BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of Application of SAN JOSE WATER COMPANY (U168W) 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.	A.17-04-001
And Related Matters.	A.17-04-002 A.17-04-003 A.17-04-006

NOTICE OF EX PARTE COMMUNICATIONS

Pursuant to the California Public Utilities Commission's Rules of Practice and Procedure, California Water Service Company (U-60-W), California-American Water Company (U-210-W), Golden State Water Company (U-133-W), and San Jose Water Company (U-168-W) ("Applicants") provide notice that the following representatives met with advisors to the commissioners at the request of Applicants:

<u>California Water Service Company</u>
Marty Kropelnicki (President & CEO)
Natalie Wales (Director, Regulatory)

<u>Golden State Water Company</u>
Bob Sprowls (President & CEO)
Jon Pierotti (Manager, Regulatory Affairs)
Joseph Karp (Partner, Winston & Strawn)

<u>California-American Water Company</u>
Richard Svindland (President, Cal-Am)
Jeffrey Linam (VP, Regulatory)

<u>San Jose Water Company</u>
Eric Thornburg (President & CEO)
Palle Jensen (Executive VP)

The meetings with advisors occurred at the Commission's offices at 505 Van Ness Avenue, San Francisco, 94102, as follows:

- Elizabeth Podolinsky, Advisor to President Michael Picker, at 1:00 pm on Tuesday, February 20, 2018.

- Travis Foss, Advisor to Commissioner Clifford Rechtschaffen, at 1:30 pm on Tuesday, February 20, 2018.
- Shannon O'Rourke, Advisor to Commissioner Carla J. Peterman, at 1:30 pm on Wednesday, February 21, 2018.

During the meetings, Applicants urged the Commission to modify the Proposed Decision ("PD") issued on February 6, 2018 so that the return on equity ("ROE") proposed for each company appropriately reflects the Commission's policy goals and the evidentiary record. While the Commission has historically achieved the balance between attracting capital investment in California water infrastructure, and ensuring affordable water rates, by making incremental changes to the ROE, the PD is a dramatic departure from this measured approach that will result in significant negative repercussions if adopted.

The Applicants indicated that the PD's unbalanced result is punitive to Applicants as compared to both the ROEs of 10% and higher adopted by the Commission for the energy companies in 2017, and the average ROE of 9.56% adopted for water companies across the country in 2017. The PD also fails to render a decision based on the evidentiary record and is therefore legally insufficient. Without acknowledging numerous material issues raised by Applicants, the PD simply adopts all positions advocated by the Office of Ratepayer Advocates ("ORA"), notwithstanding substantial evidence to the contrary. The Applicants indicated that there are numerous errors in ORA's analyses, and provided examples relating to the methodologies for calculating the costs of debt and capitalization structures for some companies.

The Applicants also explained that the challenges associated with the PD's punitively low ROEs will be compounded by changes to federal tax law were adopted after the record in this proceeding was closed. According to the attached presentation by Moody's Investor

Service at the National Association of Regulatory Utilities Commissions ("NARUC") earlier this month, recent federal tax "reform" will decrease cash flow for regulated utilities due to changes in deferred tax, rendering them less attractive to investors and subject to potential credit rating downgrades.

In sum, the Applicants explained that, if adopted as-is, the PD will have long-term negative effects for customers in the form of higher rates, less robust infrastructure investment, and barriers to taking on small struggling water systems. The Applicants urged the Commission to modify the PD to reach a balanced outcome that can benefit both customers and the companies.

The two documents provided during the meetings are attached to this notice.

Executed this **23rd day of February 2018** at San Jose, California.

/s/

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Regulatory Counsel &
Director of Regulatory Policy
California Water Service Company

