

**COUNTY OF SANTA CRUZ**

**FINAL ORAL ARGUMENT**

**A.02-09-030 ET AL**

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## REASONS WHY CHANGES MUST BE MADE TO GRC PROPOSED DECISION

The PD Implies That This Is A Run-Of-The-Mill Water Rate Case – It Is Not.

The PD Would Permit Cal-Am To Charge Rates Substantially Above Cal-Am’s Actual Cost Of Service.

The PD would permit Cal-Am to charge rates more than \$3 million higher each year, in the aggregate, than its actual cost of providing service in the Felton, Larkfield and Sacramento Districts.

There Is No Legal, Policy or Equitable Justification For Doing So.

In two prior decisions, the Commission imposed high burdens of proof on Cal-Am to justify the higher rates it seeks in these GRCs.

D.01-09-057 authorized AWW’s acquisition of Citizens’ water utility facilities and provided AWW shareholder with an opportunity to recover the acquisition premium they paid for Citizens facilities through the “Alternative Sharing Mechanism” and through rates above Cal-Am’s cost of service.

But the Commission imposed a high burden of proof for recovery of this acquisition premium - AWW and Cal-Am were required to demonstrate both that:

- (1) actual “synergy savings” have been achieved, and
- (2) the savings could not have been achieved absent AWW’s acquisition of Citizens’ facilities.

In D.02-12-068 approving RWE’s subsequent acquisition of AWW, the Commission conditioned its approval on:

- (1) RWE recovering the acquisition premium it paid for AWW solely through future growth in regulated and unregulated business and not from ratepayers,
- (2) RWE passing 100% of the benefits and savings achieved as a result of the acquisition through to ratepayers, and
- (3) Cal-Am bearing the burden of proving in future rate proceedings from which acquisition, AWW’s acquisition of Citizens, or RWE’s acquisition of AWW, savings accrue.

The Commission further held that if RWE and Cal-Am fail to meet this burden, it would attribute the savings to the RWE/AWW merger rather than to the AWW/Citizens acquisition, and require that 100% of the savings be passed through to ratepayers.<sup>1</sup>

Cal-Am has not met either of the burdens of proof imposed in D.01-09-057 or D.02-12-068 and as a result, its request to charge rates above its actual cost of service should be denied and all merger related savings passed through to ratepayers .

In no prior decision has the Commission set forth any specific rules, regulations or policies governing how the requirements of D.01-09-057 or D.02-12-068 should be implemented or enforced.

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<sup>1</sup> D.02-12-068 at 63, Ordering paragraph 12.

As a result, the Commission's decision in these GRCs will establish the means of doing so for the first time.

Cal-Am's synergy savings analysis is fundamentally flawed and based on assumptions that are completely unfounded and should be rejected.

The "synergy savings" Cal-Am claims and the PD accepts are primary due to: (1) alleged savings achieved through lower debt costs, (2) a more leveraged capital structure, and (3) allocation of General Office expenses to a larger number of customers.<sup>2</sup>

The alleged savings through lower cost of debt is based upon unsupportable assumptions inconsistent with reality.

Cal-Am assumes that the Citizens Districts cost of debt and overall cost of capital with the acquisition by Cal-Am is lower than it would have been had this acquisition not occurred.

But historical data shows otherwise – Citizens' actual cost of debt and capital for the period 1998 through 2000 was consistently lower than Cal-Am's' so there is no historical justification for assuming the opposite in the PD's analysis of synergy savings.

Cal-Am also assumes that Citizens' debt cost would decline from 7.07% to 4.92% with the acquisition, but would have remained at 7.07% had the acquisition not occurred.

This assumption is completely absurd – the only realistic assumption that can be made is that had the acquisition not occurred, the owner of the Citizens Districts would have taken advantage of historically low interest rates to refinance existing debt just like Cal-Am has done.

Cal-Am also assumes that the capital structure of the Citizens Districts with the acquisition by Cal-Am is more highly leveraged than it would have been had this acquisition not occurred – only 35% equity with the acquisition but 48.25% equity without the acquisition.

There is no justification however for assuming such a radically different capital structure - the capital structure for ratemaking purposes is set by the Commission, not the utilities, and the only reasonable assumption that can be made for purposes of analyzing synergy savings is to assume that the Commission would adopt an optimal capital structure irrespective of whether or by whom the Citizens facilities were acquired.

