BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of California Water Service Company (U60W) for Authority to Establish its Authorized Cost of Capital for the period from January 1, 2012 through December 31, 2014.	Application 11-05-001 (Filed May 2, 2011)
In the Matter of the 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, 2012 through December 31, 2014.	Application 11-05-002 (Filed May 2, 2011)
Application of California-American Water Company (U210W) for an Authorized Cost of Capital for Utility Operations for 2012 - 2014.	Application 11-05-003 (Filed May 2, 2011)
Application of Golden State Water Company (U133W) for Authority to Establish Its Authorized Cost of Capital and Rate of Return for Utility Operations for 2012 - 2014.	Application 11-05-004 (Filed May 2, 2011)

LATE-FILED EXHIBIT JT-2:

RESPONSE TO ADDITIONAL CLARIFYING QUESTIONS

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Dated: February 27, 2012

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LATE-FILED EXHIBIT JT-2:

RESPONSE TO ADDITIONAL CLARIFYING QUESTIONS

As directed by Administrative Law Judge ("ALJ") Bemesderfer during the January 23, 2012 evidentiary hearing in the above-captioned proceedings, the Division of Ratepayer Advocates ("DRA"), California Water Service Company ("Cal Water" or "CWS"), San Jose Water Company ("San Jose" or "SJW"), California-American Water Company ("California American Water" or "CAW"), and Golden State Water Company ("Golden State" or "GSW") (together, "Joint Parties") submit this response to the Additional Clarifying Questions that were circulated to the service list on January 23, 2012 subsequent to the evidentiary hearing.

<u>QUESTION 1</u>

1. What is the financial impact on rate payers of a change in the Cost of Capital? (i.e., how much does a 100 basis point reduction in the Cost of Capital impact the average

bill? How does this compare with the bills implied by the utilities' General Rate Case?)

RESPONSE TO QUESTION 1

In general, the allowed return on equity ("ROE") should be set equal to the cost of capital. This goal is consistent with the mandates of the Supreme Court's decisions in the *Hope* and *Bluefield* cases.[1] Reducing the allowed ROE below the cost of capital does not treat the regulated companies fairly. Although it provides a short-term gain to customers through a reduction in rates, it will be at the expense of an increase of long-term costs due to inefficient financing, plant investment, and operations. In economics and in life, there is no "free lunch." You get what you pay for. Providing an inadequate rate of return for a regulated company will inevitably have adverse consequences on service, costs, and efficiency in the future.

For each Applicant, the decrease in the monthly bill of an average residential customer that would result from a 100 basis point reduction from a 9.99% ROE is indicated below. For companies with multiple rate areas, the weighted average decrease is provided to account for variations between rate areas. While any short-term reduction in a customer's water bill is likely to be welcome, the resulting long-term costs of a 100-basis-point decrease are likely to more than offset any short-term benefits. This issue is discussed in more detail in the response to Question 2. The average residential customer bill for each Applicant will be impacted as follows:

- For Cal Water, the weighted average decrease in an average residential customer's bill is $0.91 per month. See Attachment 1 for details by rate area.

- For California American Water, the weighted average decrease in the average residential customer's bill is $1.06 per month. See Attachment 2 for details by district.

- For Golden State, the weighted average decrease in the average residential customer's bill is $1.24 per month. See Attachment 3 for details by rate area.

- For San Jose, the decrease in the average residential customer's bill is $0.99 per month.

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[1] *Federal Power Commission v. Hope Natural Gas*, 320 U.S. 591 (1944); *Bluefield Waterworks & Improvement Co. v. Public Service Commission,* 262 U.S. 678 (1923).

QUESTION 2

2. What is the financial impact of changes in Cost of Capital to the operating company and how does this impact the parent company? (i.e., how does a 100 basis point decline in Cost of Capital affect the profitability of the utilities and the parent organization? What secondary impacts are there from such a reduction?)

RESPONSE TO QUESTION 2

ASSUMPTIONS: The response to Question 2 assumes that:

A) The reduction of 100 basis points ("bps") is in the allowed ROE, and not on the overall weighted-average cost of capital. ROE is the typical analytical focus of cost of capital proceedings, and the Joint Parties note that a reduction of 100 bps in the overall weighted-average cost of capital would have even more severe effects than a 100 bps reduction in ROE.

