



Board of Supervisors COUNTY OF TULARE AGENDA ITEM

BOARD OF SUPERVISORS

KUYLER CROCKER
District One

PETE VANDER POEL
District Two

AMY SHUKLIAN
District Three

J. STEVEN WORTHLEY
District Four

MIKE ENNIS
District Five

AGENDA DATE: March 13, 2018

Public Hearing Required	Yes <input type="checkbox"/>	N/A <input checked="" type="checkbox"/>
Scheduled Public Hearing w/Clerk	Yes <input type="checkbox"/>	N/A <input checked="" type="checkbox"/>
Published Notice Required	Yes <input type="checkbox"/>	N/A <input checked="" type="checkbox"/>
Advertised Published Notice	Yes <input type="checkbox"/>	N/A <input checked="" type="checkbox"/>
Meet & Confer Required	Yes <input type="checkbox"/>	N/A <input checked="" type="checkbox"/>
Electronic file(s) has been sent	Yes <input checked="" type="checkbox"/>	N/A <input type="checkbox"/>
Budget Transfer (Aud 308) attached	Yes <input type="checkbox"/>	N/A <input checked="" type="checkbox"/>
Personnel Resolution attached	Yes <input type="checkbox"/>	N/A <input checked="" type="checkbox"/>
Agreements are attached and signature line for Chairman is marked with tab(s)/flag(s)	Yes <input type="checkbox"/>	N/A <input checked="" type="checkbox"/>

CONTACT PERSON: Samantha Ferrero

PHONE: 559-636-5000

SUBJECT: Letter to California Public Utilities Commission

REQUEST(S):

That the Board of Supervisors:

Approve sending a letter regarding the Proposed Decision by the California Public Utilities Commission and its effect on the Cost of Capital Proceeding for Major Water Utilities.

SUMMARY:

The California Public Utilities Commission (CPUC) is responsible for establishing the Cost of Capital for California Water Service (Cal Water), California American Water (Cal Am), Golden State Water Company, and San Jose Water Company. A separate agency, Office of Ratepayer Advocates, serves as a watchdog over the process.

The responsibility of the CPUC in setting a utility's Cost of Capital is to minimize the ratepayers' costs while ensuring a return high enough to attract capital. A Proposed Decision was issued by the CPUC on February 6, 2018 that would set a historically low Return on Equity (ROE). The ROE should allow a utility to attract necessary capital to keep drinking water service safe and reliable. Cal Water's current ROE is 9.43%. The National average in 2017 was 9.56%. The Proposed Decision by one of the Commission's Administrative Law Judges is 8.22%, the lowest approved ROE in the nation.

Although the new ROE may save statewide customers about \$1 a month, there are potential unintended consequences to consider. There is a potential limit to cash

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flow, lower credit ratings, increased reliance on standard debt, effect on equity investment, long-term increase in cost, etc. There is an attachment included in this item (Attachment A) provided by Cal Water to further outline the concerns and potential effects of the Proposed Decision.

It has been requested that the Board of Supervisors write a letter to the CPUC acknowledging the issues with the Proposed Decision and request that the Commission modify the decision such that it increases the ROE for Cal Water and the other water utilities to a level consistent with at least the average ROEs of water utilities in other states.

FISCAL IMPACT/FINANCING:

There is no net county cost.

LINKAGE TO THE COUNTY OF TULARE STRATEGIC BUSINESS PLAN:

Letter to the California Public Utilities Commission is linked to the Quality of Life initiative – Promote public health and welfare, educational opportunities, natural resource management and continued improvement of environmental quality.

ADMINISTRATIVE SIGN-OFF:

Julieta Martinez, Chief of Staff
Tulare County Board of Supervisors

Cc: Auditor-Controller
County Counsel
County Administrative Office (2)

Attachment(s) Attachment A – Cost of Capitol Summary
Attachment B – Letter to CPUC

**BEFORE THE BOARD OF SUPERVISORS
COUNTY OF TULARE, STATE OF CALIFORNIA**

IN THE MATTER OF LETTER TO THE
CALIFORNIA PUBLIC UTILITIES
COMMISSION

)
) Resolution No. _____
) Agreement No. _____

UPON MOTION OF SUPERVISOR _____, SECONDED BY
SUPERVISOR _____, THE FOLLOWING WAS ADOPTED BY THE
BOARD OF SUPERVISORS, AT AN OFFICIAL MEETING HELD _____
_____, BY THE FOLLOWING VOTE:

