/charts/chartdl.aspx?D5=0&D4=1&ViewType=0&CE=0&ShowChtBt=Refresh+Chart&D3=0&Symbol=CWT&DateRangeForm=1&C9=0&DisplayForm=1&ComparisonsForm=1&CP=0&PT=7



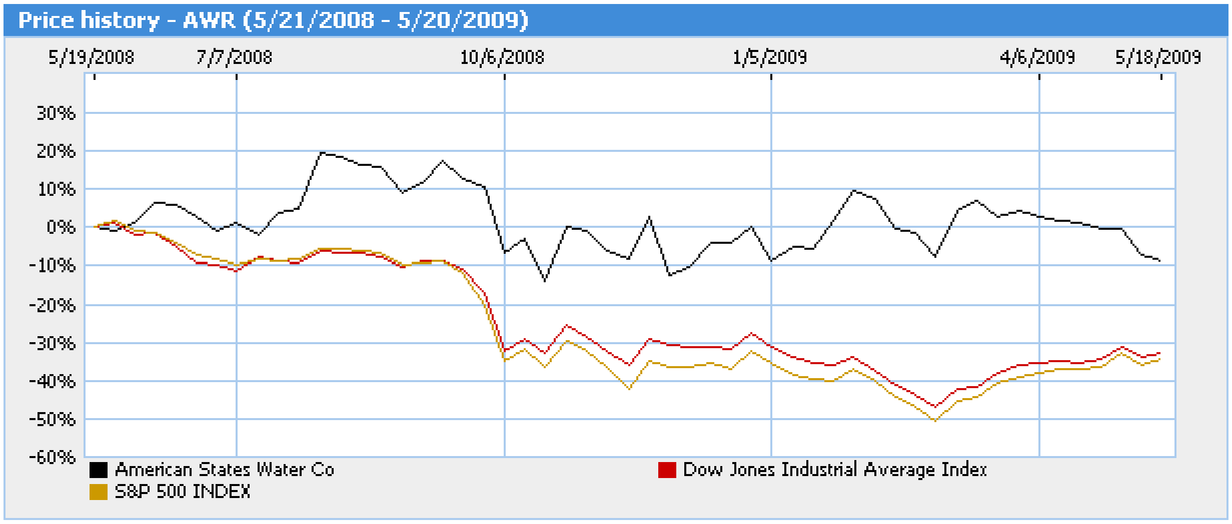
American Water Works Inc. (Ticker ID AWK) is the parent of California American and is publicly traded. The following chart shows AWK's recent trend compared to the Dow Jones Industrial Average and the Standard and Poor's 500. The chart shows that over approximately the past 12 months the market price for American Water Works Inc. suffered a significantly smaller loss in value. For example, in March of 2009 the chart shows that American Water Works Inc. had lost 20% in value whereas both the Dow Jones Industrial Average and the Standard and Poor's 500 lost approximately 50% in value. By May, American Water Works Inc, had still lost 20% while the two indices had recovered slightly but were still showing a loss of 305 in value.[18]

[18]http://moneycentral.msn.com/investor/charts/chartdl.aspx?D5=0&D4=1&ViewType=0&CE=0&ShowChtBt=Refresh+Chart&D3=0&Symbol=AWK&DateRangeForm=1&C9=0&DisplayForm=1&ComparisonsForm=1&CP=0&PT=7



American States Water Company (Ticker ID AWR) is the parent of Golden State and is publicly traded. The following chart shows its recent trend compared to the Dow Jones Industrial Average and the Standard and Poor's 500. The chart shows that over approximately the past 12 months the market price for American States Water Company suffered a significantly smaller loss in value. For example, in March of 2009 the chart shows that American States Water Company had lost about 20% in value whereas both the Dow Jones Industrial Average and the Standard and Poor's 500 lost approximately 50% in value. By May, American States Water Company was still down by 10% while the two indices had recovered slightly but were still showing a loss of 305 in value.[19]

[19]http://moneycentral.msn.com/investor/charts/chartdl.aspx?D5=0&D4=1&ViewType=0&CE=0&ShowChtBt=Refresh+Chart&D3=0&Symbol=AWR&DateRangeForm=1&C9=0&DisplayForm=1&ComparisonsForm=1&CP=0&PT=7



While it is clear that all three parent companies' stocks showed significant trading losses in market value, those losses were nowhere near the magnitude of the percentage losses experienced by the S&P 500 or the Dow Jones Industrial Average.

Based on the absence of any significant trends or other indicators that the currently authorized returns on equity for California Water, California American, and Golden State are causing financial harm, we find no need to modify our Phase 1 decision and no need for any further actions apart from adopting the Water Cost of Capital Mechanism elsewhere in this decision, as well as actions already taken to implement the revised rate case plan and the recent water action plan.

4. Comments on Proposed Decision

The ALJ's proposed decision on Phase 2 in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Timely comments were filed by DRA, there were no reply comments.

5. Assignment of Proceeding

John A. Bohn is the assigned Commissioner and Douglas M. Long is the assigned ALJ in this proceeding.

