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

Application of California-American Water
Company (U210W) for Approval of the
Monterey Peninsula Water Supply Project and
Authorization to Recover All Present and Future
Costs in Rates.

A.12-04-019
(Filed April 23, 2012)

**REBUTTAL TESTIMONY OF DAVID P. STEPHENSON
ERRATA**

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TABLE OF CONTENTS

	<u>Page</u>
I. INTRODUCTION	1
II. PURPOSE OF TESTIMONY	1
III. DRA	2
A. Surcharge 2	2
B. Equity	7
C. Cost Cap	8
D. CAW Facilities	10
E. State Revolving Fund (“SRF”)	12
F. Groundwater Recharge (“GWR”)	15
IV. MPWMD	15
G. Surcharge 2	15
H. Net Present Value Analysis	16
I. Financing Alternatives and Additional Costs	19
J. Connection Fees	22
V. CITIZENS FOR PUBLIC WATER	22
K. Surcharge 2	22
L. Stranded Costs	25
VI. WATERPLUS	26
VII. SPI ANALYSIS	27

1
2
3
4
5
6
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ERRATA

I. INTRODUCTION

Q1. Please state your name and business address.

A1. My name is David P. Stephenson and my business address is 4701 Beloit Drive, Sacramento, CA 95838. I am Director of Rates for California-American Water Company (“California American Water”).

Q2. Have your qualifications previously been provided in this proceeding?

A2. Yes.

II. PURPOSE OF TESTIMONY

Q3. What is the purpose of your testimony?

A3. The purpose of my testimony is to provide rebuttal to the positions espoused by a number of intervenors in this proceeding and to further support the application filed by California American Water. In my rebuttal testimony, I will address claims related to the regulatory issues regarding Surcharge 2, cost caps, the California American Water-only facilities, allowance for funds used during construction (“AFUDC”), groundwater recharge (“GWR”), financing alternatives and additional costs, net present value (“NPV”) analysis,

1 connection fees, “stranded” costs, and the SPI analysis. I will focus on the testimony of
2 the Division of Ratepayer Advocates (“DRA”), Monterey Peninsula Water Management
3 District (“MPWMD”), Citizens for Public Water, and WaterPlus.¹
4

5 **III. DRA**

6 **A. Surcharge 2**

7 Q4. Please describe California American Water’s request for the re-authorization of Surcharge
8 2 in this proceeding.

9 A4. California American Water requests that the Commission re-authorize Surcharge 2 as
10 approved in D.06-12-040, with minor modifications. Please see pages 17 through 21 of
11 my direct testimony in this proceeding for further details.
12

13 Q5. Do you agree with DRA’s assessment of the risks that California American Water
14 shareholders should bear for a project?

15 A5. I agree that shareholders do bear all the risk of proving that all expenditures are prudent.
16 If expenditures are deemed imprudent – then that deemed imprudent cost would not be
17 recovered.
18

19 Q6. Do you agree with DRA’s description of the Commission’s practices regarding abandoned
20 projects?

21 A6. As DRA notes, in certain instances, shareholders must bear the cost for cancelled projects.
22 This often for projects for which the utility had full control and not projects where the
23 utility acted under a mandate, as is the situation in this case. In other instances, the
24 Commission has allowed a utility to recover the costs of a cancelled project from
25 customers. This has happened on occasion for California American Water. This is a fact-
26

27 ¹ This does not mean that if other parties provided testimony that I agree with that testimony, especially in the case
28 where that testimony is at odds with California American Water’s request in this case. Given the large number of
witnesses that provided testimony and the relatively short time for rebuttal, I focused my testimony on the key
regulatory points.

1 specific determination, however, and the Commission considers a variety of factors in
2 making its determination. Moreover, just because California American Water has been
3 able to recover the cost of cancelled projects in the past does not mean that it will always
4 be able to do so in the future. Thus, DRA’s statement that customers may “unfairly” bear
5 “the risk of project abandonment” is not accurate.

6
7 Q7. Do you agree with DRA that California American Water may be able to profit on the sale
8 of the asset?

9 A7. No. California American Water carefully developed its proposal and worded its
10 application and testimony to avoid such a result for this project. Under California
11 American Water’s proposed structure, the book value will be reduced in the amount of the
12 Surcharge 2 contribution, which means that the value at the time of sale will also be
13 reduced. To put it another way, if sold, the amount contributed would not be part of the
14 basis for the sale price – it will have been removed from the equation.

15
16 Q8. Do you agree with DRA that the use of customer funds to build a new project violates the
17 pact between California American Water and its customers?

18 A8. No. DRA claims that California American Water violated this pact because California
19 American Water is not taking on the full capital risk during the construction of the
20 MPWSP. Contributions, connection fees and facilities fees, however, are all forms of
21 customer contributions that are used to offset plant costs. While these are usually applied
22 when a new customer seeks a connection in the system, they still serve exactly the same
23 purpose as Surcharge 2. The commonality between the various methods is that they all
24 are for ensuring service to the customer and that customers pay their fair share. The same
25 principle applies to the MPWSP.

1 Q9. Do you agree with DRA that as a matter of general utility regulation policy, utility
2 projects are first funded by shareholders and then rewarded with a return after the project
3 is found to be used and useful?

4 A9. No, I do not agree that this is always the case. Again, connection fees can be assessed,
5 facility fees can be assessed and many items can be contributed. Therefore, in these cases,
6 the funding comes from the customers, not the utility.

7
8 Q10. Do you agree with DRA that the Commission must ensure that capital supplied by
9 ratepayers via Surcharge 2 is established as a public contribution and is permanently
10 excluded from California American Water rate base?

11 A10. What DRA has proposed is exactly what California American Water believes its proposal
12 accomplishes, as noted above.

13
14 Q11. Is DRA correct that California American Water will be “keeping” 100% of any costs
15 savings that result and will not place the savings in the balancing account?

16 A11. No. The intent of the balancing account is to capture all revenue requirement
17 differentials. This includes cost savings resulting from actual incurred benefits and
18 efficiencies.

19
20 Q12. Do you agree with DRA that California American Water’s proposed timing for
21 Surcharges 1 and 2 would result in an unnecessary overlap, which would, in turn,
22 undermines the goal of mitigating rate shock?

23 A12. No. While there is an increase out of the box of 30% under California American Water’s
24 proposal, DRA’s modified proposal would result in more dramatic rate fluctuations. At
25 the current rate of recovery of Surcharge 1 and other costs that may be requested and
26 authorized for recovery via Surcharge 1,² it is possible that it will not be fully recovered

27 ² For example, on December 4, 2012, California American Water entered into a settlement agreement with the
28 County of Monterey and the Monterey County Water Resources Agency regarding the Regional Desalination Project.
California American Water will be requesting recovery of costs related to this.

1 until late in 2015, or possibly later. If DRA's proposal were adopted, then the recovery
2 period for Surcharge 2 would be shortened and the surcharge would not be able to
3 generate the proposed level of customer contributions. The first objective in setting the
4 timing and percentage of Surcharge 1 should be to recover the level of contributions
5 deemed appropriate. It should not be governed by an artificial decree that stifles
6 necessary beneficial contributions.

7
8 Additionally, under DRA's proposed schedule the Surcharge 2 collection in year 3 of
9 \$46.9 million is far above a 60% level. This means that there is an inconsistency in the
10 DRA proposal and either it cannot recover the amount as requested by California
11 American Water, or the annual percentage for Surcharge 2 will be greater than 60% and
12 result in a rate decrease at the time the project starts to provide water to customers.

13
14 Q13. Do you agree with DRA that Surcharge 2 reduces the overall cost of the project and
15 avoids the rate shock that would result if customers were presented with a sudden 68%
16 increase in the Monterey District revenue requirement?

17 A13. Yes. This is exactly the principle requested in the application by California American
18 Water, and is demonstrated in the working model.

19
20 Q14. Do you agree with DRA that changes are necessary so that California American Water
21 and its customers are sharing in the risk of capital in the project?