B) The 100 bps reduction is from the 9.99% ROE agreed-upon in the all-party settlement resulting in an ROE of 8.99%. A starting point must be identified to evaluate the impact of an ROE reduction because the effect of an ROE reduction on companies' financial ratios, and on the magnitude of secondary impacts, will be different for different starting points.

C) Other aspects of the settlement are not affected. Settlements often involve a trade-off among the parties on issues, so a focus on changing any one aspect of a settlement can potentially be misleading. The rationale for accepting one provision may depend critically on gaining acceptance of another provision. For example, in the settlement in this proceeding, each party accepted a different allowed ROE than it originally proposed in light of the totality of the circumstances of the settlement.

EFFECT ON PROFITABILITY: A 100 basis point reduction in the allowed ROE will reduce the net income of all of the regulated water companies by at least 10% (1.0/9.99 = 10%), and perhaps by more, if other aspects of how the revenue requirement is set are in error, because equity is the residual claimant. The dollar loss to each company depends upon the regulatory capital structure and the size of the rate base, but in general, a 100 basis point reduction in ROE will have a negative effect on earnings.

SECONDARY EFFECTS: The secondary effects of an ROE reduction of such a large magnitude are likely to be worse, for both the companies and ultimately their ratepayers, than the initial effects of an ROE reduction.

Short Term Debt: Reducing net income reduces a company's cash flow, which then requires a company to rely more on short-term debt to finance working capital. The cost of short-term debt will also increase because the terms underlying a line of credit with banks generally include provisions tying the cost of short-term debt to the financial strength of the company. Most of the companies in this proceeding have a continuing need for substantial working capital to support ongoing infrastructure investments and, for some companies, substantial balances in regulatory accounts such as revenue decoupling mechanisms.

Long-Term Debt: Reducing net income also affects the credit ratios (financial strength) by which rating agencies such as S&P, Moody's, and Fitch evaluate the credit worthiness of a company because earnings (i.e., net income) are an integral part of most of the financial ratios.

For example, funds from operations ("FFO") is generally defined as net income plus non-cash expenses such as depreciation. A reduction in net income results in a reduction in FFO, and therefore lowers the FFO-to-interest and the FFO-to-debt ratios, two of the most important ratios considered by credit rating agencies. In this manner, lower earnings result in weaker financial ratios. If financial ratios are weakened significantly, the rating agencies will either place the utilities on their credit watch or lower the companies' credit ratings, thus increasing the cost of debt going forward. One Applicant in the proceeding has already been advised that any further deterioration in its ratios will lead to a downgrade.[2]

Even if a reduction in earnings were not so serious as to cause a ratings downgrade, the cost of debt will increase in the future because investors will evaluate the weakened credit ratios, and demand a higher expected return. This is because, while credit ratings change by discrete increments (from A- to BBB+, for example), the cost of debt is a continuous function of the financial strength of a company. As a company's financial ratios weaken, the cost of debt increases even if the company's credit rating may not yet have changed.

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[2] CWS 7 (Kropelnicki Direct) at 13-14.

Reputation Effects: Another concern is that investors and rating agencies may alter their expectations regarding future allowed ROEs for Commission-regulated companies, even if sending such a message was not the Commission's intention. Regulatory decisions have a lasting effect beyond the immediate case, and it is very difficult to regain investors' confidence once it is lost. Maintaining a regulator's reputation is an important aspect in minimizing the cost of capital for the companies it regulates.

Cost of Equity: On the equity side, a lower allowed ROE is likely to lower the market prices of the water companies' stocks, which, in turn, will make it more expensive to issue both debt and equity. Debt will be more costly because the coverage ratios will be weakened by lower expected cash flow, and new equity will be more expensive because the market prices will be lower. For those parent companies for which revenues are not solely derived from California operations, the parent company may decide that the risk-return tradeoff does not justify significant additional investment in the regulated company in California. In addition, if credit ratings are weakened, companies will not be able to respond to investment needs during periods of economic turmoil because only the strongest companies are able to access the capital markets on reasonable terms during economic downturns. Weakened utilities are less able to access capital markets or can only do so at increased costs. A state with a weakened utility sector is less able to respond to bad economic times by encouraging the utilities to invest to spur economic activity. Additionally, having safe, reliable water service is an essential ingredient of economic activity in any state, and in particular, in California. A weakened utility sector will not be able to maintain a water system as well as a strong utility sector. It is not in the interests of customers or utilities to have weakened credit ratings or weakened utilities.