The PD accepts Cal-Am's flawed methodology without almost no discussion whatsoever.<sup>3</sup>

In doing so, it effectively relieves Cal-Am of the burden of proof imposed by the Commission in D.01-09-057 to justify charging ratepayers rates in excess of Cal-Am's actual cost of service for this GRC.

And worse, the PD may set a precedent that effectively relieves Cal-Am of this burden of proof forever - thereby permitting Cal-Am to charge ratepayers rates in excess of its actual cost of service in Felton, Larkfield and Sacramento for the next 38 years.

This will unnecessarily increase costs to ratepayers by over \$100 million and will unnecessarily burden local economies.

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<sup>2</sup> PD at 25.

<sup>3</sup> PD at 25.

In D.01-09-057, the Commission reserved judgment as to how a subsequent acquisition or merger would affect the opportunity provided to AWW's shareholders to recover the acquisition premium they paid for Citizens.

RWE's acquisition of AWW, announced before AWW's acquisition of the Citizens' facilities had even closed, changes circumstances in crucial respects and compels reconsideration by the Commission of the "Alternative Sharing Mechanism."

It does so for several reasons:

(1) AWW's shareholders fully recovered the acquisition premium they paid for Citizens facilities through the higher premium they received from RWE for payment of 100% of the stock in AWW – thus there is no acquisition premium related to AWW's acquisition of Citizens facilities that has not already been fully recovered by affected shareholders; and

(2) In seeking authorization from regulatory agencies for its acquisition of AWW, RWE stated that it would recover the acquisition premium it paid for AWW through growth in regulated and unregulated business and would not seek to recover any portion of such premium from ratepayers.

RWE and Cal-Am Have Failed to Comply With The Commitment They Made To Pass Through 100% Of The Benefits Of RWE's Acquisition Of AWW To Ratepayers.

With one minor exception, RWE and Cal-Am have passed through no such savings to ratepayers in these GRCs.

The PD would excuse their failure to do so on the mistaken ground that there was insufficient time for Cal-Am to include savings achieved as a result of RWE's acquisition of AWW in these GRCs.

The record in these proceedings was not closed, however, until 11 months after the Commission's decision was issued approving RWE's acquisition of AWW.

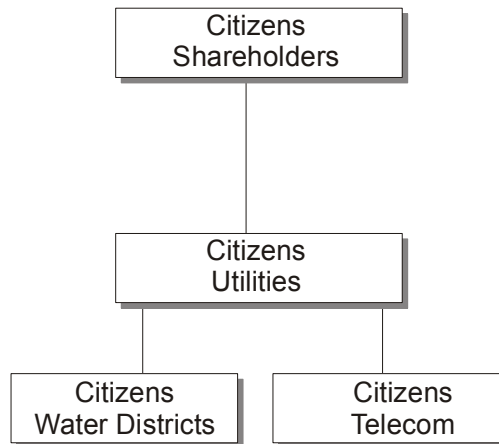
Cal-Am thus had plenty of time to amend its GRC showing to fully comply with D.02-12-068.

It chose not to avoid having to reduce rates to pass through savings D.02-12-068 clearly requires it to pass through and should not be excused from compliance

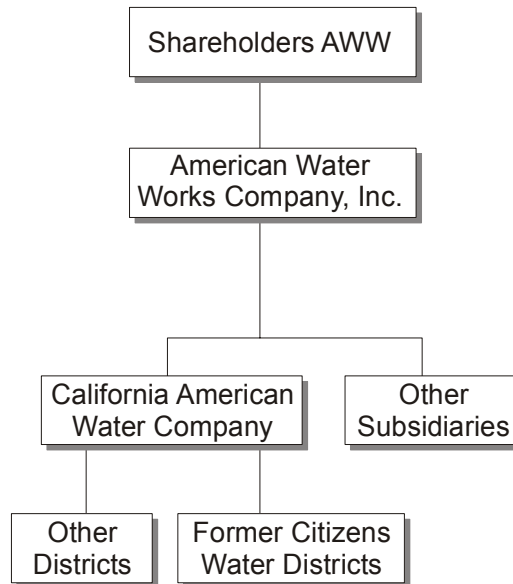
The PD assumes that a memorandum account is a sufficient remedy for the failure of RWE and Cal-Am to fulfill their commitments, but such an account would deprive current ratepayers of any benefits and would provide an inadequate remedy to future ratepayers

Since there are no standards governing what should be recorded to this account and Cal-Am will control what is recorded and how it is recorded, requiring a memorandum account will provide no assurance that ratepayers will ever receive the savings to which they are entitled under D.02-12-068.

