

Decision 08-05-036 May 29, 2008

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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

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

**DECISION DETERMINING CARRYING COSTS
FOR MEMORANDUM ACCOUNT**

1. Summary

This alternate proposed decision approves the authorized rate of return as the appropriate carrying cost for the amounts properly recorded in California-American Water Company's (Cal-Am) San Clemente Dam Memorandum Account.

2. Background

From 2003-2006, the amounts associated with the San Clemente Dam Seismic Safety Project were recorded in construction work in progress (CWIP) receiving the authorized rate of return.

In Ordering Paragraph 19 of Decision (D.) 06-11-050, the Commission directed Cal-Am to remove the San Clemente Dam retrofit project costs from rate base and place the amount in a memorandum account for later reasonableness review. When it became clear that this was no longer a short term project, the applicability of CWIP accounting became moot and therefore we removed the

dollars from rate base, transferred them to a memorandum account, and authorized the application of an Allowance for Funds Used During Construction (AFUDC) rate as the carrying cost. We did not define the appropriate AFUDC rate at that time and sought this instant application. As an interim measure, the Commission authorized the account to accrue interest at the 90-day commercial paper rate (cpr), but allowed Cal-Am the opportunity to request, by subsequent application, a different carrying cost:

The San Clemente Dam retrofit project costs shall be removed from rate base and placed in a memorandum account for later reasonableness review. The account shall accrue AFUDC [Allowance for Funds Used During Construction] at the 90-day commercial paper rate, subject to true-up, until the Commission completes a review of the appropriate AFUDC rate for this project. Cal-Am is directed to file within 60 days an application addressing the AFUDC methodology that should be applied to the San Clemente Dam retrofit memorandum account.

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

The Division of Ratepayer Advocates (DRA) and the Monterey Peninsula Water Management District (MPWMD) protested this application contending that Cal-Am had not justified an interest rate higher than the 90-day cpr, and that the request for rate base treatment was beyond the scope of the application authorized by Ordering Paragraph 19. On April 16, 2007, DRA and MPWMD

filed a joint motion to strike all Cal-Am testimony referencing the proposal to move project costs to rate base.

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

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

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

The scoping memo found that there are no identified issues of material facts in dispute among the parties and, consequently, that scheduling evidentiary

hearings was not necessary. A schedule providing for briefs addressing legal and policy issues, with factual assertions supported by a sworn declarations attached to the briefs, was adopted, and the assigned ALJ was designated the principal hearing officer in this proceeding.

3. Description of the San Clemente Dam Project

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

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

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

4. Issue for This Proceeding

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

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

5. Positions of the Parties

5.1. California-American Water Company

Cal-Am contends that it must be made whole for the ongoing cost to finance the project development and construction. The costs will be substantial, and will be financed through equity as well as debt. Cal-Am argues that the Commission has already recognized that Cal-Am will need to obtain financing for this project over several years. Consequently, the memorandum account should include the carrying costs based on Cal-Am's most recent authorized cost of capital, which is based on its cost of debt and equity.

Cal-Am presented a declaration stating that the full, weighted cost of capital would be the appropriate carrying cost for Cal-Am's investment in the San Clemente Dam, in part, because it has utilized both equity and debt to finance this project.² The declaration stated that investors expect a higher rate of return from risky investments, and that the San Clemente Dam investment is more risky than Cal-Am's overall investment in rate base such that investors would expect a rate of return higher than Cal-Am's weighted cost of capital. The declaration explained that regulators may disallow some or all of the San Clemente Dam costs which creates greater risk for recovery of the dam investment than on Cal-Am's previously-approved rate base. The declaration concluded the investors will seek higher returns for investment that will be a risk.

² California-American Water Company August 13, 2007 Opening Briefs page 5, and attached Exhibit C page 2 Declaration of David P. Stephenson.

Cal Am also referred to D.04-03-039³ for Southern California Water Company (SCWC), in which the Commission calculated the carrying cost for an AFUDC type memorandum account using the utility's authorized rate of return. That decision, in turn, referred to another SCWC decision, D.00-06-074, in which the utility was authorized to use the authorized rate of return (ROR) as its AFUDC memorandum account cost factor. In that case, there was near certainty that the construction projects would go forward. Plant additions would be required to comply with new Environmental Protection Agency and Department of Health Services rules – even though those rules had not yet become law. The Commission stated, “However, the Commission has no alternative but implement the new standards when they become law. We agree with the recommendation of the settlement that SCWC may seek recovery of these costs through separate applications to be filed when the new rules are promulgated. In the meantime, we will authorize SCWC to accrue these costs in a separate memorandum account, with carrying costs computed using the authorized rate of return, without gross-up for taxes.”⁴

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

³ D.04-03-039, 2004 Cal. PUC LEXIS 95.

