Decision 10-12-057 December 16, 2010

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Great Oaks Water Company (U162W) for Authority to Establish its Authorized Cost of Capital Pursuant to the Rate Case Plan for Water Utilities.	Application 09-05-007 (Filed May 4, 2009)

DECISION ON BASE YEAR 2010 COST OF CAPITAL AND SUBSEQUENT YEARS' ADJUSTMENT MECHANISM FOR GREAT OAKS WATER COMPANY

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DECISION ON BASE YEAR 2010 COST OF CAPITAL AND SUBSEQUENT YEARS' ADJUSTMENT MECHANISM FOR GREAT OAKS WATER COMPANY

1. Summary

This decision establishes the base year 2010 ratemaking cost of capital and return on common equity for Great Oaks Water Company (Great Oaks). This is the first proceeding for this company where the sole subject is cost of capital, separated from a general rate case, pursuant to Decision (D.) 07-05-062, the most recent rate case plan for the Class A water utilities. The rate case plan established that cost of capital would be addressed for these companies in a consolidated proceeding rather than the past practice of treating cost of capital as one other cost item in the general rate cases.

In this decision, we adopt a return on equity of 10.20% along with an imputed capital structure to include ratepayer-beneficial long term debt, and then derive a weighted cost of capital. We take note of the financial markets' dislocation and therefore consider whether there are any extenuating circumstances of sufficient importance to warrant a departure from our normal procedures. The authorized return reflects the risk reductions inherent in all of the outstanding balancing accounts or memorandum accounts available to the company. Based on our consideration of all circumstances, we adopt a return on equity of 10.20% which is based on the testimony made by the sole active intervenor, the Division of Ratepayer Advocates; discounts the request by the applicant; and considers Great Oaks' individual risk profile, which includes relative size of operations and capital ratios. We adopt the following company-specific ratios and equity return:

Great Oaks Water Company Adopted 2010 Cost of Capital			
Long Term Debt	30%	7.50%	2.25%
Preferred Stock	3%	6.00%	0.18%
Equity	67%	10.20%	6.83%
Total			9.26%

Second, this decision adopts a Cost of Capital Adjustment Mechanism which uses an interest rate index and a Moody's bond rating to adjust the return on equity and update the cost of capital for the two years 2011 and 2012 before the next cost of capital proceeding for a base year of 2013. This is the same mechanism adopted in D.09-07-051 for the three large multi-district Class A water companies and in D.10-10-036 for the smaller Class A companies (excluding Great Oaks). Consistent with D.10-10-036, we adjust the trigger mechanism otherwise used in D.09-07-051 to avoid an unintended reduction in return which may result from a high cost base year for the bond index which captures the unusual recent market instabilities.

Finally, this decision orders Great Oaks to engage an independent Certified Public Accountant (CPA), with utility client experience, to perform a full and complete audit of the company beginning with all transactions as of January 1, 2009. Great Oaks shall continue to have annual audits unless this order is subsequently rescinded by a future Commission decision. Great Oaks must file for preapproval of its proposed selection of a CPA, and may recover the reasonable costs of these audits in a new CPA Audit Cost Memorandum Account.

The specific cost impacts of this decision are not quantified and depend upon any other changes to revenue requirement scheduled to be effective on January 1, 2010 in A.09-09-001. This proceeding is closed.

2. Jurisdiction and Background

Applicant Great Oaks Water Company (Great Oaks) is a public utility subject to the jurisdiction of this Commission as defined in Section 218 of the Public Utilities Code.[1] Applicant seeks adoption of a base year 2010 cost of capital which will apply to all of its California-jurisdictional operations.

Great Oaks was required by Decision (D.) 07-05-062 to file this application concurrently with cost-of-capital applications filed by San Jose Water Company (San Jose), Valencia Water Company (Valencia), Park Water Company and its affiliate Apple Valley Ranchos Water Company (Park/Apple), San Gabriel Valley Water Company (San Gabriel), and Suburban Water Systems (Suburban). This group of companies is the single-district Class A water utilities in California. On May 1, 2009, San Jose filed A.09-05-001, Valencia filed A.09-05-002, Park/Apple filed A.09-05-003, San Gabriel filed A.09-05-004, and Suburban filed A.09-05-005. On May 4, 2009, Great Oaks filed A.09-05-007.

On June 9, 2009, the Commission held a duly noticed prehearing conference (PHC) before the assigned judge in the multiple cost of capital applications to determine parties, create the service list, identify issues, consider the schedule, and address other matters as necessary to proceed with the applications. The assigned Commissioner consolidated the five applications pursuant to Rule 7.4, excluding Great Oaks' A.09-05-007. The assigned Commissioner's scoping ruling stated that because Great Oaks is the smallest of the Class A water companies, its operational and financial risks may[2] be readily

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[1] All statutory references are to the Public Utilities Code unless otherwise stated.

[2] There is a certain ambiguity to the words "…may be readily distinguished…" which may have been better expressed as "… possibly distinguishable …" in that the scoping

Footnote continued on next page

distinguished from the other larger companies. At the request of Great Oaks, we delayed litigating the cost of capital to coincide with litigating the general rate case, A.09-09-001. Further, the ruling also held that regardless of whether Great Oaks filed a general rate case in 2009, this application (A.09-05-007) would be processed to adopt a fair and reasonable 2010 base year cost of capital; the appropriate capital structure, embedded costs of debt and other non-equity securities; and a just and reasonable return on equity, i.e., there would be a cost of capital proceeding even if there was no general rate case. (June 23, 2009 Scoping Memo at 1–4.)

Great Oaks filed its anticipated general rate case, A.09-09-001, on September 1, 2009, pursuant to the Commission's rate case plan D.07-05-062, (which also required Great Oaks to file this application, A.09-05-007, for its cost of capital). In an updated scoping memo dated November 4, 2009, the assigned Commissioner held he would not consolidate A.09-05-007 with the general rate case, A.09-09-001, but would coordinate the two schedules to minimize any burden on either Great Oaks or the Division of Ratepayer Advocates (DRA). A separate scoping memo and ruling was issued in A.09-01-001. Therefore, the two proceedings were litigated separately and the outcome in one is not dependent upon the record or the outcome of the other.

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memo could not conclusively reach such a finding, but it could anticipate such a finding. Black's Law Dictionary likewise defines "may" as a possibility, "not a word of command." (Black's law Dictionary, Fifth Edition, at 883.)

The updated scoping memo ruled that the scope would be:

> The Commission will adopt a fair and reasonable 2010 base year cost of capital for Great Oaks; it must therefore determine the appropriate capital structure, and a just and reasonable return on equity and total capital.
>
> The Commission also will address the matter of subsequent adjustments to cost of capital, if any, for post-2010, and will determine a just and reasonable adjustment mechanism, if any, to change the adopted cost of capital for the two years between the 2010 base year and the next cost of capital proceeding for base year 2013. (November 4, 2009, Updated Scoping Memo, at 3-4.)

Great Oaks timely served supplemental testimony on November 13, 2009 as permitted by the updated scoping memo. The judge denied on November 23, 2009 a November 20, 2009 motion by DRA to strike the supplemental testimony. DRA timely served its testimony on December 9, 2009, and Great Oaks timely served rebuttal on December 29, 2009. There was one day of evidentiary hearings held on January 19, 2010.