Infrastructure Effects: Finally, the regulated utilities will undoubtedly make the investments necessary to provide safe and reliable water service; however, decreasing ROE by 100 basis points, and thus increasing the cost of acquiring capital, inevitably will impact a company's investment decisions because there is always some discretion as to the timing and selection of specific maintenance and capital addition projects. Because a significant portion of a regulated water company's capital budget must be spent on routine plant replacement, rather than system expansion, a key secondary effect of a lowered ROE is likely to be an adverse impact on long-term system reliability. Inevitably, less capital investment will have an adverse effect on reliability and service costs in the long-term.

Summary: With a 100 basis point reduction from a 9.99% ROE, the minimal short-term reduction in an average customer's water bill will likely be offset by increased long-term costs. Those costs will take the form of higher capital costs, less cost-effective investment in infrastructure for long-term reliability, and a weakened utility sector. The combination of these factors is likely to cost consumers more in the long term than they save in the short term. Customers and companies both benefit when the allowed ROE is set equal to the cost of capital, no more and no less.

QUESTION 3

3. How does the trend in actual return on capital compare against past levels of authorized cost of capital? Please explain with at least 5 years of data? (Note – ten years of data would be preferred.) How does this actual return compare with the actual return experienced by comparable firms in the sector?

RESPONSE TO QUESTION 3

In Table 15 of Exhibit GSW-2, the Direct Prepared Testimony of Mr. Thomas M. Zepp submitted on behalf of Golden State, Mr. Zepp provided the earned and authorized ROEs of several water and energy companies. Attachment 4 to this response provides an updated version of Mr. Zepp's Table 15. This updated version includes corrections to the data for San Jose, and adds data for California American Water.

Being allowed a fair opportunity to earn the allowed ROE is just as important as setting the allowed ROE equal to the cost of capital. By "fair opportunity," we mean that the expected value (in a statistical sense) of the earned ROE will be equal to the allowed ROE. In other words, competently managed regulated companies should expect to earn the allowed ROE on average. Sometimes, they may earn more and sometimes they may earn less, but on average they will earn the allowed ROE. For the Applicants in this proceeding, however, this has not been the case over the past five years, as indicated in Attachment 4, which suggests either that none of the four companies have been competently managed or the regulatory regime under which they operate does not provide a fair opportunity to earn the allowed ROE.

Dated: February 27, 2012

Respectfully Submitted,

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California Water Service Company
Revenue Requirement Impact for a reduction of 1% in ROE