S&P Global

RRA REGULATORY FOCUS

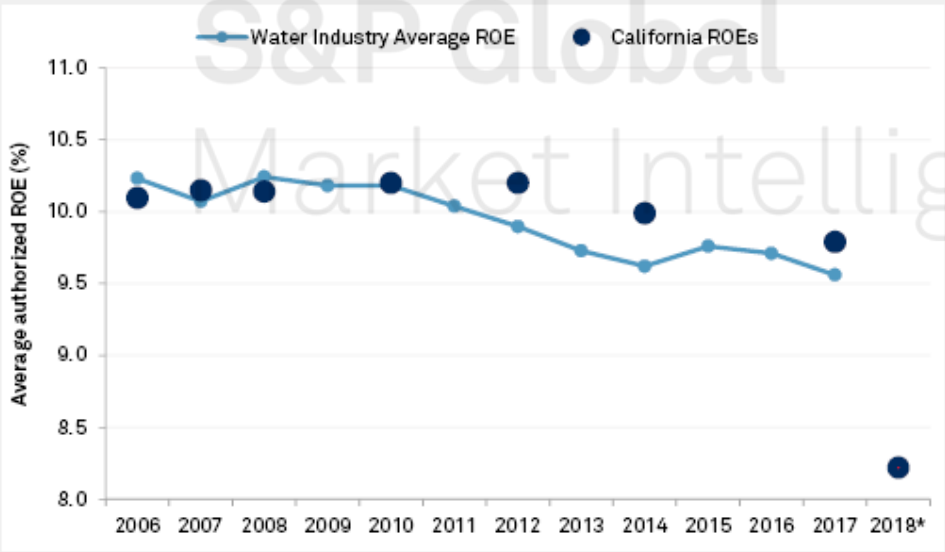
Well below average water ROE proposed by Calif. judge

Monday, February 12, 2018 12:40 PM ET

By Heike Doerr

A California Public Utilities Commission administrative law judge issued a proposed decision on Feb. 6 in a cost of capital proceeding for California American Water Company., or Cal-Am, California Water Service Comp., or Cal Water, Golden State Water Co., or GSWC, and San Jose Water Co. The proposed decision adopted the capital structure, costs of debt and ROE proposed by the Office of Ratepayer Advocates, or ORA, as shown in the table below. The judge concurred with ORA's assessment that "the risk-hedging and risk-spreading mechanisms adopted by this Commission over the years have effectively guaranteed that the Applicants will earn their allowed returns on rate base, making investment in their common equity nearly risk-free and their ROEs should be adjusted downward to reflect this fact." California's decoupling mechanism, known as the Water Rate Adjustment Mechanism, or WRAM, as well as the use of balancing accounts and advice letters, were provided as examples of mechanisms that have minimized risk for water utilities.

California vs. national average: water utility authorized ROE comparison



* The 2018 data point is the return on equity in the proposed decision, which has not been authorized.
Data compiled Feb. 9, 2018.
Source: Regulatory Research Associates, an offering of S&P Global Market Intelligence

The ROEs of 8.22% to 8.30% in the proposed decision are well below the 9.56% average ROE authorized water utilities in rate cases decided in 2017. As monitored by Regulatory Research Associates, or RRA, the New York Public Service Commission is believed to have authorized the lowest ROEs during 2017, granting a 9.0% ROE to SUEZ Water New York Inc. in January 2017 and a 9.1% ROE to New York American Water Co., or NYAWC, on May 18, 2017.

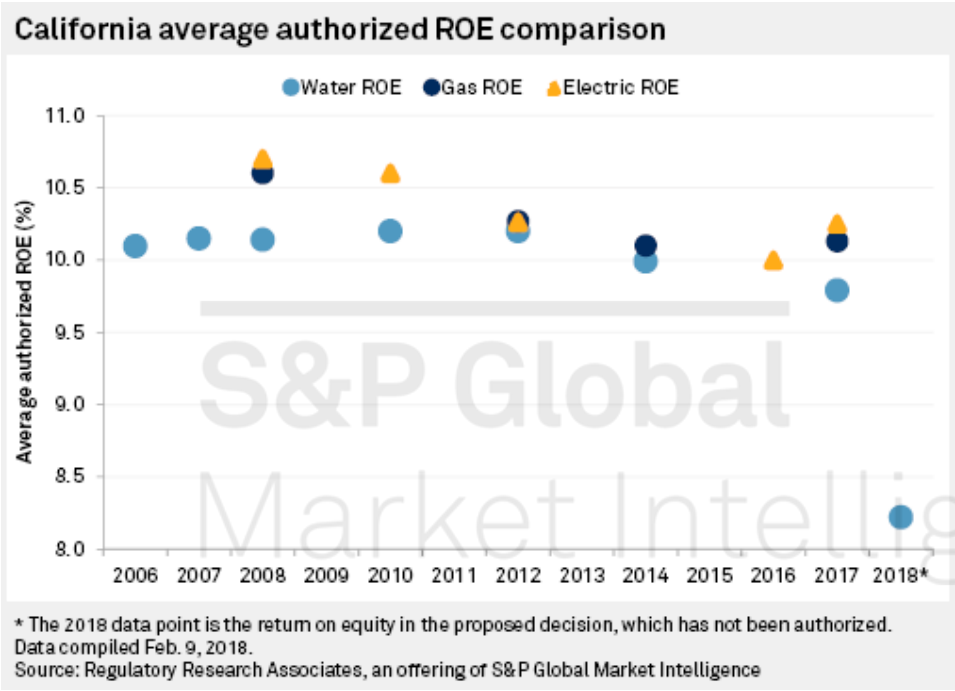
RRA currently evaluates water utility regulation in 25 state jurisdictions and monitors rate proceedings involving rate change requests of $0.5 million or greater for the thirteen largest investor-owned and privately-held water utilities. Over 200 rate cases spanning a time period between January 2006 and December 2017 have been accumulated thus far. As RRA broadens its water utility coverage to encompass all 44 states that currently regulate water utilities, this data set will continue to expand, which will likely result in some adjustments to the historical water industry averages.