22 A14. I do not agree that customers are sharing in the risk. That could only occur if there is no
23 review of the costs and the Commission authorized California American Water to recover
24 imprudent costs, or recover costs on the cessation of the project without a prudency
25 review. As proposed by California American Water, costs still need to be reviewed for
26 prudency and customer contributions will not go to fund imprudent costs.

1 Q15. Do you agree with DRA that Surcharge 2 funds should be held in a separate memorandum
2 account awaiting a reasonableness review of project expenses and that there should be a
3 second memorandum account, where funds collected from Surcharge 2 should be tracked?

4 A15. No. DRA’s proposal to for multiple memorandum accounts and advice letter process is
5 convoluted and unclear. It is unnecessary because it adds complexity without providing
6 additional benefit to customers. As detailed in the California American Water financing
7 proposal, California American has proposed that costs be held in the [memorandum](#)
8 ~~balancing~~ [A](#)account until the MPWSP is operational, at which point it will file an advice
9 letter seeking approval of the rate change. DRA and others will have the opportunity to
10 review the costs and the accounting of the Surcharge 2 at that time.

11
12 Q16. Do you agree with DRA that it is reasonable for ratepayers to earn a fair rate of return for
13 the use of Surcharge 2 funds?

14 A16. Yes, California American Water agrees that a reasonable return is appropriate, which is
15 why California American Water proposed that the balancing account accrue interest at the
16 actual costs of funds borrowed to fund the project. However, it is also logical that both
17 costs and collections earn interest at the same rate. DRA’s proposal is not balanced and
18 makes no economic sense.

19
20 In my Direct Testimony I stated, “The memo account will draw interest at the same rate as
21 would the costs incurred for the project.” For example, if the project was being funded by
22 short-term borrowings at a commercial paper rate of say 0.25%, then all surcharge
23 collections as well as all incurred costs would be subject to an interest component
24 calculated based on the 0.25%. California American Water’s proposal in the Application
25 remains our recommendation today: that the interest charges and accruals would use the
26 same exact rate and that rate would be based on the interest rate of the instrument that
27 would be used during that applicable accrual period that is used to finance the project
28 costs.

1 For the Surcharge 2 Memorandum Account, DRA recommends that the account accrue
2 interest at California American Water's cost of equity (9.99%). This would apply to the
3 total un-appropriated balance. For the MPWSP Construction Memorandum Account
4 DRA states that only the amount over the balance in the Surcharge 2 Memorandum
5 Account should draw interest at the actual cost of borrowed debt. The remainder would
6 not draw any interest.

7
8 Under DRA's proposal, California American Water would earn its actual short-term rate
9 on the costs it incurs in excess of the surcharge balance, while it would be paying 9.99%
10 interest to customers on the entire Surcharge 2 Memorandum Account. Why would
11 California American Water even consider customer funding if it had to pay more interest
12 on those collections than it would cost to borrow from a bank? The concept of AFUDC
13 and equitable sharing is completely violated by the DRA proposal. This adds significant
14 risk to the project over and above that which is already in play for California American
15 Water. I know of no Commission decision or other authorization that has ever used this
16 approach.

17
18 Q17. Does Surcharge 2 result in customers becoming implicit investors in the water supply
19 solution?

20 A17. No. They are contributors to the project just as developers are when they pay connection
21 or other fees. This is a contribution of funds, not an ownership vesting.

22 **B. Equity**

23 Q18. In at least one scenario presented by DRA, there is no equity proposed to be issued to
24 cover the cost of the facilities. What is your view on such a proposal from a regulatory
25 point of view?

26 A18. According to many of the California American Water rebuttal witnesses it has been shown
27 that it is important for the Company to maintain its current capital structure or increase its
28

1 return to remain in a neutral position to that which exists today, or all financing costs
2 would increase. In the case of no equity, this would significantly compromise the
3 viability of the utility without a significant rebalancing or increase in equity return that
4 would affect all customers of California American Water. If the Commission chose not to
5 rebalance the capital structure or increase the cost of equity, it would harm the viability of
6 California American Water which is in direct conflict with the Commission's own Water
7 Action Plan, which states:

8 If utilities are not allowed to charge adequate rates to recover the
9 costs of doing business, they will not be able to invest adequate
10 amounts in maintenance and upgrading infrastructure. The result is
11 low quality service. The Commission will carefully review the
12 rates it sets to allow utilities to charge rates which will enable them
13 a fair rate of return on capital and sufficient investment in
14 infrastructure, while keeping rates reasonable for ratepayers.³

16 C. Cost Cap

17 Q19. Do you agree with the significantly lower cost caps recommended by DRA?

18 A19. I do not. Mr. Svindland will address all the cost recommendations made by DRA and
19 how they affect the caps. I will only address my understanding of the Commission goal in
20 assigning cost caps and how the DRA recommendation is contrary to good public policy.
21

22 As I have learned through my experiences at the Commission, cost caps have been
23 employed in many industry cases to ensure that a more speculative project maintains its
24 economic viability through completion. A cap will limit the total dollars that are deemed
25 necessary to design and construct a particular project. I believe that cost caps are
26 particularly necessary in certain types of situations. The project here before us is a
27

28 ³ 2005 Water Action Plan page 21

1 number of years off until construction and there are many permits and other matters that
2 must be dealt with to come to the completion. So it is natural that some sort of cost cap is
3 necessary. However, with a project of this magnitude, a cost cap that is set too low in the
4 initial stages could result in having to come back to the Commission numerous times to
5 get the cap altered. If a hard cap is set and the costs must exceed that cap to get to
6 completion, then I believe that it will be difficult to get financing for the project. The
7 project cap has to be set realistically and set at a level that allows for contingencies.

8
9 It is apparent that DRA does not subscribe to this premise. DRA in this proceeding has
10 proposed not only a cost cap that is too low, but also a hard (or absolute) cap above which
11 no costs could be recovered. The Commission is required to provide the utility the ability
12 to earn a reasonable return on prudently incurred costs. This requirement cannot be met
13 under the DRA cap proposal – it is impossible if the hard cap is exceeded. What DRA is
14 doing is making a determination that there can be no reasonable or prudent costs over the
15 hard cap. That is impossible to know. Material prices could skyrocket, subsurface
16 construction cost issues could arise, permitting issues, totally out of the control of the
17 utility, could surface. Moreover, DRA in its assessment of project costs acknowledges
18 that there are some that are highly speculative. If that truly is the case, then an absolute
19 cap makes little sense to be proposed. Prudent and reasonable costs should all be
20 recovered as [is the practice](#) ~~incurred~~ on any project.

21
22 There is no way for any person to determine an absolute not to exceed amount. Hard caps
23 may cause prudent costs not to be recovered. While a cap or soft cap may be appropriate
24 at a level that provides investors some sense that funds will be recovered at a reasonable
25 return, DRA’s proposal could lead to the halting of the project because of risk and lack of
26 funding.

27
28 Finally, cost caps are normally used to ensure that the project selected remains reasonable.

1 This assumes choices. In this case, a project has to be built or economic ruin may be
2 realized on the Monterey Peninsula. There is no choice but to build a project. What the
3 Commission should be doing is ensuring prudent expenditures and not creating artificial
4 caps that might kill the project. California American Water should not be placed in a
5 position where it might not recover prudent costs for a project that is mandated, necessary
6 and the choice of most in the community. Hard caps are not needed and caps set at
7 reasonable levels are all that is necessary.

8
9 **D. CAW Facilities**

10 Q20. Do you agree with DRA that the last adopted cost cap for the CAW Facilities should not
11 be used in this case?

12 A20. No. Mr. Svindland will support why the \$106.875 million is a valid estimate. We
13 supported the cap in A.04-09-019 and have again provided more than sufficient evidence
14 to support that number.

15
16 Q21. Do you agree with DRA that the Commission's prior approval of the Settlement
17 Agreement is not precedential?

18 A21. I agree that any settlement is not precedential. However, D.10-12-016 fully supported its
19 position to adopt the settlement. The decision can and should provide guidance since the
20 CAW Facilities are the same as previously proposed. There are no significant changes to
21 the cost estimates or the project, in my opinion, that would warrant changes in the cap. If
22 anything, the cost may be higher as the result of time passing by.