There were two motions to strike filed on February 1, 2010: one by Great Oaks to strike DRA's written testimony; and another by DRA to remove Ex. GO-5 from the record.[3] The assigned judge denied both motions indicating that the DRA witness was accepted as an expert witness and parties could argue the merits and relevance of Ex. GO-5. We affirm all procedural rulings. DRA's

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[3] See also Transcript at 197 where Great Oaks argues the DRA witness did not perform all of the analysis himself. We find on a review of the record that the DRA witness showed a sufficient knowledge, and complete understanding of the offered analysis. As a matter of usual practice, we allow company and staff witnesses to adopt the work of consultants and subordinates when they demonstrate such an understanding. Additionally, Great Oaks was fully aware that DRA used a consultant in addition to its own staff witness and it did not object in a timely fashion.

showing was an up-dated analysis from A09-05-001 et al and DRA's witness was involved as project manager of both proceedings and demonstrated sufficient understanding of the analysis and its ratemaking implications.

Concurrent Opening Briefs were filed on March 1, 2010 and the application was submitted upon filing of Concurrent Reply Briefs on March 17, 2010.

3. Summary of Parties' Requests

Great Oaks proposes a rate of return of 17.58% on its operating expenses using a rate of margin (operating margin) analysis, which it states is traditionally applied to Class B water companies. This would equate to a return on equity of 18.70% based on a 100% equity capital structure, as explained below. Alternatively, Great Oaks argues it should receive 192 basis points above the otherwise applicable return on equity. Assuming the 10.20% return on equity adopted in D.09-05-019 and D.10-10-036 for the other Class A water companies, this would translate into a requested 12.12% return on equity for Great Oaks.

DRA imputed a capital structure of 34% debt and 66% common equity and DRA used the same average debt cost rate of 7.48% that DRA recommended for the five single-district Class A water companies considered in A.09-05-001 et al. (Ex. DRA-1 at 6.) Therefore DRA recommends the following cost of capital:

DRA's Recommended Capital Structure and Cost of Capital			
	Ratio	Cost	Weighted Cost
Debt	34%	7.48%	2.54%
Equity	66%	9.75%	6.44%
Total	100%		8.98%

4. Regulatory Environment

Our regulatory framework for Class A water utilities in California is a strong and responsive framework and is recognized as such. It provides stable

and predictable reviews in the form of general rate cases (see D.07-05-062) where we examine in detail and adopt a revenue requirement sufficient to provide an opportunity to recover reasonable operating costs. Additionally, we carefully review and determine an appropriate cost of capital and return on equity. This proceeding is a specific regulatory enhancement adopted in the latest rate case plan for water utilities. Finally, we provide for each company, based upon reasonable showing of need, an available comprehensive array of balancing accounts[4] and memorandum accounts which assure recovery of reasonably incurred costs and provide an opportunity to address unpredictable events ill-suited to inclusion in general rate cases, for example, catastrophic events such as wild fires and earthquakes.[5] Thus, the regulatory framework provides timely reasonableness reviews of balancing and memorandum accounts that recover significant portions of the company's costs free of the forecast risk inherent in general rate cases.

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[4] Great Oaks can recover actual pump taxes and purchased power via a Commission authorized balancing account.

[5] Although all Class A water companies in California have authority to establish a Catastrophic Event Memorandum Account, Great Oaks has not filed for one. It has three memorandum accounts: Santa Clara Valley Water District Memorandum Account, Military Family Relief Program Memorandum Account and a Low Income Customer Assistance Program Memorandum Account.

We know that California depends on having financially viable public utilities, and we are bound by Pub. Util. Code § 107.10[6] to ensure that a jurisdictional water utility has reasonable rates; therefore, all of our decisions must ensure that these regulated entities have a reliable process to recover their reasonable costs included in balancing and memorandum accounts; that we adopt reasonable forecasts in base sales; and the utility has an opportunity to earn a fair return.

5. Today's Capital Markets

In general, companies' long term capital cost rates for debt and equity are equal to required returns on risk-free securities plus a risk premium associated with each company. For a public utility, a number of factors may affect the appropriate debt costs and return on equity such as the regulatory environment and the specific operations of the individual company. We have extensively considered the 2008-2010 financial crises in A.05-05-002 et al. in D.09-05-019, and again in A.09-05-001 et al. in D.10-10-036.

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[6] Section 701.10: The policy of the State of California is that rates and charges established by the commission for water service provided by water corporations shall do all of the following: (a) Provide revenues and earnings sufficient to afford the utility an opportunity to earn a reasonable return on its used and useful investment, to attract capital for investment on reasonable terms and to ensure the financial integrity of the utility; (b) Minimize the long-term cost of reliable water service to water customers; (c) Provide appropriate incentives to water utilities and customers for conservation of water resources; (d) Provide for equity between present and future users of water service; (e) Promote the long-term stabilization of rates in order to avoid steep increases in rates; (f) Be based on the cost of providing the water service including, to the extent consistent with the above policies, appropriate coverage of fixed costs with fixed revenues.

We attempt to set the debt costs and return on equity at a level of return commensurate with market returns on investments having corresponding risks, and adequate to enable a utility to attract investors to finance the replacement and expansion of a utility's facilities to fulfill its public utility service obligation. To accomplish this objective, we have consistently evaluated analytical financial models as a starting point to arrive at a fair return on equity.

5.1. Legal Standard

The legal standard for setting the fair rate of return has been established by the United States Supreme Court in the *Bluefield* and *Hope* cases.[7] The *Bluefield* decision states that a public utility is entitled to earn a return upon the value of its property employed for the convenience of the public, and sets forth parameters to assess a reasonable return. Such return should be equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings attended by corresponding risks and uncertainties. That return should also be reasonably sufficient to ensure confidence in the financial soundness of the utility, and adequate, under efficient management, to maintain and support its credit and to enable it to raise the money necessary for the proper discharge of its public duties.

Hope held that the value of a utility's property could be calculated based on the amount of prudent investment minus depreciation, which we call rate base. *Hope* reinforces the *Bluefield* decision and emphasizes that the returns

[7] *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944).

should be sufficient to cover operating expenses and capital costs of the business. The capital cost of business includes debt service and stock dividends. The return should also be commensurate with returns available on alternative investments of comparable risks. However, in applying these parameters, we must not lose sight of our duty to utility ratepayers to protect them from unreasonable risks including risks of imprudent management.

6. Lay and Expert Witnesses

There were two cost of capital witnesses: one for Great Oaks, the company's president, who was specifically produced in a limited fashion as a lay witness;[8] and DRA's project manager, who was offered and qualified as an expert.[9] It is important to clearly denote the limitations of a lay witness in contrast to an expert witness for a cost of capital proceeding and we need to note that Great Oaks knowingly made the distinction and thus limited the application of its own witness's testimony in a complex, technical subject area. This distinction must also be viewed in the context of Great Oaks' actions to sever its cost of capital proceeding from the other single-district Class A companies' consolidated proceeding, thus limiting the available record here. Both Great Oaks and DRA relied, at least in part, on evidence in the record of the

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[8] "MR. GUSTER: Your Honor, if I may simply lodge an objection and point out the fact that Mr. Roeder is being offered as a lay witness and not as an expert witness." (Transcript at 95.) And also, "[Objection:] . . . Again, he's not being offered as an expert on how the financial community assesses risks of water utilities. He's here to testify as to his own personal knowledge and belief of the operational and financial risks of Great Oaks Water Company." (Transcript at 106–07.)

