BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Application of Great Oaks Water Company (U-162-W) for an Order establishing its authorized cost of capital for the period from July 1, 2024 through June 30, 2027.	Application No. 23-05-002 Filed: May 1, 2023

EXHIBIT E

AMENDED TESTIMONY OF TIMOTHY S. GUSTER REGARDING THE WATER COST OF CAPITAL ADJUSTMENT MECHANISM

Q.1. Please state your name, qualifications, role in these proceedings, and purpose of your testimony.

A.1. My name is Timothy S. Guster. I am Vice President and General Counsel, and Corporate Secretary of Great Oaks Water Company (Company). I have occupied this position since March of 2007. I have been involved in all aspects of Company regulatory affairs since that time.

I am and have been a licensed practicing attorney since 1983. My experience includes litigation in state and federal courts, all legal affairs for a $1B+ multinational corporation as General Counsel, all legal affairs for a publicly-traded corporation as General Counsel, and proceedings before administrative and regulatory agencies in multiple states, including California.

I am primarily responsible for all regulatory and legal matters affecting the Company, including this Cost of Capital Application. I was also the person primarily responsible for the handling of the last three Cost of Capital Applications submitted by the Company: Application (A.) 09-05-007, A.12-05-005, and A.18-05-001.

I am fully qualified to analyze and opine upon legal, administrative, and regulatory decisions and policies, and have done so for decades for numerous clients, including the Company.

I will be analyzing the rationale for the Water Cost of Capital Adjustment Mechanism (WCCM) authorized by the California Public Utilities Commission (Commission) for the Company, including how that rationale is relevant to and should be applied in this Cost of Capital Proceeding.

Q.2. Please explain when a WCCM was first authorized for the Company.

A.2. A WCCM was first authorized for the Company in Decision (D.)10-12-057 by the California Public Utilities Commission (Commission) stemming from the Company's 2009 Cost of Capital Application, A.09-05-007.

In D.10-12-057, issued December 21, 2010, the Commission adopted "the same Cost of Capital Adjustment Mechanism adopted in D.09-07-051 using an imputed Baa rating equivalent" with a modification to reduce the potential for a large downward adjustment caused by the then-recent economic recovery.[1] The modification was the same as adopted in D.10-10-035 for San Jose Water Company (SJ Water), Valencia Water Company (Valencia), Park Water Company and Apple Valley Ranchos Water Company (Park/Apple Valley), San Gabriel Valley Water Company (San Gabriel), and Suburban Water Systems (Suburban).

Q.3 Please explain the history of the WCCM and similar methods of adjusting cost of capital at the Commission. How and when was a WCCM applied to Great Oaks?

A.3. Cost of capital adjustment mechanisms, in one form or another, have been employed in Commission proceedings for more than twenty years. The following is a brief summary of the history of such mechanisms.

[1] D.10-12-057, at p. 30.

In D.89-01-040, the Commission established annual cost of capital proceedings for the major investor-owned energy utilities beginning January 1, 1990. This proved to be very costly and time-consuming for all concerned and did not result in material changes to the utilities' cost of capital.

In D.94-08-023, the Commission approved a five-year experiment for San Diego Gas and Electric Company (SDG&E) through which SDG&E's base rates were established through a performance-based ratemaking mechanism. Then, in 1995, SDG&E made a request "for authority to change the method of determining its cost of capital by implementing a proposed Market Indexed Capital Adjustment Mechanism (MICAM)."[2] In D.96-06-055, the Commission adopted a slightly-modified version of SDG&E's proposed MICAM. The rationale employed by the Commission in authorizing the MICAM is still instructive today.

SDG&E supported its MICAM request by presenting evidence that the MICAM would provide the following benefits: (1) cost savings; (2) increased objectivity and predictability when determining cost of capital; (3) elimination of interest rate forecasts; and (4) increased knowledge and data for future handling of cost of capital issues, all while protecting (or at least appropriately balancing) ratepayer interests. In D.96-06-055, the Commission made the following findings of fact with respect to the MICAM concept:

- Adopting the MICAM and excusing SDG&E from annual cost of capital proceedings would eliminate or redirect substantial costs being incurred in cost of capital proceedings.
- The MICAM would streamline cost of capital determinations, providing cost reductions for all parties and for the Commission.
- By eliminating interest rate forecasts and disputes concerning interest rate levels and trends, as well as uncertainties associated with conflicting perceptions of financial markets and return requirements of investors, the

[2] D.96-05-055.

MICAM would bring greater predictability to cost of capital determinations.

