Docket:	:	A.12-05-001 et. al.___
Exhibit Number	:	DRA-002 ___
Commissioner	:	Mark Ferron ___
Admin. Law Judge	:	Linda Rochester___
DRA Witness	:	Patrick E. Hoglund, P.E.
	:	

DRA
DIVISION OF RATEPAYER ADVOCATES

DIVISION OF RATEPAYER ADVOCATES
CALIFORNIA PUBLIC UTILITIES COMMISSION

DRA Report

Examining Issues Related to the Regulatory Environment for Class A Water Utilities and Providing Recommendations pertaining to Requested Capital Structure Adjustments

Cost of Capital Proceeding

Applications 12-05-001; 12-05-002; 12-05-004; 12-05-005 for Park Water Company/Apple Valley Ranchos Water Company, San Gabriel Valley Water Company, Suburban Water Systems, and Great Oaks Water Company

San Francisco, California
August 27, 2012

TABLE OF CONTENTS

A. INTRODUCTION 1
B. SUMMARY OF RECOMMENDATIONS 1
C. DISCUSSION 2
1) Park Water 2
2) Suburban Water Systems 3
3) San Gabriel Valley Water Company 5
4) Great Oaks Water Company 6
5) California's Regulatory Environment 6
6) Park/Apple Valley Common Equity Adjustment 11
7) Water Cost of Capital Adjustment Mechanism 12
D. CONCLUSION 12

A. INTRODUCTION

This report presents the Division of Ratepayer Advocates' ("DRA") review and analysis related to claims of increased regulatory risk and firm specific risk the Class A Water Utilities made in their respective applications requesting authority to establish an authorized Cost of Capital for the period from January 1, 2013 through December 31, 2015.[1] The Park Water Company and Apple Valley Ranchos Water Company ("Park/Apple Valley"), San Gabriel Valley Water Company, and Suburban Water Systems (collectively, "The Applicants") testimony in the current proceeding provide a partial perspective on California's regulatory climate and utility specific conditions to support greater Commission focus in the upper range of requested equity returns and in some cases a specific upward adjustment to the requested return on equity ("ROE"). Great Oaks Water Company's filing is limited to requesting its current adopted ROE of 10.20% or the 9.99% the Commission recently adopted for the large Class A companies in D.12-07-009. Great Oaks Water Company did not prepare any models or provide any supporting documentation to support its request.

B. SUMMARY OF RECOMMENDATIONS

The Commission has recognized that the use of "numerous regulatory mechanisms in California that protect water utilities from a wide variety of risks normally faced by competitive industry"[2] fosters a robust regulatory environment where any upward consideration of equity premiums related specifically to regulation would be unwarranted and counter-intuitive. In summary, DRA recommends that when determining a prospective and appropriate return on equity in the current proceeding, the Commission should rely upon the consistent, predictable, and reliable California regulatory environment present that is

[1] On May 1, 2012, Applications by Park Water Company/Apple Valley Ranchos Water Company (A.12-05-001), San Gabriel Valley Water Company (A.12-05-002), Suburban Water Systems (A.12-05-004) and Great Oaks Water Company (A.12-05-005) were consolidated.

[2] D.09-05-019, May 7, 2009

prospective, which does not encourage an upward adjustment for “regulatory risk.” DRA performed an analysis of the utilities’ relative risk and made adjustments to its recommended ROEs for the utilities based on its analysis. Please see pages 63 to 67 of Dr. J. Randall Woolridge’s testimony for a discussion of this analysis and DRA’s recommended adjustments.

C. DISCUSSION

1) Park Water

Park suggests that its significant balances in its regulatory, balancing, and memorandum accounts necessitates recognition and an adjustment to its equity ratio through its long-term balances is appropriate. Park argues that the existence of a Water Revenue Adjustment Mechanism/Marginal Cost Balancing Account (“WRAM/MCBA”) does not reduce risk as much as the Commission suggests. In Park’s most recent Cost of Capital, D.10-10-035, the Commission did not approve of any upward adjustment to Park’s ROE. Further, the Commission explicitly stated that there did not need to be a small size adjustment to the ROE.[3]

Park argues that California’s regulatory environment is no better than average. Even if it is no better than average, this “average” effect is captured in Dr. Woolridge’s proxy group and clearly does not call for an upward adjustment to the ROE. Park/Apple Valley continues to argue for an upward adjustment because the benchmark group is not comparable to Park. Park/Apple Valley’s witness Dr. Zepp added 80 basis points for business risks discussed in his testimony. Contrary to the method employed by Dr. Zepp, the Commission determined in the last Cost of Capital proceeding for Park/Apple Valley that no upward adjustment to the ROE was necessary.[4] The existence of the WRAM/MCBA reduces business risk nullifying the need for a risk premium of the magnitude Dr. Zepp proposes on

[3] D.10-10-035, October 28, 2010, pg 48

[4] D.10-10-035, October 28, 2010, pg 57

page 3 of his testimony. DRA recommends a smaller adjustment to Park's ROE as discussed in Dr. J. Randall Woolridge's testimony.