[9] "MS. BARRERA: He [Mr. Charvez] is our expert, your Honor. (Transcript at 168.)

consolidated proceedings A.09-05-001 et al. for the other single-district Class A water companies.

We rely on the well established definitions for lay and expert witnesses from Black's Law Dictionary:

> Lay Witness. Person called to give testimony who does not possess any expertise in the matters about which he [she] testifies. Used in contrast to expert witness who may render an opinion based on his expert knowledge if proper foundation is laid. Generally, such non-expert testimony in the form of opinions or inferences is limited to those opinions or inferences which are (a) rationally based on the perception of the witness (i.e. first-hand knowledge or observation) and (b) helpful to a clear understanding of his testimony or the determination of a fact at issue. Fed.Evid.R. 701.
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> Expert Witness. One who by reason of education or specialized experience possesses superior knowledge respecting a subject about which persons having no particular training are incapable of forming an accurate opinion or deducing correct conclusions. [citation] A witness who has been qualified as an expert and who thereby will be allowed (through his/her answers to questions posed) to assist the jury in understanding complicated and technical subjects not within the understanding of the average lay person. One possessing, with reference to a particular subject, knowledge not acquired by ordinary persons. One skilled in any particular art, trade, or profession, being possessed of peculiar knowledge concerning the same, and one who has given subject in question particular study, practice, or observation. One who by habits of life and business has peculiar skill in forming opinion on subject in dispute. (Black's Law Dictionary, Fifth Edition, at 799 and 519, respectively.)

Where specifically identified and received in the record, we affirm the judge's rulings on admissibility and exclusions of testimony and exhibits from A.09-05-001 et al. On February 1, 2010 Great Oaks filed a motion to strike DRA's testimony. DRA replied on February 5, 2010. The judge ruled in a brief email to parties on February 10, 2010, that the motion was denied, and the DRA

testimony was to be treated as expert testimony, and therefore was subject to argument in the opening and reply briefs.[10] We note and affirm the judge's ruling that Great Oaks was untimely in objecting to the offered DRA witness and untimely in its request to examine a consultant to DRA. The objection was made at the end of the evidentiary hearing. DRA's prepared testimony clearly indicated that work from A09-05-001 et al was reviewed, revised, and expanded for this proceeding. Great Oaks had notice before the hearing that Charvez was the proposed witness. DRA's witness was properly noticed and qualified as an expert. We affirm the judge's rulings that DRA laid a proper foundation thus demonstrating its witness to be qualified to offer testimony as an expert, and therefore, based upon both direct and cross examination, we will accord DRA's testimony appropriate weight in our determination of the base year cost of capital for Great Oaks. We accord less weight to the Great Oaks lay witness's testimony because we find that cost of capital is a complex technical issue, which, when tempered with our own judgment and discretion, is not a matter of observable fact, but is instead a matter of subjective opinion requiring specific training and experience to support a credible and persuasive recommendation. We do recognize that the Great Oaks witness could testify to facts regarding the operations of the company and his actions as an employee. We otherwise treat him as a lay witness as offered and limited by counsel for Great Oaks.

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[10] A more detailed ruling was not subsequently issued and was not necessary.

7. Cost of Capital Methodology

7.1. Positions of the Parties

Great Oaks did not request a conventional cost of capital for a Class A water company – it instead seeks a return based on its interpretation and application of Commission practices similar to the allowances for smaller water utilities often referred to as a rate of margin return:

> The rate of margin that we asked for in our rate case was basically a rate of margin number that we understood was -- that the PUC had found appropriate for Class B companies and we -- that's where that number came from. …Great Oaks has annual expenses exceeding what its rate base is currently. Great Oaks anticipates that its rate base will continue going down. (Transcript at 161-162.)

Great Oaks argues that it has a declining rate base and faces increasing expenses which it believes would support the rate of margin (operating margin) analysis, which it believes has been traditionally applied to Class B water companies. Great Oaks asserts it more closely resembles a Class B water utility on all relevant cost of capital, operating and financial characteristics than it does any of the other Class A water companies, with only the number of customers placing Great Oaks in the Class A category.

Great Oaks proposed a rate of return of 17.58% on its operating expenses using a rate of margin analysis. Great Oaks effectively seeks a return on equity of 18.70% based on a 100% equity capital structure.[11] In fact, Great Oaks has an actual capital structure which is 3% preferred stock and 97% equity.

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[11] "… under the model used in this rate case, the return on rate base would be 18.78 [percent]. And since the equity is 100 percent, the return on equity would, therefore, also be 18.7 [percent]." (Transcript at 163.) Also, Ex. GO-3 at A-18.

DRA opposes Great Oaks' approach and, as addressed below, supports the use of an imputed capital structure to obtain a regulatory cost of capital for Great Oaks.

7.2. Discussion – Methodology

Upon meeting the Class A size requirement, all water companies generally assume the same responsibilities and obligations to customers and generally must comply with the same regulatory processes and policies. Great Oaks argues, however, that under Pub. Util. Code § 727.5(e)[12] the Commission is free to chose any method to determine a reasonable cost of capital for a water utility, and therefore, it may depart from the typical method relied upon for Class A companies and adopt the method proposed by Great Oaks. (Great Oaks Opening Brief at 9-10.) We do not disagree with the premise that we have authority to report from the current method where it could be shown to be more reasonable, however, as explained by more of the circumstances cited by 6.0 and materially different.

Great Oaks argues that it has risks which are uniquely different from the risks faced by the other Class A companies and that the only similarity it shares with the other Class A companies is that it has more than the minimum 10,000 connections (*Id*. at 12). Great Oaks is the smallest of the Class A water companies

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[12] (e) In establishing rates for recovery of the costs of used and useful water plant, the commission may utilize a capital structure and payback methodology that shall maintain the reliability of water service, shall minimize the long-term cost to ratepayers, shall provide equity between present and future ratepayers, and shall afford the utility an opportunity to earn a reasonable return on its used and useful investment, to attract capital for investment on reasonable terms and to ensure the financial integrity of the utility. (Emphasis by Great Oaks in its Opening Brief at 10.)

but, with a forecast of approximately 24,000 connections, it is nevertheless twice the minimum size of 10,000 connections for the classification. It is much bigger than the largest Class B company, which is Alisal Water Corporation dba Alco Water Service, with fewer than 9,000 customers. Thus, Great Oaks is 2.7 times the size of the largest Class B.

Great Oaks argues it has a diminishing rate base. (*Id.* at 15.) That alone is not a risk which warrants any adjustment to return: investors are entitled to earn a reasonable return on the necessary investment to provide service. Ratepayers are not obliged to maintain investors' income level in total number of dollars, but only an opportunity to a return, as a percentage, on the necessary investment. If the utility does not need new investment it can pay dividends or reacquire stock to adjust the amount of outstanding equity to equal the level necessary for investment in rate base. We would agree that, while at some point a de minimus rate base value would provide no return on investment cushion to absorb the variations between forecast and actual expense, Great Oaks has not shown it to have such a small rate base that it faces a significant risk of an operating loss if there is a minor adverse variation in forecast expenses.[13]

Great Oaks argues that its expenses are expected to increase annually. (*Id.* at 16.) Revenue requirement is adjusted to account for the forecast costs of operations in general rate cases, the adopted attrition allowances, authorized balancing and memorandum accounts, and by other specific applications for rate

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[13] We note that in A.09-09-001, Great Oaks' pending general rate case, it indicates that its last test year rate base was $9,648,723, its rate base on a recorded basis for the calendar year 2008 was $11,888,532, and it requests a test year 2010-2011 rate base of $11,202,434. Thus, Great Oaks' rate base has both risen and fallen since its last date proceeding and its forecast through 2011.

recovery, all of which are appropriate mechanisms to offset and recoup rising expense. We should not artificially increase the cost of capital or the return on equity to offset legitimate expenses; we should set appropriate utility rates to recover either forecast costs (in rate case and attrition adjustments) or specific actual costs (in balancing and memorandum accounts). When we adopt a cost of capital or return on equity, it is not intended to offset foreseeable annual increases in expense; it is to attract and retain capital by offering a market return to investors.