AYES:
NOES:
ABSTAIN:
ABSENT:

ATTEST: Michael C. Spata
COUNTY ADMINISTRATIVE OFFICER/
CLERK, BOARD OF SUPERVISORS

BY: _____
Deputy Clerk

* * * * *

The Board of Supervisors:
Approved sending a letter regarding the Proposed Decision by the California Public
Utilities Commission and its effect on the Cost of Capitol Proceeding for Major
Water Utilities

Attachment A

California Public Utilities Commission Cost of Capital Proceeding for Major Water Utilities

Background

California Water Service (Cal Water), California American Water (Cal Am), Golden State Water Company, and San Jose Water Company are regulated by the California Public Utilities Commission (Commission). The Commission is responsible for establishing the Cost of Capital for each of the utilities. Cost of Capital is comprised of each utility's weighted average cost of debt, preferred equity, and common equity the utility has issued to finance its water infrastructure projects. The Commission is responsible for setting a utility's authorized Cost of Capital at a level sufficient to attract investors to finance the upfront costs of replacing and upgrading aging infrastructure.

Importance of Cost of Capital

The ability of the four utilities to raise sufficient capital is the lynchpin to making infrastructure investments needed to ensure the safety and reliability of water provided to customers. In setting a utility's Cost of Capital, the Commission's responsibility is to minimize ratepayers' costs while ensuring a return that is high enough to attract capital. Simply put, a Cost of Capital that is too low would mean infrastructure projects will cost more, be delayed or shelved altogether.

Commission's Current Cost of Capital Proceeding

In early 2017, Cal Water, Cal Am, Golden State Water Company, and San Jose Water Company each filed their respective Cost of Capital Applications with the Commission, which were then consolidated into a single proceeding, overseen by one of the Commission's Administrative Law Judges. Throughout 2017, the Commission received testimony from the four utilities and the Office of Ratepayer Advocates, as well as their respective experts. On February 6, 2018, a Proposed Decision (PD) was issued, and the Commission may act on it as early as March 22, 2018.

Summary of the Cost of Capital in the Proposed Decision

The PD issued in the proceeding would set a historically low Return on Equity (ROE). The proposed ROEs range from a low of 8.22% to a high of 8.30% for the four water utilities. If adopted, this would amount to the lowest ROE for water utilities in the nation and mark a material departure from ROEs granted to water and energy utilities in California.

- The difference between current ROEs for the four utilities and the proposed ROEs range from a low of 113 basis points to a high of 176.
- The proposed ROEs are well below the 9.56% national average ROE authorized water utilities in proceedings decided in 2017.
- In 2017, the ROEs approved by the Commission for the major energy utilities in California ranged from 10.05% to 10.30%.
- The reductions in the ROEs approved by the Commission for the major energy utilities in California ranged from 5 to 15 basis points.

The Proposed Decision Fails to Strike the Right Balance

For the majority of Cal Water's single-family residential customers, as an example, who pay less than \$55 per month, the proposed decision would only reduce monthly water bills about \$1. This modest reduction, however, will be short-lived because the PD will trigger unintended consequences and higher costs down the road. If approved, the proposed ROEs would hinder the utilities' ability to raise capital needed to fund significant infrastructure projects needed to ensure safe and reliable water service, such as:

- The replacement of aging water pipelines with a higher risk of failure
- The construction of new water treatment facilities, such as those for 1,2,3-trichloropropane (more commonly known as TCP) and other groundwater contaminants
- The construction of new water wells, needed to ensure customers continue to have access to reliable water supplies.

The Proposed Decision Overlooks Several Critical Factors

- **The application of the model used to estimate the ROE is flawed.** The Commission's decisions in previous Cost of Capital proceedings have expressed the idea that the right balance is struck when considering multiple factors, including different models, interest rates, credit riskiness, and the adopted returns on equity in California and

Attachment A

around the country for companies with similar risk profiles. Experts for each of the water utilities in this case demonstrate how the PD relies on the use of a single estimation model, which is riddled with flaws, inconsistencies, and mathematical errors. On the other hand, the companies' experts used multiple models to arrive at their recommended range for the ROE.