23
24 The Settlement Agreement in A.04-09-019 was approved by the Commission in D.10-12-
25 016 and was approved to facilitate implementation of the Regional Desalination Project
26 ("RDP"), and thus, help solve the water supply constraints on the Monterey Peninsula.
27 The CAW Facilities were part of that approval. The purpose of the MPWSP is the same.
28 The CAW Facilities are the same. The only difference is who will own and operate the

1 desalination facilities and where they are located.

2

3 Q22. Do you believe that the slight modifications made to the project cost should have a
4 bearing on the authorized cap?

5 A22. No. A change in the estimate is a natural occurrence as time passes. I do not see any
6 regulatory issue in regards to using the same cap as previous even though costs may have
7 changed slightly.

8

9 Q23. Since California American will now own and operate the plant, should that change the
10 treatment of the CAW Facilities?

11 A23. No. The semi-annual advice letter process was in place to ensure timely recovery of costs.
12 The adopted procedure was in place to allow CAW to recover its costs on a slightly after
13 the fact timeframe allowing some cash flow recognition. In this case, the cash flow needs
14 are greater as California American Water is constructing the desalination facility on its
15 own. This generates an even greater cash flow need for California American Water than
16 that in the RDP agreement. There is nothing in this proceeding that would justify a
17 different treatment for the CAW Facilities.

18

19 Q24. Do you believe that D.12-07-008 provide any justification for DRA to slash the cap of the
20 project?

21 A24. No. While I agree that the project can and maybe should be reassessed in this proceeding,
22 I do not believe that it provides any further guidance except to say no further recovery of
23 cost until a decision in this application.

24

25 Q25. Do you agree with DRA that all project costs, including those of the CAW facilities,
26 should all be considered as a single project and all recorded simultaneously?

27 A25. No. To fold the CAW facilities into the cost of service model and recover only after the
28 total plant is in service makes no sense. The CAW Facilities are comprised of mains,

1 tanks, wells, booster stations and PRV. These are all normal utility plant. We should be
2 seeking immediate rate consideration for these facilities – but to allow DRA some time to
3 review, California American made the current process where costs go into rate base after
4 that fact. It makes no sense for DWA to not be processing the request.
5

6 Q26. Is California American Water stating that that Commission should not examine the costs
7 for the CAW only facilities?

8 A26. No.
9

10 Q27. Did DRA adequately justify the proposed changes to the recovery process?

11 A27. No. In fact, DRA does not provide any justification for eliminating the prior approved
12 process except to say this is all one project and should be considered together. As noted
13 above, this combined treatment does not provide for cash flow and does not comport with
14 the usual treatment of water utility investments, which is to allow all costs in CWIP as
15 part of rate base. The DRA proposal is a significant burden on an investment intensive
16 utility.
17

18 **E. State Revolving Fund (“SRF”)**

19 Q28. Do you agree with DRA that the Commission must explicitly require in its final decision
20 that any SRF monies used to finance the MPWSP be accounted for in accordance with the
21 requirements prescribed for the use of these public funds in D.05-01-048?

22 A28. No. Not in all aspects. I agree that it should be treated the same for ratemaking purposes,
23 but I do not agree that the Commission can require us to handle the funds differently than
24 required by GAAP.
25

26 Q29. Do you agree with DRA that the Commission should treat SRF loans as a contribution to
27 the project financing and exclude such funds from rate base?
28

1 A29. Yes, this is the normal ratemaking treatment. However, the Commission cannot dictate
2 how we handle the loans from a financial perspective. In his testimony on behalf of
3 California American Water, Michael Barrett of Ernst & Young provides the detail on how
4 these loans have to be handled for book purposes. Additionally, Dr. William Chambers
5 discusses how the markets account for this debt in his rebuttal testimony on behalf of
6 California American Water.

7
8 Q30. Do you agree with DRA that allowing California American Water to account for the SRF
9 as debt on the balance sheet will allow California American Water to take a higher equity
10 position in the project than envisioned in Decision 12-07-009, which authorized the
11 establishment of cost of capital for the period from January 1, 2012 through December 31,
12 2014?

13 A30. No. While the SRF loan is a dedicated loan to pay off a certain portion of the plant and it
14 therefore cannot be in rate base, the loan is still a loan. If customers default, we have to
15 pay the interest and principle due. California American Water has no alternative but to
16 account for the loan as debt, reflect it on the balance sheet as such, and then re-balance the
17 debt/equity ratio to the appropriate structure the Company has established. As
18 recommended by the Commission in D.09-05-019, California American Water has
19 increased its equity ratio (from a 2008 level of 42%) to reduce leverage, provide a more
20 balanced structure, and provide the lowest cost financing to customers. To maintain this
21 lowest cost capital financing plan, it is imperative that the capital structure remains the
22 same as last authorized, which was comprised of 47% debt and 53% equity. California
23 American Water's financing proposal will ensure that this occurs, because it includes a
24 proposal to finance the debt portion with SRF Debt and properly reflect that debt on the
25 books of the Company as debt, which Mr. Barrett notes is an accounting requirement.

26
27 Q31. What would happen if California American Water did not balance the SRF debt with
28 equity for book and ratemaking purposes?

1 A31. Based on the testimony of Dr. Chambers, the markets would view this negatively and then
2 may require a higher interest rate on borrowings and a higher return on equity. The real
3 problem becomes that if you allow the SRF to remain completely out of consideration for
4 the capital structure and the markets require higher returns on debt and equity that in turn
5 affects all of the California American Water properties – not just Monterey. The SRF
6 debt is issued for a Monterey project and all costs that occur as a result thereof should be
7 reflected in Monterey, not other California American Water properties.
8

9 Q32. Do you agree with DRA that the Cost of Capital application determines the appropriate
10 level of debt-to-equity and rate of return for a water utility that is at a sufficient figure “to
11 permit the company to raise enough capital to provide reliable service at a reasonable
12 rate”?

13 A32. Yes, I do, and that is exactly what occurs in every Cost of Capital application. This is
14 exactly why California American Water has proposed in this application to finance 53%
15 of the net project cost⁴ with equity. California American Water has determined that with
16 all things considered a 53% equity capital structure is the most cost efficient.
17

18 Q33. Do you agree with DRA that California American Water is inappropriately applying SRF
19 loans as a substitute for long-term debt, even though the lower cost of these funds has not
20 been incorporated into the calculation of California American Water’s weighted cost of
21 capital?

22 A33. No, I do not. Since a financing will be made with entire amount requested applicable to
23 this project, California American Water proposed that the weighted average cost of capital
24 to be applied to this project should be exactly the same as the remainder of properties in
25 California, except to substitute for the historic weighted average cost of debt, the average
26 cost of debt of the issuance (s) necessary for this project. This proposal will maintain
27 financial integrity as well and provide the lowest cost financing for the Monterey

28 ⁴ Net project cost is the total cost less the Surcharge 2 collections

1 customers. California American Water is applying the entirety of the SRF loans to the
2 MPWSP, not the higher cost of other embedded debt in the California American Water
3 portfolio, and then offsetting that debt with equity at the same ratio as the remainder debt
4 and equity. So the SRF debt is accounted for appropriately – there is no “windfall.”
5

6 Q34. Does the Commission account for all SRF loans in exactly the same manner for book
7 purposes?

8 A34. I do not believe that there is consistent treatment of SRF loans and how they are
9 represented before the Commission. Please see [Attachment 1 which is a copy of](#)
10 Resolution W-4678, attached hereto as Attachment 1, wherein it clearly shows that the
11 Commission authorized North Gualala Water Company to show the SRF loans as part of
12 the capital structure.
13

14 **F. Groundwater Recharge (“GWR”)**

15 Q35. Do you agree with the DRA recommendation that the Commission approve a 9.6 MGD
16 desalination plant because, ~~as recommended below~~, California American Water could
17 subsequently obtain Commission approval via the Advice Letter process to down size the
18 plant if the GWR Project is viable?

19 A35. Yes, I do.
20

21 **IV. MPWMD**

22 **G. Surcharge 2**

23 Q36. Do you agree with Mr. Larkins that there are tools that can benefit customers by reducing
24 or replacing Surcharge 2?