Finally, we note that the Commission has not applied the rate of margin method to Class B water utilities, contrary to Great Oaks' apparent belief. Pursuant to D.92-03-093 (Ordering Paragraph 8), the rate of margin (operating margin) method may be used for Class C and Class D water companies. While Class B water companies utilize simpler advice letters rather than applications for their general rate cases, the Commission establishes a cost of capital and return on equity for Class B utilities, based on their rate bases, not a rate of margin as requested by Great Oaks.

For these reasons, we do not accept Great Oaks' proposal that we deviate from the traditional cost of capital approach for Class A water companies contemplated in the rate case plan.

8. Capital Structure

Great Oaks has a 97% equity and 3% preferred stock capital structure. However, DRA imputed a capital structure of 34% debt and 66% common equity. DRA argues that an imputed capital structure is reasonable, and is fair to ratepayers who would otherwise bear the cost of an equity return and the related income tax allowance for an all-equity structure. DRA argues that this is consistent with Commission precedent for setting rates of return for utilities such

as Great Oaks that have an "atypical" capital structure. DRA points out that the Commission has previously adopted an imputed structure of 34% debt and 66% equity in recent rate cases. (DRA Opening Brief, at 15–16.)

Ratemaking capital structure is long term debt, preferred stock, and common equity.[14] Because the level of financial risk that a utility faces is determined in part by the proportion of its debt to equity capital, or the degree of financial leverage, we must ensure that the utility's adopted equity ratio is sufficient to maintain a reasonable credit rating and to attract capital without incurring unnecessary costs for an excessive amount of expensive equity.

Generally, long term debt is the least expensive form of capital but the utility must ensure that it timely meets every interest payment and maintains any required terms or conditions of the loan agreements or mortgage indentures, and that it can refinance or refund the debt when it matures. Preferred stock is generally more expensive than debt (at the time it is originally issued) and may or may not have a maturity or refund provision. Interest may usually be deferred but it then accumulates and takes preference over payment of dividends to common equity owners. Thus, equity owners assume more risk than either debt holders or preferred stock owners, including the risk of losing their entire investment, and therefore equity investors require the highest return over the long run.

We believe that the company has a significant control over the mix of debt and equity and thus ratepayers should not bear unnecessary costs as a result of management discretion. Thus, even if, for the sake of argument, a smaller water

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[14] Short-term debt due within one year is excluded.

company as a matter of course has a higher transaction cost and even a higher interest cost for debt, debt is almost always cheaper than equity and does not carry the added loading of an income tax allowance in rates. Therefore, if a company carries a high equity ratio, for ratemaking purposes we should necessarily consider adjusting either the return on equity or the capital structure.

DRA relies on a venerable decision:

> [W]e have generally deemed a high equity capital structure, like that of Great Oaks, less than desirable for Class A water companies, as well as for other public utilities. This is because a high equity structure is generally inefficient in that it causes the public to be burdened with the higher costs of obtaining capital. We have previously discussed the rationale for this policy:
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> Debt financing is less expensive than equity financing because interest payments on debt are generally less than returns paid to common stockholders and because interest payments are tax deductible while returns on common equity are not. The tax savings generated by interest expense directly benefits ratepayers through a proportional reduction of revenue requirement needs. (DRA Opening Brief at 17 citing to D.93-10-046, at 3 (citing Re San Gabriel Valley Water Co. (1989) 32 Cal.P.U.C. 2d 423, 439).)

We continue to espouse this policy preference for using or imputing cost-effective debt into the capital structure of Class A utilities. In D.09-05-019, we discusssed the cost advantage to ratepayers of including debt in the capital structure and required other Class A companies to fully justify their equity ratios in a subsequent cost of capital proceeding.

Great Oaks' prior cost of capital, including capital structure, was adopted by resolution, and a settlement. Although our rules clearly denote settlements are not precedential (Rule 12.5), and we cannot unravel the give and take involved in a settlement, we can take notice of our prior adoption of imputed capital structures because our same rules require that any settlement must be

based on the evidence, consistent with the law, and in the public interest. (Rule 12.1(c).)

As noted above, Great Oaks' application was not consolidated with the other single-district Class A water companies in A.09-05-001 et al., but we can and do consider our decision D.10-10-036 in that proceeding. In D.10-10-036, we declined to use DRA's generic capital structure for the various applicants, and we adopted instead their actual capital structures which varied in their debt to equity ratios. We noted in that decision our strong preference for a reasonable amount of debt which reduces the overall cost of capital recovered from ratepayers.

Great Oaks, unlike the other Class A water companies, has no long term debt in its capital structure. In this proceeding the company proposed that ratepayers pay the higher return on equity (a premium above the cost of debt) on the significant proportion of the company's total capital that for all other Class A water companies is funded by long term debt. If we adopted Great Oaks' proposal, ratepayers would also needlessly pay a much higher income tax allowance as well. Great Oaks does not have the discretion to simply chose the most expensive capital structure and ignore the benefits to ratepayers of using tax-deductible lower cost debt. We therefore impute a debt component in these specific circumstances for Great Oaks to reduce the costs otherwise imposed on ratepayers.

Valencia and Park/Apple are the two smallest Class A water companies other than Great Oaks, and they have 2010 equity ratios of 75% and 57%,

respectively (see, D.10-10-036 at 3), significantly lower than Great Oak's 97%.[15] These lower equity ratios allow the use of tax-deductible debt, which when coupled with the normally lower cost of debt provides a significant cost savings to ratepayers. Thus the use or imputation of debt can be in the public interest because it lowers costs to ratepayers. An appropriate amount of debt, assuming the utility has sufficient cash flow and is otherwise financially sound, does not adversely impact the cost of equity allowing the investors an opportunity to earn a reasonable return on equity.

We have previously used an imputed debt allowance for Great Oaks and find DRA persuasive that we should impute a suitable capital structure rather than Great Oaks' excess reliance on equity. We therefore adopt a 30% debt structure, and allocate the remaining 70% to reflect the existing 3% preferred stock and impute a residual allowance of 67% equity. Preferred stock dividends, like common stock dividends, are not tax deductible. Thus the tax effect of this structure (30-3-67) mimics a 70% equity structure and is closer to DRA's 66% equity structure than it is to Great Oaks' 100% equity structure. This adopted capital structure is consistent with the range of the next smallest Class A companies and with our regulatory objective to set rates at the lowest reasonable level, while still leaving Great Oaks with a relatively high equity ratio for ratemaking purposes compared to other Class A companies. Using imputed debt substitutes for Great Oaks' excessive and more expensive reliance on equity and lessens the cost burden on its customers.