⁴ D.00-06-074, pp. 20-21, 26.

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

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

5.2. Monterey Peninsula Water Management District (MPWMD)

MPWMD stated that there is no reason for the Commission to stray from the accepted and traditional approach to determining carrying costs for water utility construction projects. The Commission has previously determined that predecessor costs⁵ are not actually funds used during construction and should not be subject to the rate of return. Due to the significant cost, length of time in process, and continued uncertainty of whether the project will be completed, MPWMD concluded that the costs are properly treated as predecessor costs and recorded in a memorandum account with interest to accrue at the 90-day cpr.

MPWMD disputed Cal-Am's contention that the Commission's Water Action Policy supports a higher interest rate for this memorandum account. MPWMD explained that one of the objectives of the Water Action Plan is to

⁵ Planning costs incurred prior to construction.

promote investment “needed to improve water quality.” The San Clemente Dam project, however, will only result in “meager” amounts of water, which would “be cost prohibitive and unjustifiable by any standard of measurement.”⁶

MPWMD concluded that the project does not fall within the scope of the Commission’s Water Action Plan. They argue further that seismic retrofitting of the dam would neither increase water supply nor ensure water quality.

5.3. Division of Ratepayer Advocates (DRA)

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

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

⁶ MPWMD Reply Brief at p. 9.

6. Discussion

The sole issue for today's decision is to determine the appropriate carrying cost for the accrued amounts in the San Clemente Dam memorandum account. We determine that due to the certainty of the project as expressed in the final EIR, and the policy objective of matching of the regulatory costs with actual costs, the interest on the San Clemente Dam memorandum account should accrue at the authorized rate of return. Authorizing a carrying cost less than that would not reflect the risks or actual project costs. Protection is given to the ratepayers in the form of a reasonableness review when the dollars are transferred out of the memorandum account into ratebase. If it can be shown that actual carrying costs are less than the authorized rate of return, (*i.e.*, closer to the cost of debt), we can make adjustments in the relevant general rate case proceeding.

While the dollars associated with the San Clemente Dam Seismic Safety Project have been given a variety of accounting treatments over time, it is most useful to examine the ratemaking treatment while the current EIR has been underway. For most of that time, the dollars associated with the project have been recorded in CWIP, receiving a carrying cost equal to the authorized rate of return. The arguments being made for extending the temporary carrying cost at the 90-day cpr are not persuasive.

As demonstrated in the final EIR⁷, a project is needed. In 1992, the Department of Water Resources Division of Safety of Dams (DSOD) required

⁷ We take official notice of the January 2008 Final EIR/EIS for the San Clemente Dam Seismic Safety Project prepared for the California Department of Water Resources & the US Army Corp of Engineers Chapter 3.6.1 Alternative 4, SCH 1 #997042007.

Cal-Am to upgrade the San Clemente Dam, so that it would comply with current seismic safety standards. Since that time, it has become more certain that a project will be needed to bring the dam into seismic compliance. In January 2008, the final EIR was issued. That document made clear that a “do nothing” action would not comply with current standards. We conclude that there is no question whether a project will ensue. There will be a project entailing significant capital investment on the part of Cal-Am. While the specific alternative has not yet been selected, it is clear that a project will take place and that we should review the final project costs.

This conclusion is consistent with our recent past actions. From 2003 to 2006, all costs associated with the San Clemente Dam retrofit project were booked to CWIP, earning the authorized rate of return. In D.06-11-050, the Commission removed the project amounts from the CWIP not because it doubted any project was necessary, but because the eventual project could no longer be viewed as a short term project.