- **Water utilities would have problems raising capital.** Water utilities are capital-intensive. When their water systems decay, it takes a long time to plan and construct facilities to fix them. In analyzing risk/return portfolios, investors are generally inclined to invest in companies with a higher return when the risks are similar. If the authorized ROE is less than the average ROE of similar securities issued by comparable regulated water companies in other states, investors will choose to purchase stock of other companies.
- **The risk profile of water utilities is not accurate or well understood.** California water utilities face increased costs due to the need to replace aging infrastructure, weather-driven events, increasingly stringent water quality standards, accessibility to supplemental sources of water during droughts, and insurance and regulatory factors.
- **The new federal tax act has a significant adverse impact on water utilities' risks and credit ratings despite the reduction in the corporate tax rate.** Significantly, the new tax law will reduce the California water utilities' cash flow because they will lose the benefit of deferred taxes, which have made cash available for capital investments and dividends. In addition, and very damaging to customer growth potential, the utilities will now be required to pay taxes on developer advances, contributions-in-aid-of-construction (CIAC) and grants. Those with significant groundwater operations will have to deal with the loss of the Domestic Production Activities Deduction (DPAD). All of these changes have already prompted rating agencies to issue a Credit Watch with a negative outlook for the credit ratings of the four water utilities.
- **The PD fails to account for an increasingly higher interest-rate environment.** Another key consideration is the future path of inflation. Since mid-February, U.S. Treasury notes have increased almost 60 basis points (0.60%) over the previous three months. The Federal Reserve has also signaled that it intends to raise interest rates three times in 2018. Rising interest rates, combined with tighter cash flows, will further downgrade the credit rating of water utilities, causing their borrowing costs – and therefore, customer rates – to increase.
- **The PD has already prompted investor analysts to question the stability of the regulatory environment for water utilities.** In the wake of the issuance of the PD, investor analysts with Standard & Poor's, Wells Fargo, and Wolfe Research questioned the stability of the regulatory environment for water utilities in California from an investment perspective.

Attachment B

March 13, 2018

The Honorable Martha Guzman-Aceves
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

Re: Proposed Decision in Application 17-04-001, et al.

Dear Commissioner Guzman-Aceves:

Most of the Tulare County's 100 drinking water systems are small, serving only a few hundred people. Many of these water systems have failed over the years. California Water Service (Cal Water), one of the applicants in this cost of capital proceeding, has played a major role in helping small, disadvantaged communities in our county have access to safe drinking water.

- One of these communities is West Goshen located east of Visalia. Wells in this community began failing in early 2012; the main well collapsed that year. Cal Water connected the entire West Goshen system to its Visalia water system, including new water main, hydrant and meter installations.
- Cal Water recently rehabilitated four wells and made \$8.8 million in infrastructure improvement projects to its Visalia water system, including new water mains, generators and treatment plants.
- During the height of the drought, hundreds of homes in East Porterville, a town north of Bakersfield in Tulare County, had no access to safe drinking water. Cal Water partnered with county to have water trucked to this small community.

Members of the Tulare County Board of Supervisors are concerned that setting a return on equity at the lowest level in the U.S. will hinder Cal Water's ability to raise capital essential to making the types of investments necessary to keep our water systems safe and reliable. We know that accessing capital is very competitive and a return on capital is a factor that will significantly influence investment decisions.

Moreover, rising interest rates, combined with tighter cash flows, could downgrade the credit rating of water utilities, causing their borrowing costs – and therefore, customer rates – to increase.

Attachment B

Our Board of Supervisors respectfully urge you to modify the proposed decision by increasing the return on equity for Cal Water to a level commensurate with the average returns on equity of water utilities in other states.

Sincerely,

Steven Worthley, Chairman
Tulare County Board of Supervisors

Kuyler Crocker, Vice Chairman
Tulare County Board of Supervisors

Pete Vander Poel, District Two
Tulare County Board of Supervisors

Amy Shuklian, District Three
Tulare County Board of Supervisors

Michael Ennis, District Five
Tulare County Board of Supervisors

cc: The Honorable Michael Picker, President, California Public Utilities Commission
The Honorable Carla Peterman, Commissioner, California Public Utilities Commission
The Honorable Liane Randolph, Commissioner, California Public Utilities Commission
The Honorable Clifford Rechtschaffen, Commissioner, California Public Utilities Commission
Service List for Application 17-04-001, et al.