The Economics of Claremont's Attempt to Buy the Water System

by

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Reliable and affordable water service is a critical part of a community's economic foundation. A water system serves the water needs of residences, businesses, and community parks. It is a truism in the water policy and financial communities that supply reliability and well-maintained infrastructure are paramount objectives for successful water systems. Abrupt cutbacks in water service due to drought or regulatory restrictions on water sources or from inadequate infrastructure undermine the vitality of a local community. Failure to maintain and expand necessary infrastructure compromises the long-term sustainability of a water system. At the same time, customers are understandably concerned about their water costs. Given the challenges facing California water providers, both public and private, skilled management is required to ensure that reasonable investments are made to protect the long-term reliability of municipal water delivery at a reasonable cost.

The Golden State Water Company (and its predecessor company, Southern California Water Co.) has provided water service in the City of Claremont since 1929. Golden State Water is an investor-owned utility, regulated by the California Public Utilities Commission. Golden State Water owns the Claremont Water System, as well as water rights sufficient to supply about 60% of Claremont's annual water demand; the remaining 40% is imported water.

City of Claremont officials have decided to pursue acquisition of both the Claremont Water System and the water rights owned by Golden State Water. The stated purpose of the acquisition is to provide lower water rates for Claremont citizens. Claremont has made an initial offer to Golden State Water of approximately $54 million. Golden State Water has rejected the offer, stating that its assets are not for sale, and that in any event the offered price is far too low. City officials have appropriated more than half a million dollars into a government acquisition

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fund and are taking steps toward prosecuting an eminent domain lawsuit to force Golden State Water to transfer the system and the water rights.

If the City cannot reach a voluntary purchase agreement with Golden State Water and instead pursues a takeover by condemnation, experience teaches that the ultimate price of the takeover through the legal process is almost certain to be much greater than $54 million. The cost could easily be double or triple the City's $54 million offer, or even higher.

In December 2005, the League of Women Voters of the Claremont Area released a study which reviewed the history of City-sponsored appraisals and negotiations, and assumed the takeover cost could be $100 million.[2] The study also offered some pertinent "cautionary remarks" about the takeover:

Some cautionary remarks for public decision making:

- If Claremont is to buy the water system, there must be broad public support and understanding of the issues by citizens. Buying our own water utility would not lower water rates now. Indeed, costs to consumers would almost surely be higher for the early years of paying off bonds. Long-range rates and rate increases, however, might well be considerably lower. Council, staff and public should openly and thoroughly address Advantages and Disadvantages of public ownership of this utterly necessary public utility.
- Legally, the City Council can make a decision to sell revenue bonds and to buy the water service. How should the public weigh in on this decision?
- Should the Council be encouraged to try to negotiate a purchase under new city leadership?
- If negotiations are not successful, should the City initiate eminent domain proceedings? Or do the uncertainty and high costs make that unwise?
- If there is a decision to purchase the water service, should the purchase be made with Revenue Bonds? Or should it be financed by some other method?
- What adjustments in rates or assessments would make paying off the purchase equitable and fair to all residents?

(Report of the Water Task Force of the League of Women Voters of the Claremont Area, Water System Ownership and Water Issues in the City of Claremont, Dec. 2005 [rev. Feb. 15, 2006], p. 24)

The City has released no report or feasibility study addressing these "cautionary remarks." Moreover, there has been no public dissemination of an analysis that demonstrates

[2] In the years between 2003 and 2007, the City reportedly spent about $400,000 evaluating a possible takeover of Golden State Water. The League of Women Voters' study was prepared during that evaluation period. Based on its assumptions, the study concluded that Claremont residents would probably incur higher costs for water for about 18 years after the acquisition. The study also identified a number of other significant challenges to a takeover. It is unclear whether the study's conclusions played a role in the City's decision to abandon the prior takeover effort.

how the City would provide water service from an operational and managerial standpoint, nor of probable rates and other charges customers should expect. For residents seeking to compare current rates and service levels with that of a City-operated system, there has been nothing provided to make such a determination. Finally, there has been no detail about the impact to other government services that could result from the significant long-term indebtedness the City would incur to purchase and operate the Claremont Water System.

This paper does not attempt to answer every question about the City's takeover effort. Rather, this paper examines the economics of Golden State Water's operation of the Claremont Water System, and provides a comparison of what can be expected if the City assumes ownership and control of the system. The analysis herein reveals the important role of shareholder equity in financing investment in the Claremont Water System infrastructure, a critical factor neglected by proponents of a City takeover of the Claremont Water System. The analysis of potential City ownership highlights the implications of needed financial and operating reserves as well as debt coverage ratios, factors which should not be neglected by proponents of City ownership.

The data set forth in this paper demonstrate that if the City does manage to acquire the Claremont Water System by eminent domain, higher water rates for Claremont residents are a virtual certainty for many years to come. If the goal of acquiring the system is to charge lower water rates, then the effort should be abandoned because that goal is not a feasible outcome through the condemnation process.