DRA thoroughly addressed California regulatory risk in its testimony[5] in the last Class A Cost of Capital proceeding and refuted the arguments that California's regulatory environment contributed to additional business risk. Park refers to comments made by Janney Scott Montgomery in the Janney Water Journal from April 2011 about the California regulatory environment. Janney's pessimistic view is in opposition to the healthy earnings of the California utilities and the recent acquisitions of California utilities.[6]

Park/Apple Valley's sales forecasting concerns are addressed via the WRAM/MCBA. These decoupling mechanisms reduce risk and the Commission acknowledges this in D.10-10-035 starting at page 55. Furthermore, the utilities are also protected from market risks with the inclusion of the Water Cost of Capital Mechanism ("WCCAM"), which allows for the utility's ROE to be adjusted by half of the change in the index when the designated index moves up or down by more than 200 basis points, known as the "deadband." DRA discusses the WCCAM below in Section 7.

2) Suburban Water Systems

In its testimony, Suburban identifies what it believes to be risk factors associated with operating a water utility. None of these factors are explicitly quantified or directly applied to adjust the ROE Suburban requests. Suburban's Robert L. Kelly's testimony lists nine risk factors associated with operating the company. These include:

- Changes in regulatory policy;

[5] A.11-05-001, et. al., Rauschmeier, DRA Report Examining Issues Related to the Regulatory Environment for Class A Water Utilities and Providing Recommendations Pertaining to Requested Capital Structure Adjustments, August 31, 2011

[6] See Western Water Holdings LLC acquisition of Park, D.11-12-007 and D.10-09-012

- Drought conditions and water conservation resulting in lower sales; and unrecovered fixed costs that must be absorbed almost entirely by shareholders;
- Potential loss of groundwater supplies resulting in reliance on high cost purchased water that must be absorbed entirely by shareholders;
- Water quality risk due to natural and man-made constituents;
- Business is heavily capital intensive;
- Operations are concentrated entirely in Los Angeles and Orange Counties;
- Assets are vulnerable to condemnation;
- Service areas are vulnerable to earthquakes and terrorist activities; and
- Increased maintenance costs due to aging infrastructure

All of these risks, excluding the locations in southern California, are applicable to the Benchmark Group of companies and as such are reflected in the various model results. These risk factors are applicable to virtually all water utilities. Furthermore, catastrophic memorandum accounts provide risk mitigation for the utilities by allowing the costs of disasters to be tracked for future recovery.

Balancing accounts can reduce risk associated with varying purchased water costs as a result of changing supply mix. All of these costs tracked in these accounts would be reviewed and considered for recovery in rates in a subsequent general rate case. Though Suburban has not requested a decoupling WRAM/MCBA to mitigate variations in sales and production costs resulting from changes in demand due to conservation or drought, the mechanism is a tool available to the company. Instead the company has chosen a Monterey-style

WRAM, which allows the company to manage the risk/reward associated with managing its diversified portfolio for purchased water supply.

DRA's specific adjustments for relative risk are addressed in Dr. J. Randall Woolridge's testimony beginning on page 63.

3) San Gabriel Valley Water Company

San Gabriel's testimony identifies contamination in its water supply as a significant risk.[7] In her testimony, Ms. Ahern adds an 84 basis points risk premium to her ROE recommendation to compensate for business and credit risks.[8] In response to DRA's data request PHH-002, San Gabriel indicates that it "has not claimed that the Commission has denied recovery of costs incurred for installation and operation of treatment facilities." This suggests that while supply contamination is an operational and planning challenge, there are tools in place to mitigate the financial impacts to the company. While supply treatment for contamination will add costs, the Commission has regularly allowed the recovery of reasonable costs needed for treatment.

The existence of a water quality memorandum account allows for tracking the costs associated with resolving supply contamination for possible future recovery. The Commission has also allowed for litigation memorandum accounts to recover the costs of litigation when a party has been identified as responsible for the contamination appearing in the utility's water supply.[9] Therefore, there is mitigation for the incremental risk associated with the presence of contamination in the water supply. Likewise, any costs for needed water purchases to replace contaminated supply can be tracked for recovery in balancing accounts.