The Commission concluded that project costs would be allowed to accrue AFUDC treatment consistent with the long-term nature of the investment analysis and plan. The Commission assigned a cost factor equal to the 90-day cpr as a temporary measure, with a specific order that a review of the appropriateness of cost factor be undertaken. The result is the current case. At the same time, the Commission also authorized Cal-Am to record up to about \$24 million in expenditures for the project in a memorandum account for later reasonableness review. In doing so, the Commission denied Cal-Am current full recovery of the costs pending its review of the final project. Given the growing magnitude of expected capital costs, it is appropriate to hold those costs in a memorandum account where they can be reviewed for reasonableness.

Memorandum accounts are typically used to record expenses that are not anticipated or readily quantifiable at that time. Typical expenses are litigation or water quality costs. The cost factor applied to balances in such memorandum accounts is the 90 day cpr, as they finance only expenses occurring in the course of doing business, not capital projects that are usually financed by a combination of equity and debt.

However, in a case that deals with the accrual of AFUDC and significant capital costs, not merely the unanticipated expenses or the unknown expenses of typical memorandum accounts, the Commission should decide the interest rate treatment based upon the circumstances at hand and the type of financing being used to fund the project.

The Commission has faced this question before. It has previously determined that memorandum accounts for a water utility project of long duration could accrue interest at either the 90-day cpr or the authorized rate of return. The 90-day cpr has been found to be appropriate for the Coastal Water Project for Cal-Am, whereas the authorized rate of return has been used for a project like the Calipatria treatment plant for Golden State.

In the case of the Coastal Water Project (CWP),⁸ the Commission determined that due to the uncertain nature of the project, in particular whether construction would occur at all, that a 90-day cpr was the appropriate cost factor to apply to the memorandum account balance.⁹ The Commission stated “It remains unclear at this time when (or whether) any plant construction will

⁸ D.03-09-022, p. 22 and 30.

⁹ D.03-09-022, p. 22 and 30.

commence. Therefore, allowing these preliminary costs to earn the utility's authorized rate of return now carries with it significant risk that the ratepayers may never receive the benefits of these expenditures."¹⁰ Furthermore, the EIR for the CWP had not yet been scoped at the time of that decision, let alone finalized. The use of a 90-day cpr in the case of the CWP was reiterated in D.06-12-040, in which the Commission determined that the outcome of the project remained uncertain.¹¹ In this same decision, we also stated that we would consider modifying the ratemaking treatment if the proposed project becomes more certain. A final EIR, which sheds light on the actual final project, is certainly an appropriate time to revisit the ratemaking treatment. While it is no guarantee of receiving a higher return, it is reasonable to revisit the treatment at that time. The CWP was very different from the current seismic dam safety case. At the time of the decision, the Company had not yet begun physical construction, the environmental review process had not begun, and there were questions regarding whether the project would ever be undertaken. We do not find its results applicable here.

We find more **guidance** in another case: The Commission granted the authorized ROR to Southern California Water (now Golden State Water) for its AFUDC memorandum accounts in D.00-06-074 and D.04-03-039. Those decisions refer to expenditures and projects that are more similar to the

¹⁰ D.03-09-022, p. 22.

¹¹ D.06-12-040, Conclusion of Law 8 "Cal Am's request to be allowed to earn its authorized rate of return on preconstruction costs booked in its memorandum account should be denied for the reason that it remains unclear at this time when (or whether) any plant construction will commence. All preconstruction costs should be booked in

Footnote continued on next page

San Clemente Dam situation. Both decisions relate to the construction of the Calipatria treatment plant project. While the initial decision adopted a settlement, the second decision affirmed the settlement results in the context of a general rate case proceeding. This would have been the time to argue for a different ratemaking treatment. Like the seismic dam safety project, the Calipatria treatment plant's specific form was not certain, but the fact that it was a required project was quite certain, and it was going to require substantial investment. The authorized rate of return was deemed to be the appropriate carrying cost. The Commission concluded appropriately that the authorized rate of return was the appropriate AFUDC cost factor to apply to the project costs.

In today's case, we are considering a project that must move forward. The seismic risk of the San Clemente Dam must be remedied. There is no uncertainty in that. We have found that where there are regulatory compliance requirements and long-term capital outlays for a project are a foregone conclusion, it is reasonable to authorize the use of the authorized ROR as the AFUDC rate, and it is appropriate to undertake a reasonableness review at the completion of the project.