If the City follows through with its plan to condemn, for decades Claremont residents will be required to repay the bond obligations that could easily exceed $100 million. Moreover, lacking sufficient reserves for the inevitable capital expenditures that are required to maintain a reliable system, the City will be forced to pass through to residents the expenses of capital improvements on a "pay as you go" basis.

Claremont's municipal finances will be strained by the indebtedness necessary to pay for the system, limiting Claremont's ability to enter the capital markets for other purposes, such as public works investments. Other public agencies that rely on public financing may also be affected. For example, the Claremont Unified School District recently sought voter approval in 2010 for a $95 million bond to fund educational needs, but the measure was rejected by the voters. Future educational bond elections could become even more difficult in the face of substantial new debt associated with taking the water system.

Operationally, the size of City government will have to expand rapidly in an effort to meet the significant technical and managerial demands of operating the system, none of which the City possesses. Ownership and operation of the Claremont Water System will dwarf all other services the City currently provides. The City has submitted no analysis that addresses these challenges, and no plan for how it will fund or operate the system.

Given these facts, it would be an economically perilous risk for the City to condemn the Claremont Water System.

How Golden State Water's Ownership Works in Claremont

Golden State Water's Claremont Water System is subject to regulation by the California Public Utilities Commission ("CPUC"). The CPUC sets standards for water service to protect the public health and safety of customers. Investments must be preapproved to assure that facilities are necessary and "used and useful" in terms of meeting CPUC standards of water service. Water rates are set by the CPUC to reflect the "cost-of-service." In determining the cost of service, the CPUC looks at actual water costs, operations and maintenance costs, depreciation, taxes and fees, and a regulated return on capital based on the net value of assets employed, or rate base (original cost less cumulative depreciation of capital investments).

Maintaining and improving the infrastructure that comprises the Claremont Water System requires ongoing investment. Golden State Water uses companywide debt and shareholder equity to fund such capital expenditures. Table 1 shows that the company has spent $15.1 million to maintain and improve the Claremont Water System in the past five years.[3]

Table 1
Golden State Water Capital Expenditures on Claremont Water System

Item	2007	2008	2009	2010	2011	Cumulative
Expenditure	$2,531,300	$3,798,490	$3,568,942	$2,470,630	$2,719,196	$15,088,558
Debt Financed	$1,225,335	$1,692,762	$1,697,116	$1,126,361	$1,276,916	$7,018,489
Equity Financed	$1,305,965	$2,105,728	$1,871,826	$1,344,269	$1,442,280	$8,070,069

It is important to understand how the owner of a large system, such as the Claremont Water System, can obtain the funds necessary to make the required capital expenditures. For any water system, under private or government ownership, the capital structure reflects a mix of debt and equity needed to assure payment of debt service. An excessively leveraged system (unreasonably high ratio of debt to equity) will be unable to secure debt financing at reasonable costs, if at all.

Table 2
Golden State Water Capital Structure ($1,000)

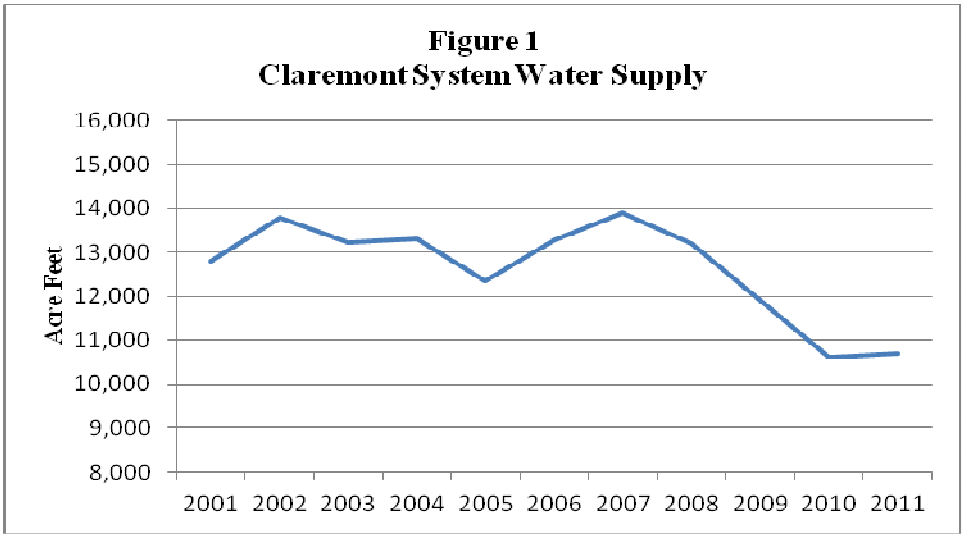
Item	2007	2008	2009	2010	2011
Long-Term Debt	261,250	260,887	300,586	300,215	340,686
Shareholder Equity	278,441	324,533	331,530	358,295	384,806
Total Capitalization	539,691	585,420	632,116	658,510	725,492
Debt Share	48.4%	44.6%	47.6%	45.6%	47.0%
Equity Share	51.6%	55.4%	52.4%	54.4%	53.0%

[3] Derived from amounts as reported in the CPUC Annual Report of District Water System Operations of Golden State Water Company for Claremont District ("CPUC Report") by taking additions during the year from Schedule A-1a and the change in Construction Work-in-Progress from Schedule A-1d. The portions debt-financed and equity-financed are based on Golden State Water's Capital Structure discussed in the text at Table 2.