---

[7] San Gabriel Valley Water Company, A.12-05-002, Exhibit SG-2

[8] Direct Testimony of Pauline M. Ahern, pg 60

[9] See for example D.10-10-018, page 53, and D.10-12-058, Appendix C, page 3

DRA recommends no specific ROE adjustment as a result of the current challenges facing San Gabriel's' water supply and believes Ms. Ahern's risk premium adjustment is excessive. As noted earlier, DRA's specific adjustments to ROE for company specific risk are addressed in Dr. J. Randall Woolridge's testimony.[10]

4) Great Oaks Water Company

Great Oaks' testimony differs from the other utilities in that it does not present any financial models or provide any supporting documentation to support its ROE request. Its request is limited to simply requesting its existing authorized ROE or in the alternative the 9.99% ROE adopted in D.12-07-009 for the large Class A water companies and a 100% equity capital structure. Great Oaks also requests that its current WCCAM remain in place.

5) California's Regulatory Environment

In A.11-05-001 et. al., DRA provided testimony[11] addressing several factors raised in the proceeding that could affect the Commission's ultimate determination of a reasonable equity return, including small system concern, infrastructure, investment opportunities, construction contracting, the Rate Case Plan, and various California regulatory mechanisms. Here DRA provides a summary of its positions that remain relevant to determining a reasonable cost of capital for the Class A water utilities.

---

[10] Testimony of Dr. J. Randall Woolridge, pgs 66 -67

[11] A.11-05-001, et. al., Exhibit DRA-002

(a) Small System Concerns

A critical distinction when considering risk factors—as repeatedly identified by private, state and federal agencies[12]—is the disparity in technical, managerial, and financial ("TMF") capabilities. In fact, the primary importance of adequate TMF capabilities led the California legislature in 1997 to enact Section 116540 of the Health and Safety Code to limit issuance of new operating permits to only those water systems able to demonstrate adequate TMF capacity. DRA is not aware of any TMF deficiencies for any of the Applicants at this time.

(b) Infrastructure Investment Opportunities

Water utilities are capital intensive businesses. They are also some of the least risky businesses.[13] Water utility infrastructure investments where reasonable investments are readily recovered are relatively low risk. One firm has touted the considerable opportunity surrounding America's infrastructure needs as "prudent investments in regulated infrastructure footprint drive long term growth."[14] As DRA noted in its testimony in A.11-05-001 et. al., "the ability of utility management to effectively support necessary investment combined with America's legitimate need for replacement of aging infrastructure framed within the regulatory structure of allowing a return on prudent investment should not create additional risk, but rather an attractive investment opportunity."

The market recognizes the low-risk investment opportunity present in California for investor-owned water utilities. Park Water Company and Apple Valley Ranchos, in a joint application with affiliates of The Carlyle Group, a

---

[12] *Protecting Public Health in Small Water Systems*, Report of International Colloquium, 2005; *Technical, Managerial, and Financial (TMF) Criteria For Public Water Systems*, California Department of Public Health, 2010; *National Capacity Development Strategic Plan*, U.S. Environmental Protection Agency, 2008.

[13] See the Testimony of J. Randall Woolridge, Attachment JRW-8, page 1 of 1

[14] Morgan Stanley Investor Presentation, American Water, 2011.

global asset manager, acknowledge this reality.[15] Explaining in the application its investors' desires "to invest in low risk assets over a long term horizon," the Carlyle Group provided support for its request to acquire the two Class A water utilities by noting its belief in the "well established and transparent regulatory framework in California." Similarly, indirect control of Suburban was transferred to an affiliate of JPMorgan IIF Acquisitions LLC, further indicating that California utilities are viewed favorably.[16] The combined purchase and merger value of these transactions totaled several hundred million dollars, which affirms California's water utilities are an attractive investment.

(c) The Rate Case Plan

The Rate Case Plan ("RCP") adopted in 2007 established the current schedules, processes, and procedures for Class A water utilities to file their general rate cases.[17] DRA notes the revisions in the RCP adopted in 2007 – including water utilities' much improved ability to obtain interim relief pending rate case disposition and the benefit of fully allocating general office increases across previously staggered district filings—have had more than five years to be incorporated into current market data and investor expectations. No specific risk adjustment for any perceived risk associated with the RCP is therefore needed.

