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California Water Association

March 9, 2018

The Honorable Michael Picker, President
The Honorable Martha Guzman Aceves, Commissioner
The Honorable Carla Peterman, Commissioner
The Honorable Liane Randolph, Commissioner
The Honorable Clifford Rechtschaffen, Commissioner

California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102-3298

Delivered by Hand and by Electronic Mail to the Addressees on the Service List for Applications 17-04-001, 17-04-002, 17-04-003 and 17-04-006

Dear President Picker and Commissioners:

On behalf of the California Water Association ("CWA") and the water utilities subject to the jurisdiction of the Commission, I am writing to respectfully request that the Proposed Decision ("PD") in the above-referenced Cost-of-Capital applications for California American Water ("CAW"), California Water Service ("CWS"), Golden State Water, and San Jose Water ("SJW") be corrected and revised in advance of the March 22, 2018 Commission meeting. Such action is required to: (1) cure the many factual errors and legal deficiencies that exist in the PD, and (2) establish a Return on Equity ("ROE") that is reasonable, reflective of the companies' risk profiles and consistent with established Commission policy and practice. If these corrections cannot be made in time, CWA requests that the PD be withdrawn or that an Alternate Proposed Decision be prepared that is factually and legally correct.

By any objective measure, the PD disrespects the record in the proceeding. It is fraught with errors. It contains numerous analytical mistakes, technical deficiencies, and obvious misstatements of fact. Bluntly put, the PD's woeful summary cannot be reconciled with the evidentiary record. When brought up for review, the Commission will be unable to defend the PD's abysmal treatment of the record.

The PD's sole reliance on discredited evidence from the Office of Ratepayer Advocates ("ORA") amounts to an abuse of discretion that cannot be ignored. This abuse results in flawed determinations of capital structures, cost of debt, and ROEs for the Applicants.

The Applicants' comments filed on February 26, 2018, provide a detailed showing of the PD's many flaws. The result is a PD that is unjust and unreasonable. If adopted, it will be harmful to the utilities, their owners, customers and employees – all in violation of the applicable legal standards.

Jack Hawks, Executive Director
California Water Association
601 Van Ness Avenue, Suite 2047
San Francisco, CA 94102-6316
415.561.9650
415.561.9652 fax
415.305.4393 cell
jhawks@calwaterassn.com
www.calwaterassn.com

Melissa Dixon, Administrative Director
California Water Association
700 R Street, Suite 200
Sacramento, CA 95811
916.231.2147
916.231.2141 fax
mdixon@calwaterassn.com

CWA President
Lawrence Morales
East Pasadena Water
626.793.6189
lawrence@epwater.com

CWA Vice President
Keith Switzer
Golden State Water Company

Evan Jacobs
California American Water

Ed Jackson
Liberty Utilities Corporation
562.299.5166
edward.jackson@libertyutilities.com

CWA General Secretary and Treasurer
Joel Reiker
11142 Garvey Avenue
El Monte, CA 91733
626.448.6183
jmreiker@sgvwater.com

CWA Billing Address
California Water Association
700 R Street, Suite 200
Sacramento, CA 95811

CWA Mailing and Shipping Address
California Water Association
601 Van Ness Avenue, Suite 2047
Mail Code #E3-608
San Francisco, CA 94102-3200

There are many infirmities detailed by the Applicants in their comments that confirm the unjust and unreasonable nature of the PD. Among them are:

- The PD's failure, as noted above, to provide an objective, balanced review of the evidentiary record. It relies exclusively on ORA's (error-filled) analysis and testimony. It ignores the Applicants' evidence and testimony. The result is a set of recommendations that is factually unsupported by the evidentiary record.
- The PD's violation of the regulatory principles established by the U.S. Supreme Court in *Bluefield Water Works Co. v. Public Service Commission of the State of West Virginia* (262 U.S. 679, 1923). *Bluefield* stated that a utility's return "should be reasonable sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to support its credit and enable it to raise the money necessary for the proper discharge of its public duties."
- The PD's violation of a threshold principle of future test year ratemaking: supplanting future test year forecasts of capital structure with unadjusted retrospective data.
- The PD's refusal to even acknowledge the utility experts' numerous and legitimate criticisms of ORA's Discounted Cash Flow ("DCF") analysis.[1]
- The PD's acceptance of an invalid and phony Capital Asset Pricing Model ("CAPM") analysis by ORA's witness, which looks solely to non-utility data. Inconsistently, the PD refuses to consider the Applicants' Comparable Earnings methodologies on the grounds that "non-utility Proxy Groups are not comparable to utility Proxy Groups for purposes of risk comparison."
- The PD's refusal to consider the valid CAPM, Risk Premium, After-Tax Average-Weighted Cost of Capital, or Comparable Earnings analyses presented into evidence by the Applicants' expert witnesses.
- The PD's acceptance of ORA's cost of debt analysis and percentage, *even though ORA's own witness admitted that this analysis contained errors.*