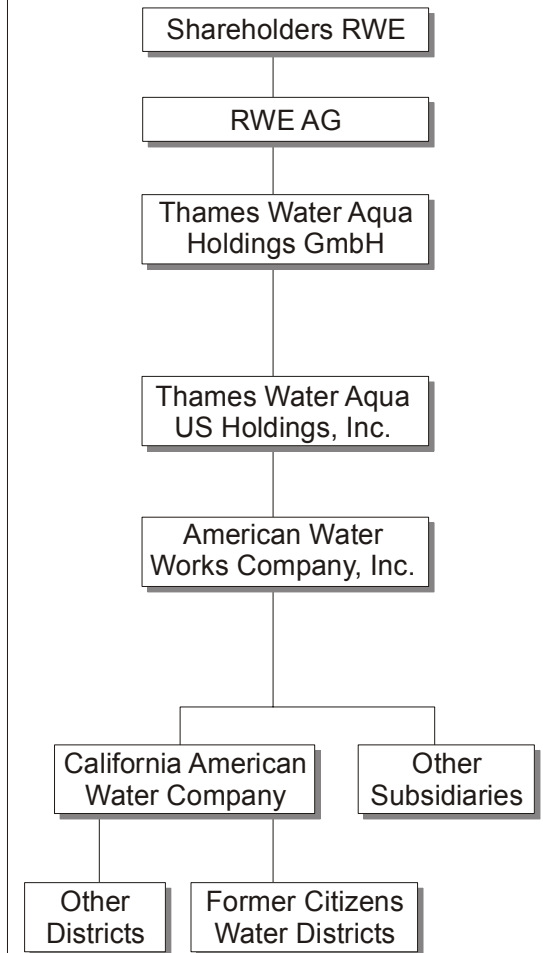
**Prior to Acquisition by AWW**



**After Acquisition by AWW and Prior to Acquisition by RWE**



**After Acquisition by RWE**



**CAL-AM EXPENSE SUMMARY (\$000's)<sup>4</sup>**

**Felton**

<b>Line No.</b>	<b>Description</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
1	Payroll	221.3	227.9	237.1
2	Division Expenses	228.2	235.0	244.4
3	Allocated Corp. Office	92.6	95.4	97.9
4	Acquisition Premium	72.4	66.0	64.1
5	Total Requested Expenses	614.5	624.3	643.5
6	Acquisition Premium as Percentage of Total Expenses	12%	11%	10%

**Larkfield**

<b>Line No.</b>	<b>Description</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
1	Payroll	185.8	191.4	199.1
2	Division Expenses	541.3	492.6	496.5
3	Allocated Corp. Office	165.9	171.1	175.5
4	Acquisition Premium	129.9	119.4	116.9
5	Total Requested Expenses	1,022.9	974.5	988.0
6	Acquisition Premium as Percentage of Total Expenses	13%	12%	12%

**Sacramento**

<b>Line No.</b>	<b>Description</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
1	Payroll	1,499.6	1,643.6	1,749.0
2	Division Expenses	5,094.3	5,307.6	5,505.1
3	Allocated Corp. Office	3,939.7	4,017.8	5,114.6
4	Acquisition Premium	2,853.7	2,873.4	2,872.5
5	Total Requested Expenses	13,387.3	13,842.4	14,241.2
6	Acquisition Premium as Percentage of Total Expenses	21%	21%	20%

<sup>4</sup> Cal-Am, Ex. CA-4 at Table 6-1R (Felton); Cal-Am, Ex. CA-3 at Table 6-1R (Larkfield); Cal-Am, Ex. CA-2 at Table 6-1R (Sacramento).