(d) California Regulatory Mechanisms

California has a robust collection of regulatory mechanisms available to the Class A water utilities. DRA presented this summary table, Figure 1, in its testimony in A.11-05-001, et. al. showing how California compared to several other states.

[15] A.11-01-019.
[16] D.10-09-012
[17] D.07-05-062.

Figure 1

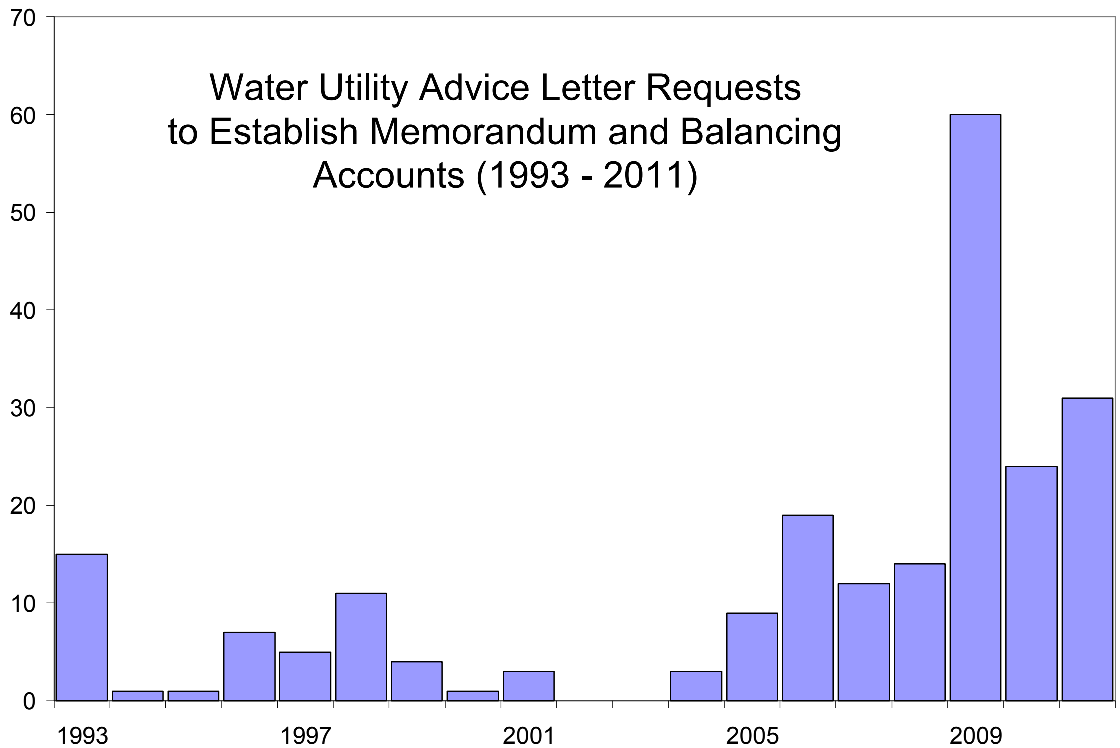
STATE	Single-Tariff Pricing	Fully Forecasted Test Year	Adjust Rates outside GRC	Purchased Water Surcharge	Purchased Power Surcharge	CWIP in Ratebase	Decoupling Revenue and Sales
California		✓	✓	✓	✓	✓	✓
Illinois	✓	✓	✓	✓		✓	
Kentucky	✓	✓				✓	
New York		✓	✓		✓		✓
Tennessee		✓					
New Jersey	✓			✓			
Virginia				✓		✓	
Pennsylvania	✓		✓			✓	
Ohio	✓		✓			✓	
W. Virginia	✓						
Indiana	✓		✓				
Iowa	✓						
Missouri			✓				

DRA continues to believe the table above, is at a minimum, a good indication of both the regulatory tools and policy directions commissions have taken in regards to mitigating water utility risks.

In regards to balancing and memorandum accounts, the upward trend in utility requests to establish new accounts as shown in the following graph[18] suggests that they are useful in mitigating utility risk.

[18] Requests to establish memorandum and balancing accounts made in general rate cases are not included.

Figure 2



source: CPUC Proposal/Advice Letter Tracking System

The Commission has previously determined in a Class A water cost of capital decision that memorandum and balancing accounts insulate utilities from "variations between forecast and actual results for many activities" and "assure recovery of reasonably incurred costs."[19]

Advice letter rate base offsets are another tool available to the utilities. As a regulatory tool that helps ensure the construction of specific capital projects while permitting Commission pre-approval of prudency when project costs or

[19] D.09-05-019.

timing remain overly uncertain, rate base offsets can offer a mutually beneficial means of gradual rate increases over a three-year rate case cycle.