[1] For example, the PD mischaracterizes a statement made by one of the companies' expert witnesses and then ignores the explanatory testimony that put his response in context. On page 19, the PD states that CWS expert Vilbert "admitted that [ORA witness] Rothschild's use of the [DCF] method was 'reasonable' and that Rothschild had 'implemented the methodology correctly' in arriving at his Water Proxy group ROE of 8.25%." Not quite. Dr. Vilbert actually said that "the sustainable growth rate method of estimating 'g' [dividend growth rate] is something that's reasonable." Vilbert later said that Witness Rothschild "has ... implemented the methodology correctly." However, in the same sentence, which the PD left out, Vilbert went on to say, "there's a fundamental problem with the methodology that I'm trying to bring forward, which is that you have estimated a 12 percent return on book value and then ... even more an 8.22 [percent ROE] can't work." As CWS noted in its comments, "... the PD's eagerness to accept an assertion by ORA that strains credulity calls into question the legitimacy of the PD."

- The PD's flawed discussion of regulatory risk and misinformed reliance on the Water Revenue Adjustment Mechanism/Modified Cost Balancing Account ("WRAM/MCBA") decoupling mechanisms, the Water Cost-of-Capital Mechanism ("WCCM"), escalation and attrition year rate filings, balancing accounts, and advice letter filings as the rationale for the absurdly low proposed ROEs. The companies' filings clearly demonstrate the fallacy of the PD's reliance on ORA's argument that these mechanisms make investments in these companies "nearly risk-free." In particular, the WRAM has done little to mitigate the risk of under-recovery. As CWS pointed out, there are at least three risk-increasing features of the WRAM. One is the significantly delayed recovery of revenues from extended, capped WRAM surcharges. The second is that the uncollected WRAM balances have necessarily been financed with short and long-term debt, thereby increasing leverage and risk. The third is that the uncollected WRAM balances earn interest at only the 90-day commercial paper rate. The PD also ignores the fact that the Commission has denied the establishment of a WRAM for one of the Applicants (SJW) several times. SJW's situation doesn't even fit the PD's false narrative.
- The PD's rejection of the Commission's own policy and established practice of treating debt redemption premiums as part of the issuance costs of new debt financing. In fact, the PD doesn't even acknowledge (much less explain) its departure from the Commission's long-established policy, which was spelled out in the Commission's own introductory white paper on utility cost of capital.[2] If the Commission is going to disallow costs incurred to refinance existing higher-cost debt with lower-cost debt, there will be a chilling effect on utilities' future willingness to engage in refinance activity that is done solely to benefit customers.
- The PD's inclusion of State Revolving Fund ("SRF") debt in CAW's cost of debt analysis, even though ORA agreed this was an error. While the amount was small, the policy implications are huge: why would any company accept SRF loans for the benefit of customers if those loans will be used to set an artificially low cost of debt for the utility?

Beyond all these errors, however, the most egregious assertion made in the PD is this statement:

> "ORA also argues that the risk-hedging and risk-spreading mechanisms adopted by this Commission over the years have effectively guaranteed that the Applicants will earn their allowed returns on rate base, making investment in their common equity nearly risk free and their ROEs should be adjusted downward to reflect this fact."

[2] California Public Utilities Commission, Policy & Planning Division, "An Introduction to Utility Cost of Capital," pp. 5-6, April 18, 2017.

For ORA to assert that the Commission's regulatory mechanisms make investments in the Applicants' stock "nearly risk-free" is ridiculous. And for the PD to accept that assertion is profoundly misguided. As noted above, the Commission's dysfunctional implementation of the WRAM, which has resulted in tens of millions of dollars being tied up in regulatory assets earning 90-day commercial paper rates, has unnecessarily harmed investors. The WCCM has only been triggered once. That event, affecting three of the four Applicants, has served to reduce their ROEs by 56 basis points.

Balancing accounts are two-way mechanisms that protect customers and investors equally. Further, many balancing accounts are created to benefit customers, not the utilities. Examples are low income assistance, tax benefits, conservation program expense, and water quality compliance. Water utilities are the only industry subject to an earnings test for approved escalation/attrition year rate adjustments. This is yet another risk that water utilities, alone, face. In short, any argument that posits a shift of risk to customers as a result of these mechanisms is specious on its face.