- Greater predictability will enable utilities to better manage their budgets.
- Implementing the MICAM proposal will add to the general body of knowledge concerning automatic cost of capital adjustment mechanisms.
- SDG&E demonstrated to the satisfaction of the Commission that the MICAM is free of systemic upward bias that would prejudice ratepayer interests in the long run.
- The risk that MICAM results could be biased in the short run is sufficiently mitigated by the Commission's intention to keep the MICAM in place for an extended period, the decision to implement MICAM after SDG&E's then-current cost of capital proceeding, and the proposed review of the MICAM after three years.[3]

SDG&E's use of the MICAM began in 1998. For the past twenty years, major energy utilities have had the MICAM or a similar mechanism in place to guide its cost of capital determinations. In 2008, the Commission confirmed the purpose of such cost of capital adjustment mechanisms, stating:

> The issue in this second phase of the consolidated ROE proceeding was to address cost of capital mechanisms that could replace annual cost of capital applications. This issue was raised to determine whether a mechanism could be adopted to maintain fair and reasonable capital structures and ROEs for the major energy utilities while reducing ROE proceedings and simplifying workload requirements and regulatory costs.[4]

Q.4. When and how were Cost of Capital Adjustment Mechanisms introduced and applied to Commission-regulated water companies?

A.4. The concept of cost of capital adjustment mechanisms was introduced to investor-owned water utilities through D.09-07-051, issued August 3, 2009. In that Decision, the Commission adopted a settlement establishing a cost of capital

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[3] *Id.*, Findings of Fact Nos. 12, 14, 16, 17, 19, 29, and 30.
[4] D.08-05-035, at p. 3.

adjustment mechanism for the three large multi-district Class A water utilities. The cost of capital adjustment mechanism was directly compared to the mechanism adopted for the major energy utilities in D.08-05-035 and found to be consistent therewith.[5] In adopting the settlement, the Commission stated:

> We find the settlement is in the public interest because it provides a synchronized means to adjust the return on equity to reflect significant changes in interest rates. This tends to preserve the marginal premium allowed on the return on equity (i.e., the extra amount of return) paid to equity investors compared to the interest paid to lenders as interest rates fluctuate up or down.[6]

In its Decision, the Commission specifically found the WCCM to be "reasonable because it fairly balances intervenor and shareholder interests and provides a reasonable adjustment to the return on equity."[7]

The Commission then built upon this foundation the next year when it adopted the "same cost of capital adjustment mechanism adopted in D.09-07-051 for the four largest Class A water companies, with two modifications (increasing the dead band to 200 basis points from 100 and setting a new base year).[8] In making this determination, the Commission stated:

> We believe the adjustment mechanism, in principle, is superior to stale forecasts. Therefore, we propose to modify the trigger this one time. Currently, the trigger mechanism has a 100 basis point dead band, plus and minus, before an adjustment occurs. We do not want an anomaly of the 2009-2010 index to likely result in a decrease simply because the economy returns to a more stable condition. Therefore, we will double the boundaries of the mechanism to 200 basis points. We will also use the base period October 1, 2009 through September 31, 2010 as the base period for these companies to offset prior market abnormalities.[9]

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[5] D.09-07-051, at pp. 2-3.
[6] *Id.*, at p. 8.
[7] *Id.*, at p. 24, Conclusion of Law No. 2.
[8] D.10-10-035, at p. 62.
[9] *Id.*, at p. 64. In its Finding of Fact No. 26, at p. 71, the Commission stated: "A Water Cost of Capital Adjustment Mechanism will allow for an accurate adjustment based on the market interest rates between base year proceedings, rather than an inaccurate adjustment based on out-of-date forecasts of debt costs."

Beginning with this Decision 2010, Class A water companies have had Water Cost of Capital Adjustment Mechanisms in their Preliminary Statements.

Q.5. When and how were Cost of Capital Adjustment Mechanisms applied to Great Oaks?

A.5. Great Oaks' first encounter with a WCCM/WCCAM came with the Decision in its 2009 cost of capital proceeding. In D.10-12-057, the Commission stated:

> We will adopt the same Cost of Capital Adjustment Mechanism adopted in D.09-07-051 using an imputed Baa rating equivalent 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-[035]. In A.09-05-001 et al. for the other single-district Class A water companies.[10]

The WCCM adopted in D.10-12-057 was continued by the Commission in its Decision adopting the settlement of the Company next cost of capital case. In D.13-05-027, the Commission stated:

> DRA and Great Oaks agree that the WCCM adopted in D.10-10-035 has fairly balanced customer and shareholder interests and has provided a reasonable mechanism for adjusting the base year return on equity for the subsequent years of the cost of capital cycle.
>
> Great Oaks' current upper boundary of the deadband is 100 basis points and the lower boundary of the deadband is 200 basis points as authorized in D.10-12-057. Great Oaks and DRA agreed to set the upper and lower deadband boundaries at 100 basis points each. Great Oaks' new benchmark period is July 1, 2012 to June 30, 2013.[11]

D.13-05-027 then goes on to describe exactly how Great Oaks' WCCM operates:

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[10] D.10-120057, at p. 30 (footnote omitted). Note: In the omitted footnote, the Commission noted that the Baa bond rating to be used for Great Oaks' Water Cost of Capital Adjustment Mechanism "is a low investment grade rating which we used for Valencia, one of the smaller Class A companies." Great Oaks is the smallest of the current Class A water companies by a fair margin.