6) Park/Apple Valley Common Equity Adjustment

Park/Apple Valley proposes an adjustment to its common equity to account for the balances in its long-term regulatory accounts. Balances in the accounts Park/Apple Valley identifies currently will be recovered over a period that can range from 1 to 3 years. This request is similar to requests Golden State Water Company and California American Water Company (CAW) made in the last Cost of Capital proceeding A.11-05-001, et. al. In that proceeding DRA opposed the requests because the requests essentially sought to override the determinations of past Commissions and sought to address issues beyond the scope of the cost of capital proceeding. Furthermore, CAW made a request for this type of adjustment in its recent GRC proceeding, which the Commission denied in D.12-06-016.[20]

DRA similarly opposes this proposed adjustment to Park/Apple Valley's common equity. Interest currently earned on the account balances is intended to compensate the utility for the time period up until the balances are recovered. Any proposed changes to the memorandum or balancing accounts are best considered in GRCs, not cost of capital proceedings. Furthermore, since implementing its WRAM/MCBA on September 15, 2008, Park has earned above its authorized ROE in two of the three full years it has been in place.[21] DRA's more extensive analysis of the Applicants' capital structures is included in Attachment JRW-14 of Dr. J. Randall Woolridge.

---

[20] Decision. 12-06-016, June 14, 2012 by the Commission in Phase 1 of A.10-07-007, see Conclusions of Law 53, 54, and 60.

[21] See the Testimony of Dr. J. Randall Woolridge, Attachment JRW-13, page 3 of 5

7) Water Cost of Capital Adjustment Mechanism

Park/Apple Valley and Suburban have requested that the Commission reduce the "deadband" for the WCCAM to 100 basis points. Great Oaks and San Gabriel Valley Water requested that the WCCAM remain in place, but did not request a change to the size of the "deadband." DRA supports continuing the WCCAM and returning the "deadband" to 100 basis points since market volatility, as measured by the Volatility Index ("VIX"), has decreased since the last cost of capital proceeding. Dr. Woolridge discusses the VIX in his testimony beginning at page 13.

D. CONCLUSION

Generally, many of the risks the Applicants identified, including supply concerns, forecasting issues, and conservation impacts upon sales, are effectively addressed by other Commission proceedings and actions that authorize the use of balancing accounts, memorandum accounts, rate base true-ups, and revenue decoupling mechanisms. Most of the issues raised by the Applicants are not new issues, and as such are reflected in market data.

For the reasons identified above, DRA recommends against the inclusion of the proposed risk adjustments to the ROE, and in the case of Park/Apple Valley the adjustment to its common equity in the current proceeding. DRA's specific recommendations for the ROE and cost of capital are included in DRA's Dr. Woolridge testimony. DRA also recommends that the existing WCCAM continue with the "deadband" reduced to 100 basis points.

QUALIFICATIONS AND PREPARED TESTIMONY OF

PATRICK E. HOGLUND

Q.1. Please state your name and business address.

A.1. My name is Patrick E. Hoglund. My business address is 505 Van Ness Avenue, San Francisco, California.

Q.2. By whom are you employed and in what capacity?

A.2. I am employed by the California Public Utilities Commission - DRA Water Branch - as a Senior Utilities Engineer.

Q.3. Please briefly describe your educational background and work experience.

A.3. I am a graduate of the University of California, Berkeley, with a Bachelor of Science Degree in Industrial Engineering and Operations Research. I am also a graduate of the University of Rochester, William E. Simon School of Business with a Master of Business Administration Degree with concentrations in Finance and Corporate Accounting. I am a licensed professional Industrial Engineer.

I have been employed by the California Public Utilities Commission since 2005. My current assignment is within DRA – Water where I work on Class A General Rate Cases, Cost of Capital proceedings, and policy related matters. From July 1999 through August 2004, I was a Senior Rates Analyst at Pacific Gas and Electric Company, where I worked on a variety of revenue requirements issues related to natural gas. From 1990 through 1997, I was employed by the California Public Utilities Commission. During this time I worked on small water utility rate cases, large water utility rates cases, and also worked in the Telecommunications and Energy Branches of the former Commission Advisory and Compliance Division, as well as in the Division of Ratepayer Advocates.

Q.4. What are your responsibilities in this proceeding?

A.4. I am responsible for the preparation of this testimony.

Q.5. Does this conclude your prepared testimony?

A.5. Yes, it does.