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[15] Valencia has subsequently reduced its equity ratio, as noted in D.10-10-036.

9. The Cost of Long Term Debt

Ratemaking long term debt costs typically are based on actual, or embedded debt costs. Future interest rates must be anticipated to reflect projected changes in a utility's cost caused by the issuance and retirement of long term debt during the year. This is because the rate of return is established on a forecast basis.

We recognize that actual interest rates do vary and that our task is to determine "reasonable" debt cost rather than actual cost based on an arbitrary selection of a past figure.[16] In this regard, we conclude that the latest available interest rate forecast should be used to determine the forecast of additional debt included in the embedded debt for the forecast period. (See recently, D.07-12-049, and 38 CPUC2d 233, where 18 years ago, the Commission definitively discussed the need for, and use of, a reliable forecast of future interest costs.)

We have a limited record on the cost of debt, essentially only DRA's recommendation of 7.48% based on the detailed study from A.09-05-001 et al. (DRA Opening Brief at 27 citing Ex. DRA-1 at 6.) To adopt an imputed cost of debt for Great Oaks, we round DRA's recommendation to 7.50% and note that this result is comfortably within the range of the embedded costs of debt for the Class A companies in A.09-05-001 et al. More specifically, we separately take note that the reported rates for corporate bonds rated Baa by Moody's, as reported in the Federal Register Statistical Release H.15[17] for September 15, 2010

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[16] 38 CPUC2d 233 at 242 and 243 (1990).

[17] http://www.federalreserve.gov/releases/h15/.

showed that interest rates were approximately 5.6% to 5.8% in August and September, and were higher (6.0% to 6.2%) in June and July. Thus, the adopted forecast of 7.50% is approximately 130 to 190 basis points higher. In December of 2004, 2005, and 2006, the rates were in the low 6.0% to 6.2% range. Thus, over time debt has been available, even at a premium over the Baa rates, which would be substantially cheaper for ratepayers than the required return on equity, when fully loaded for the income tax effects.

In the next cost of capital proceeding Great Oaks may either present testimony on its actual cost of debt (if it issues long term debt) or offer evidence on a reasonable imputed cost at that time.[18] For this proceeding, we conclude that 7.50% is a fair and reasonable proxy for the market cost of debt.

10. The Cost of Equity

10.1. Positions of the Parties

Great Oaks argues, if its rate of margin proposal is not adopted, that it should receive 192 basis points above the otherwise applicable return (Great Oaks Opening Brief at 4-5.) For comparison, the Commission adopted a 10.20% return on equity for the three large multi-district Class A water companies in D.09-05-019. We also recently adopted 10.20% return on equity for the single-district Class A water utilities (excluding Great Oaks) in D.10-10-036 issued in

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[18] The examination of Great Oaks' witness eventually disclosed that the company has had discussions with several lenders about the approximate cost of borrowing, but did not elicit any actual information provided by the lenders.

A.09-05-001 et al. Thus, Great Oaks seeks, as an alternative, approximately a 12.12% return on equity.[19]

DRA recommends a return on equity of 9.75%, which it states is consistent with its recommended return on equity for other Class A water companies in California.[20]

DRA argues that the Commission has consistently used a market analysis to determine Great Oaks' return on equity and rate of return on rate base. In D.93-04-061, the Commission adopted a capital structure that resulted in a return on equity of 11.5% and a rate of return of 10.56% for the test year 1993.[21] Again, in D.03-12-039, the Commission adopted a return on equity of 9.78% and a rate of return of 8.9% for test year 2003.[22] In both instances, DRA argues that it and Great Oaks relied on market analysis models, such as the Discounted Cash Flow model and the Capital Asset Pricing Model, to arrive at their separate recommended return on equity.[23]

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[19] A basis point is one-one-hundredth of a percent, i.e., there are 100 basis points in 1.0% and thus 192 basis points is also either 1.92% or 0.0192, as a decimal. (10.20% + 1.92% = 12.12%.)

[20] DRA Opening Brief at 6, Footnote 16, citing Exhibit DRA-1, Testimony of Raymond Charvez on behalf of DRA on cost of capital for Great Oaks Water Company, A.09-05-007, December 9, 2009, at Updated Attachment JRW-1, Panel A.

[21] Citing to DRA Opening Brief at Footnote 21 - See D.93-04-061, Re Application of Great Oaks Water Company for Authority to Increase Rates for Water Service . . . , A.92-01-001, April 21, 1993, 1993 Cal. PUC LEXIS 238, at 39-45.

[22] Citing to DRA Opening Brief at Footnote 22 - See D.03-12-039, Re Application of Great Oaks Water Company for an Order authorizing it to increase rates for water service . . . , A.02-11-048, December 18, 2003, 2002 Cal. PUC LEXIS 1063, at 34-36.

[23] Citing to DRA Opening Brief at Footnote 23 - See D.93-04-061, at 9; and D.03-12-039, at 26.

In this proceeding, DRA presented a market analysis built on its showing in A.09-05-001 et al. and updated for Great Oaks. DRA updated the analysis performed by Dr. J. Randall Woolridge, who was DRA's witness in A.09-05-001 et al.[24] DRA's witness in this proceeding revised that analysis to provide specific recommendations for Great Oaks. This application was supposed to be consolidated with the other applications in A.09-05-001 et al. but, at the specific request of Great Oaks, we delayed litigating the cost of capital to coincide with litigating the general rate case A.09-09-001. DRA argues (DRA Opening Brief at 19) that its intention was to apply the same cost of capital analysis to all Class A water companies that filed in May 2009, and that Great Oaks is the only remaining Class A water company that has not completed its cost of capital proceeding. Therefore, DRA used the same proxy groups that it used in A.09-05-001 et al. and updated its Discounted Cash Flow model and Capital Asset Pricing Model analyses to determine a fair and reasonable return on equity for Great Oaks.[25]

DRA evaluated the equity return requirements of investors on the common stock of two proxy groups: first, a proxy group of water utility companies (Water Proxy Group) and second, a proxy group of publicly-held gas distribution companies (Gas Proxy Group). (Ex. DRA-1 at 4.) DRA argues that:

> The relative size of Class A water companies is irrelevant to a market-based analysis in this context because generally all Class A water companies face similar business and regulatory risks. … Using this proxy group is reasonable because the earnings of these water companies are pre-determined to a certain degree

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[24] Ex. DRA-1, at 3.

[25] *Id.*

> through the ratemaking process and because their respective financial performance is monitored on an ongoing basis by [their respective] State and Federal Agencies and Commissions. (DRA Opening Brief at 21.)

DRA's Discounted Cash Flow analysis alone would result in a recommended return on equity of 9.7%. (Ex. DRA-1 Attachment JRW-10, at 1 (Panel A).) Similarly, its Capital Asset Pricing Model analysis alone would result in a recommended 7.9% return on equity including a 4.37% risk allowance (beta). (DRA Opening Brief at 24 summarizing Ex. DRA-1.) DRA's final recommendation is a return of 9.75%, which is the high-end of the results of its two models.

DRA does not agree with any of Great Oaks' arguments that the company faces greater risks than the other Class A water companies because of its size as the smallest Class A company. (DRA Opening Brief at 25-27.)