25 A36. I believe that it all depends on what you want to consider in the analysis and how you do
26 that analysis. As I will explain below, I still vehemently disagree with those that believe a
27 Net Present Value analysis is a sole indicator or benefits. I do agree with Mr. Larkins that
28 you need to consider more than one approach and a possible approach is to simply look at

1 periods of time. However, as I discuss above, Surcharge 2 is a reasonable charge against
2 present customers since they have significantly benefitted by having deadline after
3 deadline extended for California American Water to comply with SRWCB Order W 95-
4 10. Without all the extensions, clearly current customers would have had a much-reduced
5 supply, which in turn would have caused severe economic hardships. Therefore, I do not
6 believe it is fair for Mr. Larkins to say that some public financings are cheaper than a
7 contribution from customers with no interest cost – and from customers who need to pay
8 their pay share. I do not believe that there is any lower cost financing available to
9 California American Water in the magnitude necessary than Surcharge 2.
10

11 **H. Net Present Value Analysis**

12 Q37. Do you agree with Mr. Larkins that in the use of a NPV analysis that you need to look not
13 only at the total revenue requirement over time, and the NPV of that revenue requirement,
14 but also the annual burden on ratepayers, which is why they have added to their modeling
15 output a summary of rate payer impact over five and ten year horizons.?

16 A37. This is just as I have been saying, that the NPV analysis is only one analytical tool and
17 that there are many other tools and analyses that also should be considered. The
18 periodical and annual revenue requirements are very good tools to use and should be
19 given just as much, if not more, weight as any NPV analysis. Again, in my opinion any
20 NPV analysis that does not consider all elements of targeted group then lacks important
21 considerations. A project specific NPV analysis is only truly applicable to the
22 constructing entity. Every entity, group or individual has a different NPV factor and in
23 my view, a general factor is not appropriate to use when the analysis is for general
24 purpose that include how this affects customers.
25

26 Q38. Do you agree with Mr. Stoldt that economic comparisons of projects are most commonly
27 made on the basis of net benefits and that net benefits are determined by estimating
28

1 discounted benefits and costs over the study period, and then subtracting the discounted
2 costs from the discounted benefits to obtain discounted net benefits?

3 A38. Yes, I do, and that is exactly how the model is laid out. It determines an NPV for the
4 specific project as a matter of the projects impact on the Company. The NPV analysis in
5 the model is not a determinate of the effects against customers, all of whom have their
6 own unique considerations that lead to different discount factors.

7
8 Q39. Do you agree with Mr. Stoldt that the Commission should require alternative financing
9 approaches to be evaluated utilizing NPV evaluation, not simply a single “test year”
10 revenue requirement?

11 A39. I agree, but with certain qualifications. While a presentation of the NPV analysis is one of
12 many tools that can be used, it should not be the main focus of the determination. To do
13 this type of analysis and comparison it has to be an all in cost consideration, not just costs
14 that may be incurred by the project. So if MPWMD pays for or covers a portion of its
15 costs out of reserves, that payment should be incorporated back into the analysis from the
16 point in time that revenue stream was acquired, based on a FIFO methodology.

17
18 To my understanding, there is also no commission requirement to use any single
19 evaluating method to make a determination. The total concept, including complexity,
20 achievability, timing and other factors has to be considered. These less fungible items
21 may actually be more important and affect the evaluation process greater than any NPV
22 analysis.

23
24 Q40. Do you agree with Mr. Stoldt that the 12.1% default value contained in California
25 American Water’s January 3, 2013 financial model is not the appropriate discount rate for
26 NPV?

27 A40. No. The 12.1% is what the Commission has historically used. It is grossed up for taxes
28 weighted average cost of capital.

1 Q41. Do you agree that according to the California Department of Water Resources Guidebook
2 “The discount rate is used to adjust dollars received or spent at different times to dollars of
3 a common value, usually present day dollars (“present worth” or “present value”)?

4 A41. While a discount rate is used to adjust dollars received or spent at different times to a
5 common value, I believe that is only applicable to a specific individual, group, or entity.
6 Using a common discount rate as for an analysis of everyone’s perceived impact is not
7 appropriate.

8
9 In regards to the correct NPV rate, if we are analyzing the project against other
10 opportunities for California American Water, then it is entirely appropriate to use the rate
11 of 12.1%, a rate that is the pre-tax cost of capital. The Commission has continually
12 determined that the NPV to be used in proceedings at the Commission is the tax grossed
13 up weighted average cost of capital for the utility. If we are talking opportunity cost for
14 someone else – like customers – maybe it is 1%. A discount rate is the major driver in
15 any NPV determination and unless you specify who the discount rate is applicable to for
16 their opportunity cost there is no way to specify an appropriate rate. Each and every
17 entity, individual, or group may have a unique discount rate that they believe needs to be
18 used to determine which opportunity cost is superior.

19
20 Q42. Do you agree with Mr. Stoldt that if the Commission uses NPV analysis as an additional
21 evaluative tool, a lower discount rate in the 4% to 6% range should be used?

22 A42. No, as I discussed above, the Commission has to determine who the subject of the
23 discount rate is. If it is the utility then the pre-tax cost weighted cost of capital should
24 apply. If it is the customer, then a multitude of discount rates may be applicable.

25
26 Q43. Do you agree with Mr. Stoldt that the use of NPV is widely used in economic evaluation
27 of capital projects to determine lowest cost impacts and that ~~my~~ the statement in ~~my~~ your

1 Supplemental testimony that “discounting a stream of revenues has extremely limited
2 value and really only provides a current value of future cash flows” is incorrect?

3 A43. No, my statement is not incorrect. In this case, since we have no idea to whom the
4 discount is being applied toward we really do not know whether there is value or not. If it
5 is the overall net cost/benefit of the project to California American Water, then the pre-tax
6 costs of capital should be used. If we are discounting the net operating costs, then the
7 after tax rate of return should be used. The facts have to be determined based on the
8 affected party, not a universal group.

9
10 Q44. Do you agree with Mr. Stoldt that California American Water has calculated that its
11 weighted average cost of capital for the Monterey Peninsula Water Supply Project is less
12 than 4.0%?

13 A44. I agree that we calculated a projected all-in cost of financing the entire project at less than
14 4%, but that applies to all financing of the project, including equity, SRF debt, and zero
15 cost customer contributions. This is in no way the opportunity cost for California
16 American Water. In the model we used the rate that Commission has historically used in
17 any NPV analysis, which is the pre-tax weighted average cost of capital or 12.1%.

18 19 **I. Financing Alternatives and Additional Costs**

20 Q45. How will the Commission view alternative financing proposals and additional costs that
21 might need to be considered?

22 A45. In my opinion, and just like most proposed financings, I believe the Commission will take
23 an “all-in” approach to the cost review. In my experience the Commission never looks
24 only at a proposed interest rate, but they also look at all the brokerage fees, Commission
25 fees, placement fees, attorney fees and any and all other anticipated costs. In General
26 Order 24-C, the Commission states that as the part of any bond financing what is required
27 is a description of the bonds or other evidences of indebtedness, issued during the period
28 detailed above, under the authority of the Commission, including: 1) the principal amount

1 of the issuance; 2) the commissions paid; and 3) the total proceeds received. Costs of a
2 loan are usually established as debt expense is used to offset the loan proceeds and
3 increase the effective interest rate.
4

5 Q46. To the extent that the public financing proposals from MPWMD result in increased costs
6 for California American Water, do any of the current proposals provide a method for
7 recovery?

8 A46. No. Since these costs are not known and could be significant, not only at the time of
9 issuance, but to manage the process and track through various entities, California
10 American Water requests that if the Commission authorizes a portion of the costs of the
11 MPWSP facilities to be funded through an alternative financing such as proposed by
12 MPWMD, then a balancing account would need to be authorized to ensure that all the
13 costs related thereto are captured and recovered appropriately ~~from~~ the customers in
14 Monterey and no harm is placed upon the remainder of the customers in California
15 American Water.
16

17 Q47. Based on your experience, do you believe that the Commission will have a great tolerance
18 for uncertainty in the financing of the project?