**CLAIMED COST OF CAPITAL SYNERGIES**

<b>Historic Data</b>	<b>Cal-Am<sup>5</sup></b>	<b>Citizens<sup>6</sup></b>	<b>Difference<sup>7</sup></b>
<b>1998</b>			
Cost of Debt	7.98	7.83	(0.15)
Weighted Avg. Cost of Capital	9.12	8.19	(0.93)
<b>1999</b>			
Cost of Debt	7.98	7.83	(0.15)
Weighted Avg. Cost of Capital	9.15	8.19	(0.96)
<b>2000</b>			
Cost of Debt	7.98	7.83	(0.15)
Weighted Avg. Cost of Capital	9.07	8.19	(0.88)

<b>Cal-Am and ORA Synergy Savings Analysis</b>	<b>Citizen with Acq. by Cal-Am<sup>8</sup></b>	<b>Citizen w/o Acq. by Cal-Am<sup>9</sup></b>	<b>Difference<sup>10</sup></b>
<b>2004</b>			
Assumed Cost of Debt	5.04 to 5.17	7.07	up to 2.00
Assumed Weighted Avg. Cost of Capital	7.01 to 7.20	8.20	up to 1.19

<sup>5</sup> Ex CA-8 at 2-5.

<sup>6</sup> Ex CA-8 at 2-5c.

<sup>7</sup> Calculated differences.

<sup>8</sup> Ex CA-8 at 3-6c, and see Ex ORA-1B.

<sup>9</sup> Ex ORA-1B, see also Ex CA-20 at 31 to 32.

<sup>10</sup> Ex ORA-1B, see also Ex CA-20, at 31 to 32.

**In Support of its Application to Acquire AWW, RWE  
Promised to Pass Through 100% of the Benefits of  
RWE's Acquisition of AWW to Cal-Am Ratepayers**

- 100% of the benefits and savings achieved as a result of RWE's acquisition of AWW will be passed through to Cal-Am's ratepayers. – *D.02-12-068, Findings of Fact 19.*
- Capital expenditure savings “will begin to materialize upon closing of the transaction, and will be passed on to [Cal-Am] ratepayers as avoided costs associated with construction projects.” – *Rebuttal Testimony of Daniel Kelleher, Senior Vice President for American Water Works Company, Inc at 18-19 (A.02-01-036).*
- Deployment of RWE's “design/build” construction process will save Cal-Am ratepayers \$2.2 million in construction costs “in the first three years after the close of the transaction.” – *RWE/Cal-Am Joint Reply Brief at 6 (A.02-01-036).*

**Cal-Am Has Not Included Any Ratepayer Savings  
Related to the RWE Acquisition in This Proceeding**

- Consolidated GRC test year figures do not include any Cal-Am ratepayer savings related to RWE's acquisition of AWW. – *Lenard Weiss, Attorney for Cal-Am (A.02-09-030 et al., Tr. at 583).*
- Cal-Am has not included any Cal-Am ratepayer savings related to RWE's design/build process. – *Lenard Weiss, Attorney for Cal-Am (A.02-09-030 et al., Tr. at 404).*

**Comparison of Monthly Residential Bills  
5/8-inch Meter Test Year 2003  
Cal-Am Standard Rate Design vs. Four District Consolidation<sup>11</sup>**

Usage (Ccf)	Monthly Bill using Cal-Am Standard Rate Design	Monthly Bill using Consolidated Rates	Dollar Change	Percent Change
<b>Montara</b>				
10	\$82.66	\$26.89	-\$55.77	-67.47%
20	\$137.44	\$35.46	-\$101.98	-74.20%
<b>Felton</b>				
10	\$64.28	\$26.89	-\$37.39	-58.17%
20	\$106.98	\$35.46	-\$71.52	-66.85%
<b>Larkfield</b>				
10	\$43.25	\$26.89	-\$16.36	-37.83%
20	\$70.73	\$35.46	-\$35.27	-49.87%
<b>Sacramento</b>				
Flat Rate	\$24.33	\$23.90	-\$0.43	-1.77% <sup>12</sup>
10	\$18.31	\$26.89	\$8.58	46.85%
20	\$28.67	\$35.46	\$6.79	23.68%

<sup>11</sup> MSD/Schmidt, Ex. I-1 at 20; Santa Cruz/Schmidt, Ex. I-3 at 22. *See also* MSD/Schmidt, Ex. I-1 at Tab 2; Santa Cruz/Schmidt, Ex. I-3 at Tab 2.

<sup>12</sup> The majority of Sacramento District ratepayers are on flat service. *See* Cal-Am, Ex. CA-2, at Table 5-1, 5-2.