If approved, the ROE in the proposed decision, would mark the lowest ROE authorized a water utility across the observed coverage group.

ROE comparison to California electric utilities

On July 13, 2017 the PUC adopted a memorandum of understanding regarding 2018 and 2019 cost of capital issues for Pacific Gas and Electric Co., or PG&E; San Diego Gas & Electric Co., or SDG&E; Southern California Edison Co., or SCE; and Southern California Gas Co., or SCG. The PUC's decision reduces the utilities' authorized ROEs for 2018 as follows: PG&E, from 10.4% to 10.25%; SDG&E, from 10.3% to 10.2%; SCE, from 10.45% to 10.3%; and SCG, from 10.1% to 10.05%.

The ROE reductions for the energy utilities ranged from 5 to 15 basis points, which is a markedly smaller decline, than in the current water utility proceeding. As shown in the following chart, the difference in ROEs authorized between the electric, gas and water utility sectors has narrowed since 2010. If authorized, the water ROEs in the proposed decision, would mark a material departure from ROEs granted in California.



For additional details on the California regulatory climate for energy utilities, refer to the RRA Commission Profile. Similar to the water utility sector, electric and gas utilities have full decoupling mechanisms, employ automatic gas cost recovery mechanisms and utilize balancing accounts. The regulatory climate is viewed as "constructive" for energy utilities, and RRA accords California an Above Average/3 ranking.

RRA water rating under review

RRA has categorized the regulatory climate in California as it relates to water utilities as relatively constructive and accords an Above Average/3 ranking. Equity return authorizations have been at the industry average at the time established and the use of multiple balancing accounts provide the water utilities a reasonable opportunity to earn these allowed returns. 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.

Current water utility ROEs

The water utilities had previously been operating under an ROE adopted in D-12-07-009, which authorized an ROE of 9.99%. Due to a decline in the average Moody's Aa utility bond index rate, the adopted ROE, effective Jan. 1, 2013, was adjusted downward by 56 basis points to 9.43% for California Water Service, Golden State Water and San Jose Water

through the Water Cost of Capital Mechanism, or WCCM. With a lower debt rating than the other water utilities, Cal-Am's WCCM was not triggered, and its ROE remained at 9.99%. The water utilities were authorized one-year extensions in 2015, 2016 and 2017, which left their existing automatic cost of capital adjustment mechanism in place and authorized ROEs unchanged.

Proceeding background

On April 3, 2017, Cal-Am, Cal Water, GWSC and San Jose Water Co. each filed a cost of capital application with the PUC for the period Jan. 1, 2018, through Dec. 31, 2020, which were combined into a single proceeding.

Cal Water is a subsidiary of California Water Service Group. CAWC and NYAWC are subsidiaries of American Water Works Co. Inc. GSWC is a subsidiary of American States Water Co., and San Jose Water is a subsidiary of SJW Group. Suez Water New York is a subsidiary of SUEZ Water NA.

For a complete, searchable listing of RRA's in-depth research and analysis, please go to the S&P Global Market Intelligence Energy Research Library.