19 A47. I really can't speak for how the Commission will consider uncertainty in any specific
20 application, but it has been my experience that the Commission has in the past been
21 inclined to agree to proposals that may cost slightly more if that proposal is more certain.
22 The problem with speculation is that not only do you speculate on the components of the
23 particular request, you also have to speculate on how the market conditions will change
24 and if the period of speculation will cause other factors to change and negatively impact
25 the proposal. In D.10-12-016 the Commission noted "However, we cannot delegate our
26 duty to balance the need for additional water and the impact on ratepayers, pursuant to
27 Pub. Util. Code § 701 and the California Constitution, Article 12." I think this speaks
28 volumes in this situation and infers that the Commission needs to look at all aspects of the

1 proposals and determine if the speculation will cause more harm than good – especially if
2 the harm is any further delay in the project.

3
4 Q48. What is the normal process the Commission adheres to in the review and approval of
5 financings and does the process involve speculation?

6 A48. Rule 3.5 of the Commission Rules of Practice and Procedure establish the process and
7 requirements necessary to receive permission for a private utility to secure increases in
8 capital. Generally, to receive authorization to acquire new debt and/or equity, a utility
9 must file and get approval of an application that states the general purpose of the capital,
10 what type of capital is to be issued – including all the terms, rate of interest, and whether
11 and how it is to be secured; the amount and description of the indebtedness which
12 applicant desires to assume, a description of the obligation and copies of any securities to
13 be assumed. The Commission does a very thorough review of the application to make
14 sure that the assumption of the capital does not place the viability of the entity in jeopardy
15 and to make sure that the terms and conditions are reasonable. To ensure success in the
16 application the applicant needs to know all possible facts about the transaction. Financing
17 approvals can take up to twelve months, or longer. This process is in place to assure the
18 viability of a utility. Speculation is not highly regarded in this process and there are
19 requirements for the facts. Speculation could lead to delays in the approval or outright
20 rejection of the application.

21
22 Q49. Do you believe the Commission would consider any public contribution as a contribution
23 in aid construction?

24 A49. No, I do not believe that it would be a true contribution in aid of construction. For
25 ratemaking, it might be excluded from rate base, but it would not offset the plant as a
26 contribution as this is much more akin to a loan that has to be repaid. Basically, the plant
27 would simply not be reflected for ratemaking in the revenue requirement and likewise
28 there would be no recorded contribution.

1 **J. Connection Fees**

2 Q50. Do you agree with Mr. Stoldt that the proposed connection fee should not be set at the
3 same level as the current MPWMD connection fee and that the Commission should direct
4 California American Water and MPWMD to coordinate on the analysis and setting of a
5 connection fee for new connections?

6 A50. I agree that the Commission has the final say on setting the fee, but I disagree with Mr.
7 Stoldt that the appropriate fee should not be \$24,000 per AF of allocation. The MPWMD
8 Fee is already established at approximately \$24,000 per AF and it appears that the
9 community has accepted that fee. The MPWMD Fee is for new water supplies, which is
10 similar to the purpose of the MPWSP fee. Moreover, there are water rights presently sold
11 in Monterey for over ten times this amount, it is my opinion that a fee set at \$24,000 per
12 AF of rights purchased is reasonable.

13
14 **V. CITIZENS FOR PUBLIC WATER**

15 **K. Surcharge 2**

16 Q51. Do you agree with Mr. Riley’s characterization of Surcharge 2?

17 A51. Mr. Riley has made a number of statements and comments about to Surcharge 2 that are
18 misplaced, possibly due to a lack of understanding of our proposal. Mr. Riley claims that
19 he objects to the proposed \$99 million surcharge because the surcharge includes a
20 reversed risk-reward relationship, reduces incentives for prudence, avoids competition,
21 and creates inter-temporal inequity. To support these points Mr. Riley suggests that
22 because the surcharge is collected concurrently with costs incurred there will be no
23 prudence of the costs incurred and that there is no incentive to reduce or eliminate costs.
24 This is untrue.

25
26 Q52. Please explain why you disagree with the idea that a reverse risk-reward relationship
27 exists in regards to Surcharge 2.

1 A52. Mr. Riley claims that because of regulation shareholders are already unfairly rewarded
2 with a reduced risk profile as compared to entities engaged in the open market.
3 Additionally, Mr. Riley believes that Surcharge 2 places ratepayer money up first in the
4 most risky time of project development. I have a few comments in regards to this notion.
5 First, all costs incurred for the project may be reviewed for prudence. The Commission
6 always has the ability to review expenditures and could easily remove costs they deem
7 imprudent from the proposed memorandum ~~balancing~~ account. If the Commission
8 determines that a cost is imprudent, then the monies collected for that cost under
9 Surcharge 2 would go to pay for other prudent costs. Therefore, the ratepayer is not
10 bearing the risk – the risk still survives with the Company. Additionally, it is very clear in
11 my direct testimony that there are stop/start points as well as review points in the process
12 to ensure that even if the project is stopped – the monies collected will be accounted for
13 only after a Commission decision, and that decision could say to refund all collections to
14 ratepayers. So no risk shifting has occurred and what risk exists is properly provided a
15 reasonable rate of return, just as spend by utilities are likewise provided the same level of
16 return. Finally, Mr. Riley is incorrect that Surcharge 2 is security for later project funding.
17 Surcharge 2 is simply one funding source and a positive source in that it reduces the capital
18 upon which a return has to be provided and ensures that rate shock does not occur at the
19 time the project actually provides water to customers.

20
21 Q53. Do you agree with Mr. Riley that Surcharge 2 would discourage prudence and create an
22 all-in approach or create the potential for runaway costs?

23 A53. No. As I explained above, all costs incurred in the project will still be subject to a
24 prudence review. This is just the same as any other project. While the proposal is to use
25 Surcharge 2 to reduce the charges into the balancing account, it does not suggest that costs
26 are written off the books and become no longer subject to review because they are covered
27 by the surcharge collections. There is no reduction of incentive to continue to make the
28 best decisions in regards to all aspects of the project. To do otherwise could harm the

1 utility as it is constantly under review for its actions, and imprudence could cause negative
2 Commission reactions in many venues.

3
4 Q54. Do you agree with Mr. Riley that Surcharge 2 reduces competition and provides an
5 advantage to California American Water?

6 A54. Not at all. I believe what is important is the consideration of ratepayers. California
7 American Water has structured a proposal that it believes provides the best balance in
8 spreading the cost of the facility over both present and future customers and in doing so
9 produces rate impact projections that are much less subject to rate fluctuations than would
10 be achieved by any other financing proposal. Additionally, California American Water is
11 a regulated entity. It has to “play by the rules” of the Commission in proposing a
12 methodology to pay for the facility. California American Water has to charge its
13 customers on a cost basis of the facility.

14
15 Q55. Do you agree with Mr. Riley that Surcharge 2 creates inter-temporal inequity?

16 A55. No. You must look at the entire responsibility for the creation of the plant. The plant is ~~is~~
17 not for growth – it is for current customers. Current customers are today receiving the
18 benefit of the proposed facility in that if it wasn’t in the planning stages, the State Water
19 Resource Control Board could have a long time ago required that California American
20 Water only produce water up to its legal water right. That would have sent the entire
21 community into a nightmarish situation wherein there would have been very significant
22 rationing which in turn could have destroyed the economy of the area. Therefore, the
23 pursuit of the project has and continues to provide significant benefits that today’s
24 customers should pay. Future customers will be bound by the costs of this new facility
25 that has had significant changes in scope and delays, all of which were the result of
26 current situations, not future growth or future customers. So it is today’s customers that
27 should shoulder their share of the facility as a result of the situation, and future customers
28

1 should pay a reasonable share of the costs, definitely not all costs as might occur is
2 Surcharge 2 were eliminated.

3
4 Finally, the proposed flat percentage surcharge will not unfairly burden low-income
5 ratepayers. Those customers are already on a very heavily subsidized rate and to say that
6 a surcharge of 60% across the board should be allocated in some other way is irrational.
7 Even with a sixty percent surcharge customers being billed in the lowest tier will still not
8 be paying the cost of service.

9
10 Q56. Do you agree with Mr. Riley that Surcharge 2 is not needed to reduce rate shock because
11 rate shock will exist no matter what?