District	2012 Adopted Rate Base	2012 Adopted Revenue	NTG	1% of ROE Impact Amt	1% of ROE Impact %	$ Impact Monthly Per Customer	Weighted Impact Per Customer
				-0.530% [1/]			
Antelope Valley	6,010.5	2,298.2	1.65726	(52.8)	-2.3%	$ (3.62)	
Bakersfield	106,773.7	64,491.5	1.65753	(938.0)	-1.5%	$ (0.78)	
Bayshore	69,381.2	61,088.6	1.60446	(590.0)	-1.0%	$ (0.53)	
Bear Gulch	53,472.0	36,551.3	1.69760	(481.1)	-1.3%	$ (1.73)	
Chico	43,143.9	20,418.7	1.61366	(369.0)	-1.8%	$ (0.61)	
Dixon	7,909.1	2,423.8	1.61770	(67.8)	-2.8%	$ (1.57)	
Dominguez So. Bay	57,741.6	56,731.9	1.67029	(511.2)	-0.9%	$ (0.43)	
East Los Angeles	41,283.3	33,549.1	1.69554	(371.0)	-1.1%	$ (0.72)	
Hermosa Redondo	35,587.2	27,634.8	1.67331	(315.6)	-1.1%	$ (0.64)	
Kern River Valley	15,851.5	5,622.9	1.66411	(139.8)	-2.5%	$ (3.88)	
King City	8,291.8	2,924.5	1.63177	(71.7)	-2.5%	$ (1.33)	
Livermore	27,662.0	21,352.8	1.70592	(250.1)	-1.2%	$ (0.77)	
Los Altos	33,930.3	25,536.4	1.68401	(302.8)	-1.2%	$ (0.90)	
Marysville	7,325.3	3,286.6	1.61568	(62.7)	-1.9%	$ (0.76)	
Oroville	8,328.9	4,177.9	1.65680	(73.1)	-1.8%	$ (1.03)	
Palos Verdes	28,183.2	42,650.3	1.70779	(255.1)	-0.6%	$ (0.71)	
Redwood - Coast Springs	1,235.9	444.5	1.60964	(10.5)	-2.4%	$ (7.13)	
Redwood - Lucerne	4,218.1	1,805.1	1.70575	(38.1)	-2.1%	$ (4.67)	
Redwood - Unified Area	953.6	610.5	1.62085	(8.2)	-1.3%	$ (2.99)	
Salinas	57,005.6	26,057.8	1.65743	(500.8)	-1.9%	$ (0.80)	
Selma	10,952.3	4,410.1	1.63475	(94.9)	-2.2%	$ (0.83)	
Stockton	57,028.7	33,831.6	1.68019	(507.8)	-1.5%	$ (0.65)	
Visalia	53,641.0	24,385.5	1.61725	(459.8)	-1.9%	$ (0.58)	
Willows	4,163.5	2,077.0	1.64750	(36.4)	-1.8%	$ (0.93)	
Westlake	18,906.3	19,039.1	1.70883	(171.2)	-0.9%	$ (1.41)	
Total	$758,980.5	$523,400.4		(6679.6)			($0.91)

[1/] 1% reduction of ROE at 53% of the Capital Structure based on Proposed Settlement

California American Water

Revenue Requirement Impact for a reduction of 1% in ROE

District	2012 Adopted Rate Base	2012 Adopted Revenue	NTG	1% of ROE Impact Amt	%	$ Impact Per Customer	Weighted Impact
				-0.53% 1/			
Sacramento	138,149.6	45,704.6	1.75000	(1281.3)	-2.8%	$ (1.32)	
Larkfield	7,112.9	2,712.9	1.75000	(66.0)	-2.4%	$ (1.59)	
Toro	2,350.1	444.3	1.75000	(21.8)	-4.9%	$ (1.93)	
Monterey Water	131,066.3	44,757.1	1.75000	(1215.6)	-2.7%	$ (0.86)	
Wastewater	1,471.0	3,185.0	1.75000	(13.6)	-0.4%	$ (0.40)	
Los Angeles	59,817.8	25,186.7	1.75000	(554.8)	-2.2%	$ (1.28)	
San Diego	15,202.9	19,572.2	1.75000	(141.0)	-0.7%	$ (0.24)	
Ventura	34,933.3	31,205.2	1.75000	(324.0)	-1.0%	$ (0.62)	
	$390,103.8	$172,768.0		(3618.2)	-2.1%		$ (1.06)

1/ 1% reduction of ROE at 53% of the Capital Structure based on Proposed Settlement

Golden State Water Company

Revenue Requirement Impact for a reduction of 1% in ROE

District	2012 Adopted Rate Base	2012 Adopted Revenue	NTG	1% of ROE Impact Amt	%	$ Impact Per Customer	Weighted Impact
				-0.55% [1]			
Region I							
Arden Cordova	16,010.3	11,568.1	1.79474	(158.0)	-1.4%	$ (0.41)	
Bay Point	10,178.0	5,833.2	1.81223	(101.4)	-1.7%	$ (1.11)	
Clearlake	5,250.1	2,172.9	1.79081	(51.7)	-2.4%	$ (1.86)	
Los Osos	8,781.6	3,768.6	1.78241	(86.1)	-2.3%	$ (1.55)	
Ojai	15,486.3	5,463.6	1.80252	(153.5)	-2.8%	$ (2.18)	
Santa Maria	21,816.3	10,182.7	1.78259	(213.9)	-2.1%	$ (1.04)	
Simi Valley	9,188.0	12,378.5	1.80860	(91.4)	-0.7%	$ (0.47)	
Region 1	86,710.7	51,367.5		(856.1)	-1.7%		
Region 2	271,247.8	127,554.0	1.80679	(2695.5)	-2.1%	$ (1.27)	
Region 3	242,612.6	124,157.2	1.80094	(2403.1)	-1.9%	$ (1.23)	
	$600,571.0	$303,078.7		(5954.7)	-2.0%		$ (1.24)