MOODY'S
INVESTORS SERVICE

NARUC General Session: Implications and Complications of Tax Reform

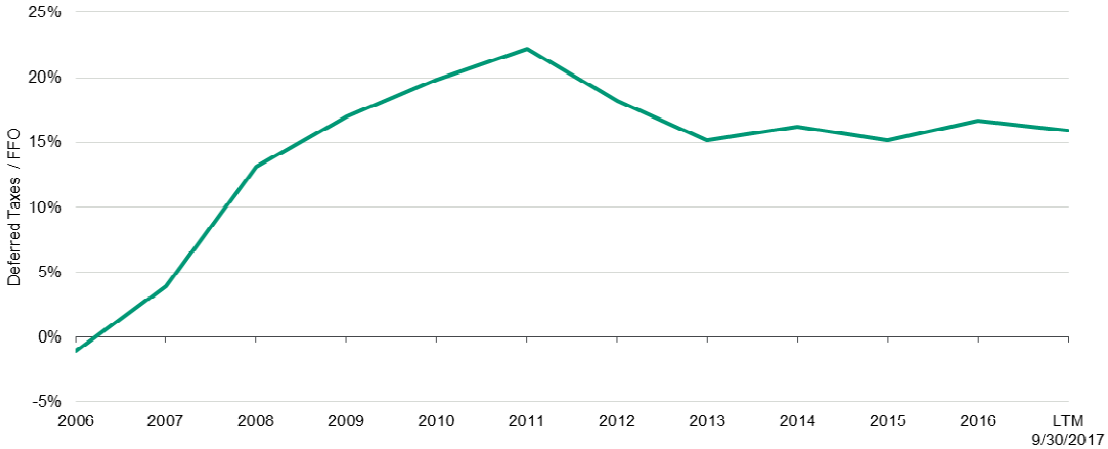
Ryan Wobbrock, VP - Analyst, Infrastructure Finance

February 2018

Tax reform is credit negative for utilities

- Rate reduction to 21% is the biggest driver
- The utility sector has not paid cash taxes for several years
  - Retaining the cash collected based on a 35% tax rate
  - Resulting in large deferred tax liabilities and cash flow contribution
    - Roughly 25% of adjusted capitalization is deferred tax liabilities
    - About 15% of funds from operations comes from deferred taxes

Deferred taxes have increased as a component of utility FFO



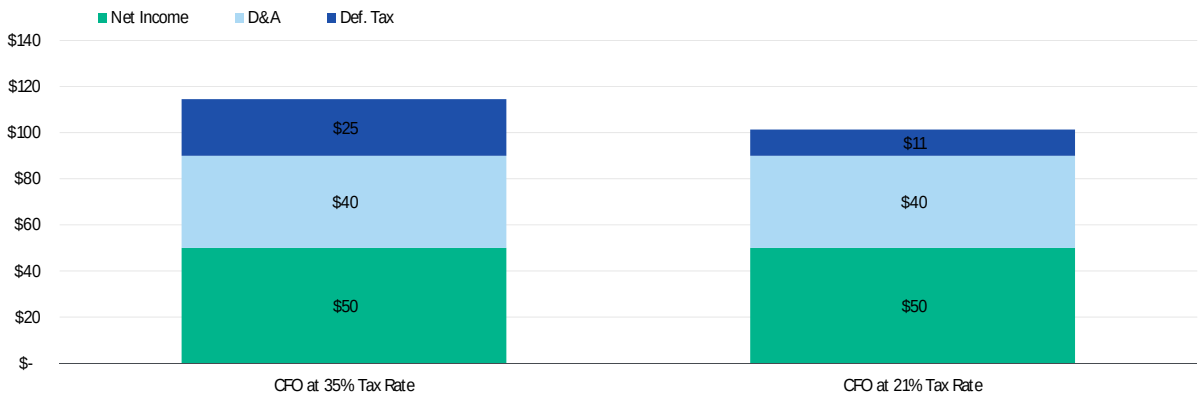
Source: Moody's Investors Service

Lower tax rate means less cash

Regulators will look to reduce customer rates as soon as possible

- Cash flow benefit of deferred taxes could be cut by ~50%
  - Projected cash flow to debt ratios will drop by 150 – 250 bps
  - Debt to capitalization will increase by roughly 400 bps

Illustrative: Deferred taxes and CFO will decline with a reduced tax rate



Source: Moody's Investors Service

- Cash outflow as excess deferred taxes are returned to customers over time
- Loss of bonus depreciation, thus paying cash taxes sooner rather than later

Potential for ratings downgrades

January 2018 – negative rating action for 25 companies

- Initially focused where financial metrics will be lower for longer:
  - Already weak for a company's current rating
  - Had been expected to decline; exacerbated by tax reform
  - Financial cushion exists, but now close to

    "What could change the rating down?" threshold
- "All else being equal" - things can change over the next 12-18 months

“All Else” will not remain equal

Management teams will attempt to mitigate cash loss

- Pursue rate and cash stability through regulatory channels
  - Accelerate recovery of other regulatory assets or investment
  - Offset pending rate increases
  - Increase allowed ROEs or equity layers
- Cut costs to earn higher returns for a period of time
- Adjust corporate financial policies
  - Reduce debt
  - Issue equity
  - Slow dividend growth