12 A56. No. As DRA noted, “the MPWSP would ultimately result in a significant increase of up
13 to a 100% (\$46.0 million annual revenue requirement increase) in rates for the company’s
14 ratepayers in the Monterey Peninsula.” Surcharge 2 benefits customers by gradually
15 increasing rates and avoiding a sudden and substantial spike in rates – rate shock. With
16 Surcharge 2, rates go up over time. Without it, rates are increased 100% at the time the
17 project produces water for customer use. A 100% increase would definitely cause rate
18 shock.

19
20 **L. Stranded Costs**

21 Q57. Do you agree with Mr. Riley’s characterization of Commission practice regarding the
22 sharing of stranded costs between ratepayers and investors (approximately 90-10)?

23 A57. As I discussed above, the Commission’s review of a request for recovery of stranded costs
24 is very fact-specific. Contrary to Mr. Riley’s claims, I do not believe the Commission has
25 “abandoned” any of its policies regarding recovery of such costs. In my experience, the
26 Commission has completed independent reviews of the situations that led to the stranded
27 costs and based on the prudence and requirements to incur the costs have made a
28

1 determination on the process for recovery. Each and every situation is different and the
2 experiences in each case will lead to the decision of the Commission.

3
4 Q58. Do you agree with Mr. Riley about the costs he asserts California American Water has
5 recovered in Monterey over the past number of years and that California American Water
6 has recovered all the costs it incurred?

7 A58. No, not at all. In the case of the Carmel River Dam project, over \$3.6 million was
8 incurred and only \$3.2 million was authorized. As for the cost related to the A.04-09-019,
9 there has to date only been a little over \$31 million approved for both Mr. Riley's items 2
10 and 3. There has been spend that exceeds the authorized level by well over \$1 million that
11 the Company did not recover. However, the most important item is that the costs at issue
12 here were for a Monterey water supply alternative. They were not for any specific project
13 and most of the costs incurred would have been incurred no matter which project was
14 pursued. In short, the costs incurred in A.04-09-019 are not abandoned project costs as a
15 water supply project is still being pursued.

16
17 **VI. WATERPLUS**

18 Q59. Do you agree with Mr. Weitzman that California American Water has proposed Surcharge
19 2 because it unable to secure financing for the MPWSP?

20 A59. No. There is nothing in any record where California American Water has ever stated over
21 the past few decades that it is unable to secure financing on this or any other project.
22 California American Water as part of American Water is currently able to get financing on
23 all of its required investments at very good rates as a result of that financing being
24 obtained from its sister affiliate, American Water Capital Corp.

25
26 Q60. Do you agree with Mr. Weitzman's characterization of Surcharge 2 as "robbery"?

27 A60. Of course not. Contrary to Mr. Weitzman's claims, the purpose of the Surcharge 2
28 proposal is not to reduce risk, or have shareholders pay nothing, or some other financing

1 maneuver. California American Water proposed Surcharge 2 to reduce the annual
2 revenue requirement once the plant is delivering water to customers and to avoid rate
3 shock, as well as to place an appropriate level of responsibility on current customers.
4

5 **VII. SPI ANALYSIS**

6 Q61. Do you have any comments on the SPI analysis?

7 A61. Yes, I have read Section 5 of the SPI analysis and do have some comments on the total
8 annual cost of water presentation. In my response I will limit my comments to address
9 what I believe are concerns more of a regulatory nature and not cover other issues that I
10 have been told exist in other facets of the analysis.
11

12 From a regulatory point of view, there are multiple factors that go into producing an
13 authorized revenue requirement. It appears that in the SPI analysis they developed what
14 they call a Capital Recovery Factor (CPR) to estimate the 30-year average revenue
15 requirement.
16

17 First, I have never seen any such factor used in any regulatory proceeding. The factor is
18 simply ½ of the first year's revenue requirement. Annual revenue requirement can vary
19 greatly especially when deferred taxes are taken into account – for which SPI has not
20 accounted for tax depreciation in the revenue requirement as required by the Commission.
21 Second in looking at all the factors, I do not understand why a 3.33 depreciation was used
22 when we have stated in our model that it should be more in line with 2.5%. We have also
23 stated in our supplemental testimony that our current long-term debt interest rate would be
24 4.25%. In using the 4% coupon rate for the other entities, I don't believe this in the least
25 captures any financing or reserve costs, both of which can be substantial. So I believe the
26 current analysis is flawed to a degree. Additionally, the Commission requires that as a
27 part of the cost of debt for any issuance, the financing cost will have to be included as a
28 level annual amount added the interest cost. The annual interest cost plus the annual

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financing cost divided by the total net proceeds of the loan becomes the effective cost for the loan. Again, this procedure is exactly how the Commission requires the true cost of each issuance to be included in the annual revenue requirement. The Commission requires that all regulated entities provide the total annual revenue requirement each and every year and do not allow a utility to do any form of simply average. The fact is that the first few years of the revenue requirement are more steeply trended downwards due to deferred taxes. It is simply not acceptable to use a one-year number divided by two to get an average.

Q62. Does this complete your rebuttal testimony?

A62. Yes it does.

ATTACHMENT 1

WATER/RSK/KOK/DLW/RHG

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

**DIVISION OF WATER AND AUDITS
UTILITY AUDIT, FINANCE AND
COMPLIANCE BRANCH**

**RESOLUTION W-4678
MARCH 13, 2008**

R E S O L U T I O N

RESOLUTION W-4678. NORTH GUALALA WATER COMPANY (NGWC). REQUEST FOR AUTHORITY TO BORROW \$100,000, UNDER THE SAFE DRINKING WATER STATE REVOLVING FUND LOAN PROGRAM (SRF); TO ENCUMBER ASSETS IN CONNECTION WITH THE LOAN; AND TO INSTITUTE A SURCHARGE TO PAY OFF THE LOAN.

By Draft Advice Letter filed on November 7, 2007.

SUMMARY

This Resolution grants NGWC the authority requested in the filing.

NGWC requests authority, pursuant to §§ 816 and 851 of the Public Utilities Code, to borrow \$100,000, under the SRF, and to enter into a secured loan contract with the Department of Public Health (DPH) and the Department of Water Resources (DWR).¹ The proceeds of the loan will be used to finance a planning study to be conducted on NGWC's water system.

In addition, NGWC requests authority to establish a surcharge to make payments of principal and interest on the loan and to establish a separate bank account and balancing account for depositing surcharge collections and making payments on the loan. As required by the loan contract, NGWC proposes to appoint a fiscal agent or trustee to manage the funds.

¹ All statutory references are to the Public Utilities Code unless otherwise indicated.

On January 18, 2008, a public notice of the proposed debt and surcharge was published in a newspaper circulated in the County of Mendocino. Subsequently, on January 24, 2008, a bill insert of the proposed debt and surcharge was mailed to each customer. Two customers responded to the notice. One requested information about the purpose and handling of the loan, and one objected to the proposed loan and surcharge.

BACKGROUND

NGWC is a Class C water utility subject to the jurisdiction of this Commission. NGWC provides water service to approximately 1,033 metered customers in Gualala and vicinity, located approximately 15 miles south of Point Arena, Mendocino County.

Pursuant to its Income Statement as of December 31, 2006, NGWC reported that it generated total operating revenues of \$740,069 and net income of \$7,529.

The company's Balance Sheet as of December 31, 2006 is summarized below:

<u>Assets</u>	<u>Amount</u>
Current and Accrued Assets	\$ 592,089
Investments	0
Deferred Charges	682,983
Net Utility Plant	<u>4,596,950</u>
 Total Assets and Deferred Charges	 <u>\$5,872,022</u>
 <u>Liabilities & Capital</u>	
Current and Accrued Liabilities	\$ 70,863
Long-Term Debt	3,847,238
Deferred Credits	0
Advances for Construction	0
Contributions in Aid of Constructions	1,065,961
Corporate Capital and Retained Earnings	<u>887,960</u>
 Total Liabilities & Capital	 <u>\$5,872,022</u>

The \$3,847,238 long-term debt, shown above, is a 1996 Safe Drinking Water Bond Act (SDWBA) loan, authorized by Resolutions (Res.) F-645, and W-4108, with a term of 35 years, and being paid through a surcharge. The proceeds of the loan were used for the replacement of existing water mains, construction of water storage facilities, including a pump station and emergency generators, and improvements to NGWC's surface water treatment plant. The outstanding balance as of December 31, 2007, is \$3,754,162.77, with a remaining term of 25 years.