While several different methods are being considered for compliance, the fundamental points are that the San Clemente project must go forward in some form, and whatever form the project takes will not be a matter of expenses, it will be a matter of substantial investment, relying on equity and debt.

an interest bearing memorandum account and accrue interest at the 90-day short term commercial rate."

Therefore, we conclude that the amounts properly recorded in the San Clemente Dam memorandum account should accrue carrying costs at the authorized rate of return.

7. Need for Hearings

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

8. Comments

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments on the proposed decision were filed on March 26, 2008, and reply comments were filed on April 1, 2008. Comments on the Alternate were filed on May 19, 2008, by DRA, MPWMD, and Cal-Am, and reply comments were filed on May 27, 2008 by Cal-Am.

In both sets of comments Cal-Am contended that the San Clemente Dam project was more certain than the Coastal Water Project because the dam must be retrofitted. DRA and the Monterey Peninsula Water Management District argue that the Coastal Water Project is the most analogous to the San Clemente Dam Project.

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

9. Assignment of Proceeding

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

Findings of Fact

1. San Clemente Dam is located on the Carmel River in Monterey, California.
2. The San Clemente dam was constructed in 1921.
3. Cal-Am is undertaking the San Clemente Dam Seismic Safety Projects under orders of the DSOD.
4. The EIR analyzed four alternatives to the dam strengthening option: dam notching, dam removal, river bypass, and no project.
5. Cal-Am and the involved state and federal agencies have not determined which alternative project will be implemented to address seismic deficiencies in the San Clemente Dam.
6. The Final EIR for the San Clemente Dam Seismic Safety Project concluded that the “no project” alternative would not meet the project purpose and need of increasing dam safety to meet current standards.
7. The proper carrying cost of the dollars associated with the seismic safety project is a project-specific cost of capital reflecting the risks of this investment.
8. Cal Am has utilized both equity and debt to finance this project.
9. The San Clemente Dam seismic safety project, when selected, will involve significant capital dollars.
10. From 2003-2006, dollars associated with the San Clemente Dam Seismic safety project were given the authorized rate of return through the CWIP ratemaking mechanism.
11. D.06-11-050 placed the project costs in a memorandum account for later reasonableness review and did not decide the final applicable interest rate.
12. D.06-11-050 gave the project costs an interim carrying cost at the 90-day cpr.

13. Previously, the Commission adopted an AFUDC rate at the authorized rate of return for the Calipatria Treatment Plant of Southern California Water Company (now Golden State Water Company).

14. The San Clemente Dam project and the Calipatria treatment plant of Southern California Water Company (now Golden State Water Company) have substantially the same legal and regulatory status and therefore should be given the same accounting treatment.

15. There are no disputed issues of material fact which require evidentiary hearing for resolution.

Conclusions of Law

1. There is certainty that large capital dollars will be spent by Cal-Am on a capital project to bring the San Clemente Dam into seismic compliance.

2. Where possible, we want to match the regulatory carrying costs with the actual costs incurred.

3. Setting the AFUDC rate below the actual current cost is harmful.

4. Long term projects, with significant capital dollars, designed to bring a utility into regulatory compliance, have been given two interest rate treatments, 90-day cpr and the cost of capital.

5. The San Clemente Dam Seismic Safety Project, unlike the Coastal Water Project, has a final EIR.

6. The San Clemente Dam Seismic Safety Project is more similar to the Calipatria Treatment Plant than the Coastal Water Project.

7. The Coastal Water Project EIR is currently ongoing and the scope of the EIR was not known at the time of decision D.03-09-022.

8. Cal-Am should record carrying costs equal to the authorized rate of return on all amounts properly recorded in its San Clemente Dam project memorandum account.

9. The Commission shall review the reasonableness of all amounts recorded in the San Clemente Dam project memorandum account prior to any amount being included in revenue requirement or rate base.

10. Hearings are not necessary.

11. This proceeding should be closed.

O R D E R

IT IS ORDERED that:

1. California-American Water Company shall include in its San Clemente Dam Memorandum Account carrying costs equivalent to the authorized rate of return on all amounts properly recorded in the account.

2. Application 07-02-023 is closed.

This order is effective today.

Dated May 29, 2008, at San Francisco, California.

MICHAEL R. PEEVEY

President

DIAN M. GRUENEICH

JOHN A. BOHN

RACHELLE B. CHONG

TIMOTHY ALAN SIMON

Commissioners