Findings of Fact

1. The record on the Water Cost of Capital Mechanism is composed of the joint motion for the adoption of the settlement and the settlement agreement.

2. There is a full and complete record for the financial markets dislocation that is composed of testimony, work papers, examination of witnesses, as well as full and complete opening and reply briefs.

Settlement

3. The parties to the settlement adopted in this decision had a sound and thorough understanding of the issue, and all of the underlying assumptions and data and could therefore make informed decisions in the settlement process.

4. The adopted settlement is among competent and well-prepared parties who were able to make informed choices in the settlement process.

5. The Water Cost of Capital Mechanism is consistent with the energy utility mechanism adopted in D.08-05-035.

6. We interpret the settlement as an agreement among the settling parties to propose a similar Water Cost of Capital Mechanism in subsequent cost of capital proceedings and that the settlement binds the parties but not the Commission in the future.

7. The settlement is silent on the source of interest rate forecasts to be used by the adjustment mechanism.

Financial Markets Dislocation

8. The impacts of the financial market dislocation on the applicants have on the whole been less severe than the impacts on the stock market as a whole.

9. There is no persuasive evidence that applicants cannot obtain commercial paper financing.

10. There is no persuasive evidence that the commercial paper rates are above the costs of long-term debt or equity.

Conclusions of Law

Settlement

1. Applicants alone bear the burden of proof to show that the proposed Water Cost of Capital Mechanism is reasonable.

2. The Water Cost of Capital Mechanism settlement is reasonable because it fairly balances intervenor and shareholder interests and provides a reasonable adjustment to the return on equity.

3. The Water Cost of Capital Mechanism uses a measurement adjusted to the water utilities and is therefore reasonably distinguished from the energy utility mechanism adopted in D.08-05-035.

4. The settlement is reasonable in light of the whole record.

5. The settlement, which we interpret to contain an agreement among the settling parties to propose a similar Water Cost of Capital Mechanism in subsequent cost of capital proceedings, is consistent with the law, and does not contravene or compromise any statutory provision or Commission decision.

6. The settlement is in the public interest.

7. Adoption of the settlement has no precedential status for other jurisdictional utilities or for subsequent applications by the applicants.

Financial Markets Dislocation

8. No action is required to address the financial market dislocation at this time.

Procedural

9. This order should be effective immediately.
10. This proceeding should be closed.

O R D E R

IT IS ORDERED that:

1. The settlement agreement (Attachment A) for California Water Service Company, California American Water Company, and Golden State Water Company with the Division of Ratepayer Advocates to implement the Water Cost of Capital Mechanism is adopted for calendar years 2010 and 2011. Within 14 days of the effective date of this decision, each company shall file a Tier 2 Advice Letter to include the mechanism in each company's preliminary statement, substantially as follows:

> The Water Cost of Capital Mechanism provides an automatic adjustment, up or down, to [utility's] adopted return on equity for 2009 (and thus, its overall rate of return on rate base for 2009) for calendar years 2010 and 2011 only if there is a positive or negative difference of more than 100 basis points between the then current 12-month October 1 through September 30 average Moody's utility bond rates and a benchmark. For 2010, [utility's] initial benchmark is equal to the average interest rate of Moody's Aa utility bonds if it has an AA or A credit-rating or higher, or Moody's Baa utility bonds if [utility] has a BBB+ credit rating or lower for the period October 1, 2007 to September 30, 2008. The subsequent October 1 through September 30 average shall be based on the foregoing parameters. If the 100 basis point "deadband" is exceeded, [utility's] return on equity will be adjusted by one-half of the difference between the benchmark and the October 1 to September 30 average. In any year where the 12-month October through September average of Moody's utility bond rates triggers an automatic return on equity adjustment, that average becomes the new benchmark.

> If the 100 basis point "deadband" is exceeded, [utility] will file a Tier 2 advice letter by October 15 that updates return on equity and related rate adjustments to become effective on January 1 of the following year. The advice letter would also update long-term debt and preferred stock costs to reflect actual August month-end embedded costs in that year and forecasted interest rates for variable long-term debt and new long-term debt and preferred stock scheduled to be issued. However, [utility's] capital structure, as adopted for base year 2009, shall not be adjusted. Workpapers outlining the calculations relating to the change in return on equity, long-term debt costs, preferred stock costs and resulting changes in rates to become effective on the following January 1 are required to accompany the advice letter.

2. California Water Service Company, California American Water Company, and Golden State Water Company shall meet and confer with the Division of Ratepayer Advocates on or before September 1, 2009, to agree upon a uniform source for interest rate forecasts.

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

This order is effective today.

Dated July 30, 2009, at San Francisco, California.

MICHAEL R. PEEVEY
President
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
TIMOTHY ALAN SIMON
Commissioners

ATTACHMENT B

************** **PARTIES** **************

APPENDIX A
************ **SERVICE LIST** ***********
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A0805002 LIST
A0805003/A0805004

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(End of Attachment B)