Pending before the Commission, is NGWC's general rate case, filed on August 1, 2007, seeking an increase in rates of approximately \$233,258 or 30%, of present rates, and a request to impose a monthly surcharge of \$6.78 for sixty months, to recover extraordinary expenses totaling \$420,533.24, pursuant to Decision (D.) 02-11-004.

On October 30, 2007, NGWC filed an application with DPH for a planning loan, under the SRF, for an estimated amount of \$100,000. NGWC plans to conduct an investigation regarding alternative source capacity, including new wells, continued use of existing wells, and desalination of sea water. The planning study will also include consideration of additional storage capacity, rehabilitation of existing tanks, the replacement of undersized water mains, the installation of monitoring systems, backup power-generation equipment, and improvement of fire-flow conditions within the system.

NOTICE AND PROTESTS

On January 18, 2008, a public notice of the NGWC's filing was published in the Independent Coast Observer, a weekly newspaper printed, published, and circulated in the County of Mendocino.

By bill insert, dated January 24, 2008, NGWC notified its customers of the proposed planning loan and the surcharge to repay the loan. The notice also stated that based on the results of the planning study, NGWC may at a later date, submit a pre-application to undertake water system improvements with DPH. If the project is fundable, an invitation to submit application from DPH will be received by NGWC. At that time, a full application for construction loan will be submitted, subject to DPH's and DWR's review and approval.

On January 29, 2008, a customer sent an e-mail to the Commission's Division of Water and Audits (DWA), asking for a copy of NGWC's filing. On January 30, 2008, DWA's Utility Audit, Finance and Compliance Branch (UAFCB) sent the customer a copy of NGWC's filing and a brief explanation of the loan and advice letter procedures. On the same day, staff requested NGWC to respond to the customer's concerns.

On January 30, 2008, another customer sent NGWC a letter questioning the loan and the surcharge.

By letters, dated February 5, 2008, NGWC provided the first customer with the components of the estimated cost of the planning study, and informed the other that the SRF loan facility carries a lower interest rate than commercial banks.

DISCUSSION

In connection with NGWC's application with DPH for a planning loan, and in order to comply with the requirements of § 818, NGWC filed the draft advice letter, to secure Commission authorization for the \$100,000 SRF loan, to encumber its property, and impose a surcharge, as required under the SRF loan program.

A. Description of Financing

According to DPH's Policy and Procedures Manual, planning loans are generally appropriate where an applicant is unsure of the best means of solving a particular problem and cannot afford to pay the up-front costs of evaluating the problem and doing the necessary preliminary engineering to prepare a construction loan application. Any project that is awarded as a planning loan will remain on DPH's priority list and will retain its ranking until such time that a construction loan is executed. However, the award of a planning loan does not guarantee that a subsequent construction loan will be offered or available.

In connection with the loan application, DPH assesses the utility's financial needs to meet water quality standards and its ability to meet the loan obligations. DWR acts as the lending agency. Loan funds may be used only for eligible project costs approved by DPH.

A planning loan may be used to conduct feasibility studies, evaluate problems and potential solutions, conduct environmental evaluations, conduct all preliminary engineering, and prepare a full application for a construction loan.

The interest rate that will apply to the planning loan will be the same as for a construction loan and will be determined at the time the planning loan contract is executed. DPH's approval of NGWC's application will result in the preparation and execution of an immediate loan contract with DWR. In connection with the loan, DWR requires a security interest in the utility's real and personal properties.

Before DWR can disburse funds under the planning loan, the borrower must provide the following:

- (a) Satisfactory documentation of the action taken by its governing body authorizing it to borrow funds and to enter into a loan contract, and designating a representative to execute the contract and to sign a claim for disbursement of funds.
- (b) Satisfactory documentation showing that it has dedicated a source of revenue for repayment of the principal amount of the loan plus interest.
- (c) Security for the loan.
- (d) A separate bank account entitled "Safe Drinking Water State Revolving Fund Account" for deposit of loan proceeds.
- (e) A fiscal agent who will oversee surcharge deposits and loan payments.
- (f) An initial budget of eligible project costs approved by DPH.

All recipients of planning loans are required to submit a draft planning report to the district office of DPH, within 18 months from the date of the

loan contract execution. The purpose of this is to assure that all work performed was eligible for reimbursement, the study addressed the problem adequately, and any technical, managerial and financial deficiencies required to be addressed as conditions of the loan were evaluated.

The repayment of a planning loan will commence within six months from the date the draft planning report is received and approved, and shall be fully repaid within five years from when the repayments begin. Should a construction loan be awarded, the planning loan and the construction loan may (at the option of the applicant) be combined into one loan with repayment beginning at the same time the repayment of the construction loan would normally commence.

B. Use of Proceeds & Cost Estimates

NGWC proposes to use the proceeds of the SRF loan to finance the cost of studies, planning, and preliminary engineering for various projects, to enable the utility to meet safe drinking water standards.

NGWC's cost estimates, as described in detail in its fax message to UAFCB, dated January 30, 2008, are summarized as follows:

Engineering study on potential sources of new water, evaluation of existing supply, identification of sites for off-stream water storage reservoir, and preparation of a long-term plan on storage capacity and system requirements	\$ 39,500
Geotechnical investigation to evaluate site, with subsurface exploration, geotechnical and geological evaluation of viable site, development of project feasibility and comprehensive plan	25,000
Predesign study to establish detailed cost estimates, design, project priorities, and construction schedules	6,000

Environmental documentation for categorically exempt and negative declaration projects, identification of specific studies and permits	10,000
Financial study on financing requirements, rates, and surcharges	12,000
Application for Construction Funds preparation, incorporating reports and studies, using State guidelines	5,000
Real estate appraisal to establish value of property and easements	<u>2,500</u>
Total	<u>\$100,000</u>

Normally, for plant expenditures that will be included in ratebase, the reasonableness of such expenditures is addressed during a general rate case. In this case, the plant expenditures will not be included in ratebase and we will not make a finding in this Resolution on the reasonableness of the proposed budget. However, for SRF-funded plant expenditures, the utility may only expend funds on DPH approved project components and DPH verifies all work performed prior to reimbursing the utility. Accordingly, we are assured that the payments made on SRF-funded loans, with ratepayer surcharges, are for proper purposes.

C. Capital Ratios

NGWC's capital ratios are shown below as recorded and adjusted to give pro forma effect to the transactions listed:

	(\$)				
	<u>Recorded</u>		<u>Adjustments</u>	<u>Proforma</u>	
Long-term debt	3,847,238	81.24%	100,000	3,947,238	80.63%
Short-term debt	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Subtotal	3,847,238	81.24%	100,000	3,947,238	80.63%
Common Equity	500	0.01%	-	500	0.01%
Paid In Capital	-	-	-	-	-
Retained Earnings	<u>887,960</u>	<u>18.75%</u>	<u>60,000</u>	<u>947,960</u>	<u>19.36%</u>
Total Capitalization	<u>4,735,698</u>	<u>100.00%</u>	<u>160,000</u>	<u>4,895,698</u>	<u>100.00%</u>

(1) Issuance of \$100,000 debt requested in this filing.

(2) Increase in retained earnings of approximately \$60,000 (based on Summary of Earnings, Test Year 2008, shown on Sheet VII-1 of NGWC's general rate case filing of August 1, 2007). NGWC is requesting an increase in the rate case filing, of approximately \$233,258 or 30%.

While NGWC's proposed debt does not appear to materially change NGWC's capital structure to the detriment of ratepayers, capital structures are normally subject to review in cost of capital or general rate case proceedings. We will not, therefore, make a finding in this Resolution of the reasonableness of the projected capital ratios for ratemaking purposes.