10.2. Effect of Water Revenue Adjustment Mechanism (WRAM) on Market Return

The Commission has adopted two variations of a WRAM: a "Full WRAM" which ensures the actual collection of the adopted revenue requirement regardless of variations in sales or revenues for any reason; and a "Monterey-Style WRAM" which only adjusts for the difference in revenues from actual sales caused by adopting a conservation-focused rate design. In this latter WRAM, the revenues for actual sales are re-computed using non-conservation rates and compared to the revenues resulting from conservation rates with the resulting difference attributed entirely to the effect of the conservation rate design. This difference is subsequently collected or refunded in rates. At issue in the separate general rate case, A.09-09-001, is whether Great Oaks should have either WRAM.

Great Oaks argues that it faces greater risks because of mandatory conservation orders by the Santa Clara Valley Water District and "DRA's steadfast refusal to address lower water sales." (Great Oaks Opening Brief at 22.) There is no further elaboration on this assertion, but it appears that Great Oaks considers the purported difference in the sales forecasts between itself and DRA (in the general rate case) to be a "refusal" rather than a difference in opinion.

In the separate general rate case (A.09-09-001) the Commission must and will adopt what it believes to be just and reasonable rates relying upon the most persuasive arguments and supporting evidence including what the Commission considers to be the most likely sales forecast for the test year. For cost of capital we cannot assume there is an unjust or an unreasonable forecast skewing the required return. Therefore, we will not adjust the return for any risk perceived by Great Oaks that the adopted sales forecast may be unreasonable or that it fails to consider the effects of conservation. Additionally, the Commission has found that there has not been enough experience with WRAM to determine the likely impact on the required rate of return, except to determine that we believe a WRAM would reduce risk because otherwise it would be foolish to adopt a mechanism for Great Oaks or the other Class A water companies which knowingly increases risk. Thus, if or whenever we can reasonably quantify the impact of any WRAM, we expect the impact to be a reduction in the required return compared to the return required in the water industry generally and that of a company without a WRAM. We would not adopt a WRAM to increase a company's risk.

10.3. Discussion-- Cost of Equity

In competitive markets for goods, the return on common equity is determined by the relative risks of alternative investments and the willingness of

individual investors to accept varying degrees of risk. In a closely regulated market, regulation substitutes for competition and the regulator, acting as a substitute for the market, provides investors an opportunity to earn a fair and reasonable return for accepting the degree of risk presented by the regulated business.

We take note of the financial markets' dislocation and therefore consider whether there are any extenuating circumstances of sufficient importance to warrant a departure from our normal procedures. The Commission must, as always, exercise extreme caution and critically review the wide range of results seemingly rendered from the same models held in different hands. Recently we noted:

> What stands out in a comparison of the testimony of the experts is the inevitable and pervasive use of [their] judgment, which colors all results. (D.07-04-046 at 58.)

We also noted at that time:

> Although the parties agree that the models are objective, the results are dependent on subjective inputs. For example, each party used different proxy groups, growth rates, and calculations of market returns. (*Id*. at 57.)

Great Oaks argues that unlike the proxy groups used by DRA (or by inference, the larger Class A companies) it is not publicly traded. Several Class A companies are not publicly traded and are closely held. In setting a return on equity our objective is to identify the return any investor would require to invest in a California Class A company. The Commission has never quantified a return differential for the marketability of widely traded (generally larger) companies and narrowly traded or closely held (usually smaller) companies. We see no basis for such a distinction for Great Oaks.

We therefore conclude that the current return of 10.20% on equity for Class A water utilities adopted in D.09-05-019 for the three large multi-district Class A water companies and in D.10-10-036 for the other single-district Class A companies is a just and reasonable return on equity for Great Oaks at this time. This authorized return reflects the risk reductions inherent in all of the outstanding balancing accounts or memorandum accounts available to the company, as well as the relatively high imputed equity ratio.

11. Adopted Capital Structure and Cost of Capital

As discussed above, we impute a capital structure of 30% long term debt, 3% preferred stock, and 67% equity for Great Oaks, adopt a long term debt forecast of 7.50%, and adopt a return on equity of 10.20%, consistent with the return found reasonable for the other Class A water companies in recent proceedings. These determinations result in a 9.26% cost of capital for Great Oaks for 2010, as shown below in Table 1.

Table 1 Adopted 2010 Cost of Capital			
Long Term Debt	30%	7.50%	2.25%
Preferred Stock	3%	6.00%	0.18%
Equity	67%	10.20%	6.83%
Total			9.26%

12. Water Cost of Capital Adjustment Mechanism

We will adopt the same Cost of Capital Adjustment Mechanism adopted in D.09-07-051 using an imputed Baa rating equivalent[26] but with one modification: we increase the lower boundary of the dead band to 200 basis points to reduce the potential for a large downward adjustment to the authorized return on equity caused by the economic recovery which may significantly change the Moody's bond indices. This is the same modification adopted in D.10-10-036 in
A.09-05-001 et al. for the other single-district Class A water companies.

13. Urgent Need for Ongoing Independent Audits

13.1. Summary

The record in this proceeding does not show that Great Oaks has had its financial records audited by an independent Certified Public Accountant (CPA) with utility client experience.[27] We are very concerned that the financial records in this proceeding may not be reliable and may not state the true financial position of the company. We therefore cannot independently know with the usual certainty whether Great Oaks has been earning its authorized return,[28] has unreported debt obligations, or has been correctly accounting for its operations

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[26] In D.10-10-036 in A.09-05-001 et al., we use the actual Moody's rating for the rated companies or otherwise impute a rating. Baa is a low investment grade rating which we used for Valencia, one of the smaller Class A companies.

[27] No audited financial statements are on file with the Commission nor were any included in this application or A.09-09-001, the pending general rate case.

[28] See the discussion, for example, at Transcript 150–154 where it is not clear and accurate in the record what the company is earning over time on an actual rate of return basis or the precise causes of fluctuations in expenses and earnings.

in accordance with generally accepted accounting standards and compliance with prior Commission decisions. (It is not DRA's obligation to perform such an audit; any examination by DRA is more likely to focus on the reasonableness and prudence of management actions and is not intended to substitute for an independent CPA's examination of Great Oak's financial statements.)

We believe that audited financial statements are invaluable not just for the protection of shareholders in publicly traded companies but equally for the protection of customers of any monopoly public utility. Audited financial statements provide a highly reliable foundation for cost of service rate regulation.

We have the inherent authority to order a jurisdictional utility to undertake an independent audit in order to ensure that "(a)ll charges demanded or received by any public utility…for any product or commodity furnished or to be furnished or any service rendered or to be rendered shall be just and reasonable." (Pub. Util. Code § 451.) Second, we have the authority to order an audit to ensure that Great Oaks maintains its accounts in proper conformance with Pub. Util. Code § 792.[29] Third, we have the authority under Pub. Util. Code § 701 to order an audit to ensure that we are able to effectively and efficiently

[29] Section 792. "The commission may establish a system of accounts to be kept by the public utilities subject to its jurisdiction, or classify such public utilities and establish a system of accounts for each class, and may prescribe the manner in which such accounts shall be kept. It may also prescribe the forms of accounts, records, and memoranda to be kept by such public utilities, including the accounts, records, and memoranda of the movement of traffic as well as the receipts and expenditures of moneys, and any other forms, records, and memoranda which in the judgment of the commission may be necessary to carry out any of the provisions of this part.

exercise our jurisdiction.[30] Fourth, Pub. Util. Code § 701.10 specifies that the Commission must ensure that it authorizes adequate rates[31] and therefore it must have access to independent reliable financial statements. And finally, Pub. Util. Code

§ 727.5(c)[32] allows the Commission to authorize rate recovery of any cost necessary to ensure stable rates. An independent audit will provide the

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[30] Section 701. The commission may supervise and regulate every public utility in the State and may do all things, whether specifically designated in this part or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction.