Since the large majority of advice letters are simply compliance filings resulting from general rate case decisions, the reference to "various specific advice letters relating to particular rates and charges" as a shareholder risk reduction mechanism is equally fallacious. The difficulty of achieving timely approval of advice letters is evidence enough that advice letters and risk reduction do not belong in the same sentence.

The utilities have not changed the way they apply the standard financial models in cost of capital proceedings. What have changed in this proceeding, apparently, are the Commissioners' priorities. If the Commission wanted to determine cost of capital for the Class A water utilities in a manner materially different from the methods used in the past, the Commission should have provided advance notice of the change so that, at a minimum, the utilities would have been able to present evidence consistent with the new approach. The failure to provide such notice to the utilities is a denial of due process.

Contrary to the PD's assertions on risk, California is among the riskiest states in the country for an investor-owned water utility. Stringent water quality regulations, the arid climate, the recurrence of weather-driven and geo-seismic catastrophic events, the threat of inverse condemnation rules subjecting utilities to strict liability of damage awards regardless of fault, the legacy damage to groundwater aquifers, and the growing deleterious effects of climate change on water resources all make risk a fact of life in California. No state has the severe combination of water supply, water quality and operational risks that utilities experience in California. This fact should be paramount when considering company-specific risk factors.

The PD is unduly discriminatory to water utilities and their stakeholders by virtue of the fact that it would set ROEs more than 100 basis points lower than the national average for regulated water utility ROEs. This is despite an absence of proof that California water utilities are subject to less business, operational and regulatory risks than their counterparts elsewhere. Equally significant is the fact that the proposed ROEs are almost 200 basis points below the ROEs just recently granted by the Commission to the major California energy utilities. How does one explain this difference between the water and energy utilities when the latter entities have the benefit of even more robust revenue protection mechanisms? No one can argue that the risk profiles of energy utilities are that much higher than those of water utilities, so there is no valid explanation other than undue discrimination.

As the companies noted in their comments, these risks do not translate into the regulatory arena. The PD adopts ORA's assertion that California has a favorable regulatory environment, a view that is not shared by financial analysts around the country. Indeed, several reports issued by financial analysts since the PD was issued have noted the declining regulatory environment in California and the increased regulatory risks faced by water utilities there,[3] including likely downgrades of credit should the PD prevail.

In his remarks on March 6, 2018, at the Senate Energy, Utilities and Communications Committee's CPUC Oversight Hearing, President Picker discussed the recent negative stock reports and downgrades in the electric utilities' credit ratings. He noted that this was a "new phenomenon" that was "making it hard for the electric utilities to gain access to capital." He went on to say that the downgrades and negative stock reports don't just affect shareholders and owners, but also ratepayers because the higher borrowing costs will go into rates over time. "It absolutely, always goes to the ratepayers," and is "a challenge we will have to confront," he said. This scenario is precisely the outcome that this PD will lead to for the water utilities should it be adopted – lower debt ratings and equity reports, more problematic access to capital, higher borrowing costs, and higher rates for customers.

CWA acknowledges that the Constitutionally independent Commission is under political pressure from the legislature, the media, and certain activist groups (dominated by affluent and high-volume water users) to appear responsive to ratepayer interests. CWA does not accept the premise that the PD is customer-friendly because it prioritizes a short-lived "rate cut" over long-term water service reliability. Unlike government-owned water utilities, which may set rates by a simplified political process, public utility commissions nationwide must use an independent, deliberative legal process to determine cost-of-service rates for regulated utilities that is insulated from such pressures. The very purpose of an evidentiary record is to protect against arbitrary decision-making. The PD's stunning failure to apply the record in this proceeding suggests that external pressures played a large role in shaping this unjust outcome.

[3] See, especially, the comments and appendices filed by Golden State Water Company.

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For all the reasons detailed in the Applicants' comments and this letter, CWA respectfully requests that the Commission revise the PD to reflect and respond to the spectrum of evidence presented in the record. A Commission decision that accurately summarizes and is guided by the evidence and follows long-standing Commission ratemaking policies and practices on prospective test year ratemaking simply cannot reach the same conclusions as the PD with respect to ROE, capital structure and cost of debt.

Therefore, CWA requests that the Commission adopt an appropriate selection from the proposed revisions to the Findings of Fact and Conclusions of Law submitted by the Applicants on February 26, 2018, and establish a reasonable ROE for the Applicants of not less than the national average for water utilities.

Sincerely,

John K. Hawks

Cc: Water Cost of Capital Service List