D. Loan Approval

NGWC's proposed financing transaction is in the public interest and is intended to enable NGWC to evaluate and determine the best way to improve its water system. As a public utility, NGWC has the responsibility to maintain its quality of service and provide necessary improvement to its present water system.

We do not find anything in the customers' concerns that would require the Commission to reject NGWC's financing request. Public interest dictates that the utility should have the ability to conduct studies relating to water system improvements, specifically, if the DPH, the state agency responsible for water supply health and safety, is involved in the processing of the loan application, project evaluation, and reimbursement procedures.

Upon order of the Commission and for proper cause, § 818 allows the use of proceeds from the issue of debt security for purposes reasonably required in the operation of a utility.

Section 851 requires Commission authorization before a utility may "sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or any part of its... plant, system, or other property necessary or useful in the performance of its duties to the public..."

SRF borrowings represent a much lower cost of capital than either equity or other forms of debt. In addition, there are conditions set by DPH and this Resolution to ensure proper accounting and handling of the loan proceeds.

We will authorize NGWC to borrow up to \$100,000; to execute a loan agreement on terms and conditions contemplated herein; and to encumber its assets in connection with the loan.

E. Proposed Surcharge

NGWC's present rate schedule for general metered service was authorized by the Commission's approval of Advice Letter No. 60, effective January 26, 2006, which granted a 3.3% increase in rates. In addition to their monthly bill, customers are responsible for a monthly surcharge to repay the 35-year SDWBA loan authorized by Res. F-656 and Res. W-4108.

NGWC estimates that it will need \$10,639 semi-annually, or \$21,278 per year, to make principal and interest payments throughout the 5-year loan

term.² NGWC estimates the surcharge for each customer will be \$1.72 per month.

The current monthly bill for a 5/8 x 3/4-inch metered customer using approximately 955 cubic feet of water (at a quantity rate of \$3.13 per 100 cu. ft.) would increase from \$66.39 to \$68.11, or 2.59%, for five years. Of NGWC's 1033 connections, 897, or 86.8%, are 5/8 x 3/4-inch metered, single-family residential users.

We are aware that NGWC will not be able to obtain the SRF loan until it demonstrates that it has the source of funds to be used for repayment of the loan, and that such dedicated funds are documented in an order or resolution. To the extent that the source of funds requirement remains a condition in this low-cost funding, NGWC's financing request cannot be processed by DPH and granted without a surcharge authorization.

The ratepayers ultimately pay for all water system requirements and improvements, regardless of the manner in which they are financed. If the utility were able to borrow the money to make the water system improvements entirely from regular commercial sources, it would be far more expensive for the ratepayers than the low-cost state-funded loan. Likewise, if the utility owners invested their own funds to pay for the water system improvements, they would be entitled to similar earnings on such funds.

The surcharge method of recovery ensures that the loan will be repaid without financial stress to the water utility. The surcharge serves only to repay the loan and will not generate any profit to the utility owners.

Therefore, it is reasonable to authorize NGWC to impose a surcharge on its customers, as set forth herein.

The following conditions apply:³

1. The loan repayment surcharge shall be separately identified on customers' bills.

² The proposed \$100,000 SRF planning loan is to be repaid over a 5-year term, with an estimated 2.28% annual interest rate, and with the first payment due June 1, 2008.

³ On February 20, 2008, NGWC, by e-mail, informed DWA that it has no objection to the added conditions and is waiving its opportunity for formal comment.

2. NGWC shall use a balancing account to be credited with revenues collected through the surcharge and to be charged with payments of principal and interest on the loan.
3. NGWC shall deposit all surcharge revenues with a fiscal agent approved by DWR or DPH. Such deposits shall be made within 30 days after the surcharges are collected from customers.
4. The surcharge rates to repay the loan shall last for approximately 60 months, until the loan is fully paid.
5. Any surplus accrued in the bank account shall be refunded or applied on behalf of the customers when ordered by the Commission.
6. Changes in future surcharge rates shall be accomplished by normal advice letter procedure subject to review and approval.
7. The cost of the studies financed through the surcharge shall be excluded from ratebase for ratemaking purposes.

F. Fees

Whenever the Commission authorizes a utility to issue debt, the Commission is required to charge and collect a fee in accordance with § 1904(b).

The fee for this financing authority as set forth by § 1904(b) is \$200.⁴

COMMENTS

While there were two customers concerned about the proposed loan and surcharge, there were no showings as to why the proposed project would not lead to improvement of service or why the proposed surcharge could

⁴ The amount subject to the fee is \$100,000. The fee is determined as follows: $(\$2 \times (\$100,000/1000)) = \$200$.

not be justified. DWA did not receive any formal protests after NGWC responded to the customer concerns.

Section 311(g) (1) generally requires that draft resolutions be served on all parties and subject to at least 30 days public review and comment prior to a vote of the Commission.

NGWC, the only party in this filing, has informed the DWA that it has no objection to the conditions added to the relief requested in the draft advice letter, and that it is waiving its right to the 30-day public review and comment period. These added conditions are to: (1) separately identify the loan repayment surcharge in its customer billing; (2) remit surcharge revenues to the fiscal agent, within 30 days of collection; and (3) exclude from ratebase, the cost of the studies financed through the surcharge.

Accordingly, pursuant to § 311(g) (2), the otherwise applicable 30-day period for public review and comment is being waived.

FINDINGS

1. NGWC, a California corporation, is a Class C water utility subject to the jurisdiction of this Commission.
2. The proposed borrowing is for proper purposes.
3. With a surcharge type of recovery, the utility or its owners do not personally benefit from the planning loan.
4. DWR requires a customer surcharge to repay the loan, and a security interest on the utility's properties.
5. The surcharge will generate approximately \$21,278 annually. Surcharge revenues will not be commingled with other utility charges.
6. The cost of the studies financed by the SRF loan is not to be included in ratebase.

7. The reasonableness of any resulting interest rate and cost of money arising from debt capital are normally subject to review in cost of capital or general rate case proceedings.
8. NGWC should establish a separate balancing account to be credited with revenue collected through the surcharge and any interest earned on the account, and reduced by payments of principal and interest on the loan and trustee fees.
9. DWR requires a fiscal agent to ensure adequate accountability of surcharge revenues, interest earned, loan amortization payments and fees paid to the trust account.
10. NGWC should pay the fee determined in accordance with § 1904(b).

THEREFORE, IT IS ORDERED that:

1. North Gualala Water Company is authorized, pursuant to § 816 et seq. of the Public Utilities Code, to borrow \$100,000, under the Safe Drinking Water State Revolving Fund; to encumber its assets in connection with the loan; and to use the proceeds for the purposes described in the body of this order.
2. North Gualala Water Company shall establish a separate bank account, managed by a trustee or fiscal agent, as requested in the filing.
3. North Gualala Water Company shall establish a balancing account and record all billed surcharges, interest earned, and reduced by payment of trustee fee and principal and interest on the loan, as requested in the filing.
4. North Gualala Water Company is authorized to file in accordance with General Order No. 96-B, six months from the date the draft planning report is received and approved by the Department of Public Health or one hundred eighty days prior to the first semi-annual billing, an advice letter, which establishes a monthly surcharge on customer bills, with an equal charge of \$1.72 per customer, for a period of five years. The filing shall become effective on five days' notice.

5. The authority granted herein shall be subject to condition Numbers 1 through 7, enumerated on pages 10 and 11, of this order.
6. North Gualala Water Company shall file with the Division of Water and Audits' Utility Audit, Finance and Compliance Branch a copy of the loan agreement and fiscal agreement within 15 days of execution.
7. The authority granted by this order shall become effective when North Gualala Water Company pays \$200, the fee set forth by Public Utilities Code § 1904(b).
8. This Resolution is effective today.

I certify that the foregoing Resolution was duly introduced, passed, and adopted at a conference of the Public Utilities Commission of the State of California held on March 13, 2008. The following Commissioners approved it.

/s/ PAUL CLANON

Paul Clanon
Executive Director

MICHAEL R. PEEVEY
President

DIAN M. GRUENEICH

JOHN A. BOHN

RACHELLE B. CHONG

TIMOTHY ALAN SIMON

Commissioners