February 27, 2018

The Honorable Michael Picker
The Honorable Carla J. Peterman
The Honorable Clifford Rechtschaffen

The Honorable Martha Guzman Aceves
The Honorable Liane M. Randolph

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

Proposed Decision of ALJ Bemesderfer - In the Matter of the Application of San Jose Water Company for Authority to Adjust its Cost of Capital and to Reflect that Cost of Capital in Its Rates for the Period from January 1, 2018 through December 31, 2020. And Related Matters

Dear President Picker and Commissioners:

Founded in 1895, the National Association of Water Companies (NAWC) represents the private water utilities across the country that deliver vital services to approximately one in four Americans every day. NAWC is the organization exclusively representing this group of quality service providers, innovation drivers, and responsible partners serving their customers, securing their quality of life, and contributing to the economic prosperity of their local communities. NAWC member companies range from small businesses that provide water and wastewater services to as few as 100 customers to the largest water utility in the country that serves 16 million Americans every day. NAWC members are dedicated to providing the services required to help ensure safe and reliable water treatment and delivery across the nation. As the national organization that tracks policy developments for the private water sector, NAWC recognizes the challenges that are affecting the entire industry, public and private alike, that need to be met by sound business practices and policy.

NAWC has become aware of a Proposed Decision in the Cost of Capital Case for four of our member companies – San Jose Water Company, California Water Service Company, Golden State Water Company, and California American Water Company (A.17-04-001, A.17-04-002,

A.17-04-003, A.17-04-006). In the Proposed Decision (PD) issued on February 6, 2018, conclusions are reached that are both factually incorrect, and also have profound long-term negative consequences for the four utilities and their customers.

The authorized ROEs for California water companies should be established based on a review of the market returns for a proxy group of comparable companies. The PD, however, arbitrarily set the water utilities' authorized Return on Equity[1] (ROE) far below the ROE for the proxy groups and far below the national average of other water utilities.[2] While the PD goes so far as to say that the water utilities provided no evidence that they were riskier than the proxy group or the national average group,[3] nowhere in the PD is there a reference to the California water utilities being *less* risky either.

Water companies uniquely face issues not faced by other utilities, such as declining use per customer and significant capital requirements fueled, in part, by water supply constraints, having to meet increasing water quality standards, as well as replacing aging infrastructure.[4] The PD adopted the arguments of the Office of Ratepayer Advocates (ORA) that California's ratemaking principles (revenue decoupling, various balancing accounts, etc.) make "investment in their common equity nearly risk free and their ROEs should be adjusted downward to reflect this fact."[5] In fact, many of these mechanisms were initiated or approved by the Commission in pursuit of policy and regulatory objectives (e.g., as articulated in the Commission's Water Action Plan) and constitute responses to other risks for California water utilities that have heightened or appeared. For example, the WRAM/MCBA[6] balancing account enables decoupling of water utilities sales from revenue in order to encourage water conservation efforts. The SRM[7] balancing account enables a reduction in WRAM/MCBA customer surcharges by reforecasting sales annually during a rate case cycle. Regulatory mechanisms that promote conservation and mitigate the adverse

[1] 8.22% California Water Service Company, 8.22% Golden State Water Company, 8.23% California American Water Company, 8.30% San Jose Water Company.
[2] 9.56% national average authorized ROE's for water utilities in 2017. 9.68% national average authorized ROE's for water utilities in 2016.
[3] Proposed Decision, page 9
[4] The Commission's Water Action Plan objectives rest on four key principles: 1. safe, high quality water, 2. highly reliable water supplies, 3. efficient use of water, and 4. reasonable rates and viable utilities. California Public Utilities Commission Water Action Plan 2005, page 3; and Water Action Plan 2010, page 2
[5] Proposed Decision, page 5.
[6] Water Revenue Adjustment Mechanism/Modified Cost Balancing Account
[7] Sales Reconciliation Mechanism

effect of weather variability on revenues effectively reduces the adverse impacts of reduced volumetric sales and weather variability for both the water utilities and their customers. The LIRA[8] balancing account enables assistance to qualifying low-income customers by lowering their monthly bills. Balancing accounts, like LIRA, also mitigate risks for both the water utilities and their customers while supporting public or regulatory policy objectives. In addition, in the state of California, water utilities, like all utilities operating for the public good, are subject to Inverse Condemnation rules subjecting them to strict liability of damage regardless of fault. This unique requirement creates enormous asymmetric risks as has been shown recently in the state through the electric utilities and wildfires, and mitigating asymmetric risks cannot be easily accomplished.

The United States Supreme Court's *Hope* and *Bluefield* decisions established the standards for determining the fairness or reasonableness of a utility's authorized ROE. Among the standards established by the Court in those cases are: (1) consistency with other businesses having similar or comparable risks; (2) adequacy of the return to support credit quality and (3) access to capital at reasonable terms. [9] Equity investment in California water utilities is not guaranteed a return, but rather should be granted the opportunity to earn an authorized return, and that authorized return should be commensurate with returns expected elsewhere in the market for investments of equivalent risk. If it is not, debt and equity investors will seek alternative investment opportunities for which the expected return reflects the perceived risks, thereby inhibiting California's water utilities ability to attract capital at reasonable cost.

The financial community carefully monitors the current and expected financial condition of utility companies, and the regulatory framework within which they operate. In that respect, the regulatory framework is one of the most important factors in both debt and equity investors' assessments of risk. It is critical that California be viewed as a stable regulatory environment by investors who have a choice of investments. As quickly as the morning after the release of the PD, investor analysts recognized the PD. "The PD is further evidence that California's regulatory environment has shifted from above to below-average." (Wells Fargo, Sarah Akers). "The precedent that an ALJ sided with the ORA's relatively low ROE is bothersome." (Wolfe Research,

[8] Low Income Rate Assistance Program
[9] *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Company,* 320 U.S. 591 (1944).

Steve Fleishman). "It is unclear, why the risk profile of the water utility appears to have changed, as the mechanisms referenced by ORA and the administrative law judge have been in place for some time and similarly exist for electric and gas utilities. Should the proposed decision be finalized with an industry-low ROE, a reduction in RRA's water ranking for California may be justified." (Regulatory Research Associates/S&P, Heike Doerr). When investors are looking for somewhere to put their money they look at all financial instruments (equities, bonds, funds, etc.). They look for a certain risk/return portfolio and when equities of the same risk are valued quite differently, their money will flow to the higher return. This is a clear indication that many of the regulatory mechanisms (adjustment clauses, riders, trackers, forward test years, and cost recovery mechanisms) are already largely embedded in financial data, such as stock prices, bond rating, and business risk scores for water utilities. This will put California water utilities at a distinct disadvantage versus other water utilities in the country considering the equal risk, but lower return. This will drive up the utilities' cost of financing, hamper their ability to assist small water systems, and ultimately burden consumers.

NAWC urges the Commission to revisit the PD[10] issued in this Cost of Capital case and to appropriately increase the ROE commensurate with the risks faced by these utilities and consistent with average ROEs authorized by other State Public Utility Commissions during 2016 and 2017. Reducing ROEs at a time when utilities are facing the growing need to replace water infrastructure will severely hamper the California water utilities' ability to meet their obligations.

Sincerely,

_____/s_____

Christopher Franklin

President

National Association of Water Companies

Cc: Water Cost of Capital Service List

[10] Proposed Decision of ALJ Bemesderfer - In the Matter of the Application of San Jose Water Company for Authority to Adjust its Cost of Capital and to Reflect that Cost of Capital in Its Rates for the Period from January 1, 2018 through December 31, 2020. And Related Matters (Mailed February 6, 2018).