[31] Section 701.10. The policy of the State of California is that rates and charges established by the Commission for water service provided by water corporations shall do all of the following:

(a) Provide revenues and earnings sufficient to afford the utility an opportunity to earn a reasonable return on its used and useful investment, to attract capital for investment on reasonable terms and to ensure the financial integrity of the utility.

(b) Minimize the long-term cost of reliable water service to water customers.

(c) Provide appropriate incentives to water utilities and customers for conservation of water resources.

(d) Provide for equity between present and future users of water service.

(e) Promote the long-term stabilization of rates in order to avoid steep increases in rates.

(f) Be based on the cost of providing the water service including, to the extent consistent with the above policies, appropriate coverage of fixed costs with fixed revenues.

[32] Section 727.5(c). The commission shall consider, and may authorize, a water corporation to establish a balancing account, rate stabilization fund, or other contingency fund, the purpose of which shall be the long-term stabilization of water rates.

necessary information to determine whether the utility is earning an adequate return and spending funds as authorized by the Commission.

We therefore order Great Oaks to engage an independent CPA, with utility client experience, to perform a full and complete audit of the company beginning with all transactions as of January 1, 2009. Great Oaks must continue to be audited annually, indefinitely, unless or until this order is rescinded. We authorize Great Oaks to establish a CPA Audit Cost Memorandum Account. Upon providing full and complete records as described herein, and satisfying this Commission that it acted prudently in engaging an independent CPA and cooperated fully at all times during the examination, it may amortize the reasonable costs in rates.

13.2. Selecting an Independent CPA

A CPA is a person who has met the requirements of California state law and has been issued a license to practice public accounting by the California Board of Accountancy.[33] The selected CPA must be authorized by the California Board of Accountancy to perform a full range of accounting services including signing reports on attest engagements. Attest engagements include an audit, a review of financial statements, or an examination of prospective financial information. (See California Board of Accountancy.[34]) This CPA must further be authorized by Great Oaks to disclose any and all information to the Commission that was acquired, developed, or otherwise used in the course of the audit engagement subject to the Commission's rules on confidentiality. (See General

[33] See, Business and Professions Code §§ 5070-5079. (http://www.leginfo.ca.gov/cgi-bin/displaycode?section=bpc&group=05001-06000&file=5070-5079).

Order (GO) 66-C.[35]) It is our intention that the CPA perform an audit examination of Great Oaks' accounting records to formulate an opinion on the financial statements. The CPA must follow generally accepted auditing standards.[36] Great Oaks must solicit audit proposals and bids from multiple CPA firms that are currently licensed to practice, and already possess recent experience in auditing regulated utilities in California, and are independent (as defined by the auditing standards) and therefore able to formulate an opinion.

Any time that Great Oaks undertakes to change a CPA for an audit required by this decision, Great Oaks must submit its request for proposals and, subsequently, copies of all bids to the Commission's Division of Water and Audits within 10 days of issuance or receipt, respectively. Great Oaks must prepare and submit to the Division of Water and Audits a written summary of its evaluation of the proposals and all the criteria applied to the selection process within 21 days after selecting a CPA.

We require that Great Oaks file a Tier 2 advice letter for preapproval of its selection process to engage a CPA. Great Oaks may solicit and retain a CPA for multiple annual audits; the preapproval sought by advice letter may cover that

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[34] http://www.dca.ca.gov/cba/index.shtml

[35] http://162.15.7.24/Published/Graphics/644.pdf

[36] Generally Accepted Auditing Standards are sets of standards against which the quality of audits are performed and may be judged, which were developed by the American Institute of Certified Public Accountants, and which consist of general standards, standards of field work, and standards of reporting, along with interpretations. (See, http://www.aicpa.org/Storage/Resources/Standards/DownloadableDocuments/AU-00150.PDF).

multi-year period. The advice letter must include the information required above, as well as any other justifications for the selection, the scope of the audit engagement, the engagement letter, and the cost of the audit engagement. Following preapproval, Great Oaks must submit a copy of an executed engagement letter to the Division of Water and Audits within 10 days of its execution. These documents shall all be confidential pursuant to GO 66-C.

The 2009 and 2010 audited financial statements, the related disclosures,[37] and attest opinion of the CPA must be completed and submitted to the Division of Water and Audits on or before October 31, 2011. Thereafter, the annual audited financial statements, related disclosures, and attest opinion of the CPA must be filed with the Division of Water and Audits (or successor organization) annually on or before March 31 of the subsequent year beginning on March 31, 2012 for calendar year 2011 concurrent with the Annual Report required by GO 104-A.

13.3. CPA Audit Cost Memorandum Account

Great Oaks may establish a CPA Audit Cost Memorandum Account to record for subsequent recovery the reasonable costs of the required annual independent audits of its financial records.

The CPA Audit Cost Memorandum Account shall accrue interest using 1/12 of the most recent month's interest rate on Commercial Paper (prime, three

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[37] Audited financial statements must disclose all significant information that would be of interest to a concerned investor, creditor, or buyer. Among the types of information that must be disclosed are accounting policies employed, litigation in progress, lease information, and details of pension plan funding. In addition, accounting practices applicable to a particular industry and any other unusual applications of accounting principles are disclosed.

months), published in the Federal Reserve Statistical Release, G.13. The company may file a Tier 3 advice letter to amortize reasonable costs recorded in the memorandum account concurrent with other balancing accounts' or memorandum accounts' recovery on an annual basis.

14. Procedural Matters

By Resolution ALJ 176-3234, the Commission preliminarily determined that this application was a ratesetting proceeding and that hearings were expected. This ratesetting classification was subsequently affirmed in the Assigned Commissioner's Scoping Memo and Ruling. The Scoping Memo and Ruling designated Administrative Law Judge Douglas M. Long as the principal hearing officer, established an evidentiary hearing schedule and determined the issues in this proceeding.

15. Comments on Proposed Decision

The proposed decision of the judge in this matter was mailed to the parties in accordance with Pub. Util. Code § 311 and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure (Rules). Comments were timely filed by DRA on November 22, 2010. Great Oaks was granted an extension to November 29, 2010, and reply comments were filed by DRA on December 9, 2010.[38] Some changes and clarifications have been made where needed based upon the comments. Where parties only reargue litigation

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[38] Service was properly made to Great Oaks as listed on the service list used for all other service. Great Oaks' general counsel claimed not to receive the proposed decision. The assigned ALJ allowed an extension to file comments and also granted DRA 10 pages for its reply and rescheduled reply comments to December 9, 2010. DRA's opening comments were extremely brief and Great Oaks did not reply on December 9, 2010 beyond its late-filed opening comments.

positions and do not indicate legal or factual errors those comments have been ignored. Great Oaks claims in comments that its constitutional rights were violated and it was denied due process. The record shows that the company was allowed great latitude in presenting its case; we delayed at Great Oaks' request consideration of cost of capital to be concurrent with its general rate case, and we properly considered and appropriately weighed all of Great Oaks' testimony and arguments. These claims are unsubstantiated hollow rhetoric.