[11] D.13-05-027, at p. 11.

> If Moody's average of Baa bond rates for the period from July 1, 2013 to June 30, 2014 is either 100 basis points above or below the initial benchmark, then Great Oaks' return on equity for the year July 1, 2014 to June 30, 2015 shall be adjusted by one-half the difference between the initial benchmark and the July 1, 2013 to June 30, 2014 average. If the return on equity is adjusted, the average of Moody's Baa bond rates for the period from July 1, 2013 to June 30, 2014 shall become the new benchmark. For the subsequent years of Great Oaks' cost of capital cycle, the Settlement adjusts the return on equity and benchmarks similarly.[12]

The effective date for D.13-05-027 was July 1, 2013. No adjustments were required to the return on equity between July 1, 2013 and May 1, 2018, the date Great Oaks filed its next Cost of Capital Application (A.18-05-001). Due to the filing extensions granted to the Class A water companies, the cost of capital authorized at the time the extensions were granted was maintained as the authorized cost of capital.

The Commission issued D.18-12-002 on December 13, 2018, approving of the partial settlement agreement and resolving the remaining disputed issues in A.18-05-001. The continuation of the WCCM was uncontested in A.18-05-001 and the settlement agreement approved by the Commission continued the WCCM.[13] When the Commission determined that the effective date for Great Oaks' Cost of Capital from A.18-05-001 was July 1, 2019, this resulted in establishing July 1, 2018 through June 30, 2019 as the next initial benchmark period for Great Oaks' WCCM.[14]

Q.6. Explain how Great Oaks applied the WCCM since July 1, 2019.

A.6. Following the issuance of D.18-12-002, Great Oaks compiled the necessary data to establish the initial benchmark year for the WCCM.

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[12] *Id.*, at p. 12.
[13] D.18-12-002, Appendix A, at p. 5.
[14] *Id.*, at p. 6.

Then, on January 22, 2020, in a letter to the Commission's Executive Director, the four largest Class A water companies[15] jointly requested a postponement of their scheduled 2020 Cost of Capital filings. One of the conditions of the extension request was that there be no changes to the companies' respective cost of capital during the requested one-year extension. As part of this request, the four largest Class A water companies conferred with the remaining Class A water companies to seek an agreement that their Cost of Capital proceedings would also be postponed for one year (*i.e.*, until 2022) and that there would also be no changes to their respective costs of capital during the one-year extension (a condition mirroring a condition included in previous Commission approvals of Cost of Capital filing extensions). A copy of the letter requesting the postponement of Cost of Capital filings is attached hereto as Exhibit E-1.

That agreement was reached, and, on March 11, 2020, the Commission's Executive Director granted the postponement request. A copy of the letter granting the request to postpone the Cost of Capital filings is attached hereto as Exhibit E-2. The postponement of the Cost of Capital filings for the four largest Class A water companies effectively suspended the WCCM for all Class A water companies until the Commission issues a Decision on each company's next Cost of Capital Application.

This was confirmed when, on March 2, 2022, Great Oaks, together with Suburban Water Systems, San Gabriel Valley Water Company, Liberty Utilities (Park Water) Corp., and Liberty Utilities (Apple Valley Ranchos Water) Corp. requested a one-year extension to file their respective Cost of Capital Applications. Included within the request was the continued maintenance of the then-currently authorized cost of capital for each company, a condition consistent with previous Commission approvals of Cost of Capital filing extensions. A copy of the March 2, 2022 letter requesting a postponement of 2022 Cost of Capital Filings is attached hereto as Exhibit E-3.

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On March 25, 2022, the Commission's Executive Director granted the requested filing extension which specifically included the continued maintenance of the currently authorized cost of capital for each company. A copy of the letter granting the request to postpone the Cost of Capital filings to May 1, 2023 is attached hereto as Exhibit E-4.

Because of the Cost of Capital filing extensions and postponements, as of the filing date for this Application, Great Oaks has maintained the cost of capital authorized by the Commission in D.18-12-002 since July 1, 2019.

Q.7 Should one of the results of the cost of capital application be that the WCCM is continued?

A.7. Yes. The rationale behind the initial creation of the WCCM continues to exist, supporting Great Oaks' request for the continuation of the WCCM. The base year for the WCCM should be adjusted so that there is sufficient time to file any necessary advice letter to adjust cost of capital so that the adjusted cost of capital, and resulting rates, are effective on the first day of Great Oaks' rate year (July 1 to June 30 rate year), using the same Baa utility bond data, deadband, and adjustment mechanism presently authorized. Great Oaks proposes the benchmark period established in this proceeding be for a time period that will be fully known while this Application is being considered.

Q.8. Does that include your direct testimony?

A.8. Yes.