[1] 1% reduction of ROE at 55% of the Capital Structure based on Proposed Settlement

Attachment 4 to
Exhibit JT-2 (Joint Settling Parties' Response to Clarifying Questions)

RESPONSE TO CLARIFYING QUESTION 3

Water Utilities Sample		2006	2007	2008	2009	2010	Average
Aqua America, Inc.	Earned ROE	10.60%	10.00%	9.60%	9.60%	10.90%	
	Authorized ROE	10.08%	10.10%	10.18%	10.33%	10.33%	
	Difference	0.52%	-0.10%	-0.58%	-0.73%	0.57%	-0.06%
California Water Service Group	Earned ROE	8.20%	8.10%	10.20%	9.80%	9.00%	
	Authorized ROE	10.10%	10.20%	10.20%	10.20%	10.20%	
	Difference	-1.90%	-2.10%	0.00%	-0.40%	-1.20%	-1.12%
Connecticut Water Services, Inc.	Earned ROE	7.06%	9.04%	9.45%	9.78%	9.04%	
	Authorized ROE	12.70%	10.13%	10.13%	9.75%	9.75%	
	Difference	-5.64%	-1.09%	-0.68%	0.03%	-0.71%	-1.62%
Middlesex Water Company	Earned ROE	8.55%	8.83%	8.85%	7.04%	9.03%	
	Authorized ROE	10.04%	10.00%	10.00%	10.15%	10.15%	
	Difference	-1.49%	-1.17%	-1.15%	-3.11%	-1.12%	-1.61%
SJW Corp.	Earned ROE	11.41%	8.81%	8.24%	8.46%	8.04%	
	Authorized ROE	10.10%	10.13%	10.13%	10.20%	10.20%	
	Difference	1.31%	-1.32%	-1.89%	-1.74%	-2.16%	-1.16%
American States Water	Earned ROE	8.43%	9.57%	7.18%	8.82%	9.01%	
	Authorized ROE	9.80%	10.10%	10.20%	10.20%	10.20%	
	Difference	-1.37%	-0.53%	-3.02%	-1.38%	-1.19%	-1.50%
Golden State Water Company	Earned ROE	8.90%	9.86%	9.23%	7.73%	7.28%	
	Authorized ROE	9.80%	10.10%	10.20%	10.20%	10.20%	
	Difference	-0.90%	-0.24%	-0.97%	-2.47%	-2.92%	-1.50%
California American Water	Earned ROE	1.01%	1.30%	-0.54%	-0.11%	4.67%	
	Authorized ROE	10.10%	10.00%	10.15%	10.20%	10.20%	
	Difference	-9.09%	-8.70%	-10.69%	-10.31%	-5.53%	-8.86%

California Energy Utilities		2006	2007	2008	2009	2010	Average
Edison International	Earned ROE	14.00%	13.00%	12.80%	10.80%	10.50%	
	Authorized ROE	11.60%	11.60%	11.50%	11.50%	11.50%	
	Difference	2.40%	1.40%	1.30%	-0.70%	-1.00%	0.68%
PG&E Corporation	Earned ROE	12.70%	11.80%	12.60%	11.20%	9.50%	
	Authorized ROE	11.35%	11.35%	11.35%	11.35%	11.35%	
	Difference	1.35%	0.45%	1.25%	-0.15%	-1.85%	0.21%
Sempra	Earned ROE	14.80%	13.50%	14.00%	13.10%	10.50%	
	Authorized ROE	10.70%	10.70%	11.10%	11.10%	11.10%	
	Difference	4.10%	2.80%	2.90%	2.00%	-0.60%	2.24%