16. Assignment of Proceeding

John A. Bohn is the assigned Commissioner and Douglas M. Long is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. Applicant is a Class A water company and a public utility subject to the jurisdiction of this Commission.
2. Great Oaks is twice the minimum size for a Class A water company and 2.7 times the size of the largest Class B water company.
3. There is a framework of regulatory proceedings to set rates necessary for Great Oaks to provide safe and reliable service.
4. Great Oaks proposed a return on margin methodology the Commission has to date only applied to Class C and Class D utilities.
5. Great Oaks' rate base has both risen and declined in recent years.
6. The Commission has not quantified any specific risk reduction impact of a Water Revenue Adjustment Mechanism for a company with such a mechanism compared to the risk of a company without such a mechanism.
7. DRA proposed a return on equity based on the application of expert judgment to the results of two costs of capital models.

8. DRA's analysis would support a return on equity of 9.75% for a capital structure of 34% debt and 66% equity.

9. An imputed capital structure with long term debt would be less expensive for ratepayers than the actual 100% equity structure of Great Oaks.

10. Debt is generally reported as available to borrow at rates under 7.5%.

11. The Commission has previously considered the results of expert analysis of a Discounted Cash Flow Model and a Capital Asset Pricing Model.

12. The Commission has consistently included actual long term debt costs in cost of capital and has imputed long term debt when utilities do not have long term debt.

13. It is reasonable to use a Cost of Capital Adjustment Mechanism using an interest rate index and a Moody's Baa bond rating to adjust the return on equity and update the cost of capital for the two years 2011 and 2012 to reflect changes in the financial markets.

14. Great Oaks does not have its financial statements audited by an independent CPA.

15. Audited financial statements would provide greater assurance that Great Oaks' reported earnings and financial condition are accurate and complete.

16. A memorandum account would allow Great Oaks to recover the reasonable and prudent costs of engaging an independent CPA.

17. Pre-approval of the selection and cost of an independent CPA would help ensure ratepayers are protected from unreasonable costs.

Conclusions of Law

1. The existing framework of regulatory proceedings sets just and reasonable rates for Great Oaks to provide safe and reliable service pursuant to Pub. Util. Code § 107.10.

2. Great Oaks is properly classified and treated as a Class A water utility subject to the Commission's jurisdiction.

3. The legal standard for setting the fair rate of return has been established by the United States Supreme Court in the *Bluefield* and *Hope* cases. (*Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia*, 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Company,* 320 U.S. 591 (1944).)

4. Financial models are dependent on subjective inputs; therefore, it is reasonable to apply informed judgment when considering financial modeling results.

5. This decision reasonably relies on the entire record of the proceeding and accords weight based upon the evidence's relevance and the persuasiveness of the parties' arguments.

6. The Commission may impute long term debt in a capital structure to derive a fair and reasonable cost of capital.

7. On technical matters the Commission should accord greater weight to a credible expert opinion compared to the weight accorded a lay opinion on that same technical matter.

8. The Commission may adopt a Cost of Capital Adjustment Mechanism to ensure rates are just and reasonable in between cost of capital proceedings.

9. The Commission has the authority to order Great Oaks to engage an independent CPA to perform annual audits.

10. All rulings by the assigned judge were lawful and should be affirmed.

11. This decision should be effective today.

12. These proceedings should be closed.

O R D E R

IT IS ORDERED that:

1. Great Oaks Water Company's cost of capital for its base year 2010 operations is as follows:

Great Oaks Water Company Adopted 2010 Cost of Capital			
Long Term Debt	30%	7.50%	2.25%
Preferred Stock	3%	6.00%	0.18%
Equity	67%	10.20%	6.83%
Total			9.26%

2. Great Oaks Water Company must file a Tier 1 advice letter to implement the rate changes to reflect the change in the 2010 cost of capital within 30 days of the effective date of this order. The rate changes to reflect the change in the cost of capital shall be effective on January 1, 2010, subject to a determination by the Commission's Division of Water and Audits that the advice letter is in compliance with this decision.

3. Great Oaks Water Company must file a new cost of capital application on or before May 1, 2012 for a new 2013 base year.

4. Great Oaks Water Company must file a Tier 1 advice letter to implement a Cost of Capital Adjustment Mechanism which uses an interest rate index and a Moody's Baa bond rating to adjust the return on equity and update the cost of capital for the two years 2011 and 2012.

5. Great Oaks Water Company must engage an independent Certified Public Accountant, with utility client experience, to perform a full and complete audit of the company beginning with all transactions as of January 1, 2009. Great Oaks

Water Company must continue to have annual audits unless this requirement is rescinded by a future Commission decision.

6. Great Oaks Water Company must comply with the following minimum requirements in choosing a Certified Public Accountant for an annual audit required by the preceding Ordering Paragraph:

a. Great Oaks Water Company must solicit audit proposals from multiple Certified Public Accountants who are experienced in auditing regulated public utilities in California.

b. Great Oaks Water Company must submit its request and copies of all bids to the Director of the Commission's Division of Water and Audits within 10 days of issuance or receipt, respectively.

c. Great Oaks Water Company must prepare and submit to the Director of the Division of Water and Audits a written summary of its evaluation of the proposals and all the criteria applied to the selection process within 21 days of selecting a Certified Public Accountant.

d. Following preapproval, Great Oaks Water Company must submit a copy of an executed engagement letter to the Director of the Division of Water and Audits within 10 days of its execution.

These documents shall all be confidential pursuant to General Order 66-C.

7. Great Oaks Water Company must file a Tier 2 advice letter for preapproval of its selection process for engaging its selected Certified Public Accountant. Great Oaks Water Company may solicit and retain a Certified Public Accountant for multiple annual audits; the required preapproval sought by advice letter may cover that multi-year period. The advice letter must include the following information:

a. The audit proposal and copies of all bids;

b. The written summary of its evaluation of the proposals and all the criteria applied to the selection process;

c. Any other justifications for the proposed selection;

d. The scope of the audit engagement;

e. The draft engagement letter; and

f. The cost of the audit engagement.

These documents shall all be confidential pursuant to General Order 66-C.

8. Great Oaks Water Company must submit all annual audited financial statements, the related disclosures and the attest opinion of the Certified Public Accountant to the Division of Water and Audits (or successor organization) annually on or before March 31 of the subsequent year beginning on March 31, 2012 for calendar year 2011. The 2009 and 2010 audited financial statements must be completed and submitted on or before October 31, 2011. The audited financial statements must be filed concurrent with filing the Annual Report required by General Order 104-A.

9. Great Oaks Water Company may file a Tier 1 advice letter to establish a Certified Public Accountant Audit Cost Memorandum Account which shall accrue interest using 1/12 of the most recent month's interest rate on Commercial Paper (prime, three months), published in the Federal Reserve Statistical Release, G.13.

10. Great Oaks Water Company may file a Tier 3 advice letter to amortize reasonable costs recorded in the Certified Public Accountant Audit Cost Memorandum Account concurrent with other balancing accounts' or memorandum accounts' recovery on an annual basis.

11. All rulings by the assigned judge were lawful and are affirmed.

12. Application 09-05-007 is closed.

This order is effective today.

Dated December 16, 2010, at San Francisco, California.

MICHAEL R. PEEVEY
President
DIAN M. GRUENEICH
JOHN A. BOHN
TIMOTHY ALAN SIMON
NANCY E. RYAN
Commissioners