Table 2 demonstrates that Golden State Water's business model is not one based on high financial leverage.[4] Over the past five years, the company's debt share has declined from 48.4% in 2007 to 47.0% by 2011. The equity share has grown from 51.6% in 2007 to 54.4% by 2011. This capital structure demonstrates that $7.0 million (47%) of the $15.1 million investment in the Claremont Water System was financed from funds available from debt issuance, and $8.1 million (53%) was paid from shareholder equity (reinvestment of retained earnings). Under the CPUC's July 2012 approval of the company's Cost of Capital application, the company's targeted capital structure for 2012 through 2014 is 45% debt share and 55% equity share.

Whether privately owned or government-owned, municipal water systems face a variety of risk factors. A major one involves how variable water demands interact with a cost structure dominated by fixed costs (costs that do not vary with volume of water sold). The demands of the Claremont Water System customers are met by deliveries of local groundwater and imported water ("Claremont Water System Supply"). From 2001 to 2008, annual water deliveries fluctuated between approximately 12,000 acre-feet (one acre-foot equals 325,851 gallons) and 14,000 acre-feet (see Figure 1). Thereafter, annual water deliveries fell below 11,000 acre-feet. A significant equity cushion is required to meet debt service obligations in the face of this demand volatility.

Figure 1
Claremont System Water Supply



The CPUC sets water rates paid by customers of the Claremont Water System. The CPUC rates are based on a "Revenue Requirement" (the costs of meeting assumed levels of water demands) for Golden State Water service areas in Southern California.

Table 3 calculates the annual Revenue Requirement for Golden State Water—the actual costs incurred (Total Water Supply Costs, Operations & Maintenance, Administration & General Overhead, Shared Services, Depreciation, and Taxes) plus an Allowed Return based on the Claremont Water System Rate Base and the CPUC Allowed Return. Table 4 charts the Allowed Return as percentage of Rate Base.

[4] Long-Term Debt includes current portion. Data reported in the annual Form 10-K filed with the Securities and Exchange Commission.

Table 3
Claremont Water System Revenue Requirement

Item	2007	2008	2009	2010	2011	Annual Increase
Revenue Requirement[5]	$13,403,447	$14,459,306	$15,442,616	$16,757,164	$16,021,820	4.6%
Total Water Supply Cost[6]	$3,874,857	$4,536,260	$4,661,264	$5,108,514	$4,296,822	2.6%
Operations & Maintenance[7]	$1,518,566	$1,496,996	$1,563,573	$1,778,865	$1,538,415	0.3%
Admin. & General[8]	$511,695	$512,709	$628,349	$579,548	$609,962	4.5%
Shared Services[9]	$1,758,352	$2,067,172	$2,145,065	$2,425,714	$2,743,499	11.8%
Depreciation[10]	$1,651,089	$1,672,444	$1,825,374	$2,240,512	$2,277,694	8.4%
Non-Income Taxes[11]	$311,310	$323,726	$330,945	$361,374	$381,311	5.2%
Income Taxes[12]	$1,114,064	$994,793	$1,245,894	$1,311,786	$1,266,471	3.3%
Allowed Return[13]	$2,663,514	$2,855,206	$3,042,152	$2,950,851	$2,907,646	2.2%

[5] Revenue Requirement: sum of rows Total Water Supply Cost through Allowed Return.

[6] Total Water Supply Costs: purchased water, power for pumping, and pump taxes:

Purchased water: amounts as reported in the CPUC Annual Report of District Water System Operations of Golden State Water Company for Claremont District ("CPUC Report") (Schedule B-2, Acct. 704). Actual cost of purchases from Three Valley Municipal Water District, leases from colleges and City of Claremont, and watermaster assessments. Lease payments to City of Claremont grew from $114,596 in 2007 to $230,083 in 2011—a 19.0% cumulative annual growth rate. Power for pumping: amounts as reported in the CPUC Report on Schedule B-2 (Acct. 726). Pump taxes: amounts as reported in CPUC Report on Schedule B-4.

[7] Operations & Maintenance: actual cost incurred for Claremont Water System. Amounts as reported in the CPUC Report on Schedule B-2.

[8] Administration and General: actual costs incurred for Claremont Water System. Amounts as reported in the CPUC Report on Schedule B-2.

[9] Shared Services: apportionment of company personnel and services related to executive management, human resources, water quality, customer phone center, infrastructure planning/operations, information technology, accounting and financial matters, regulatory affairs, legal and risk management. Amounts as reported in the CPUC Report on Schedule B-2 (Acct. 790). Some of the increase in Shared Services expenses beginning in 2010 resulted from a change in ratemaking treatment mandated by CPUC. Starting in 2010, CPUC mandated that conservation-related costs be recovered in rates as an operating expense, which is included within the Shared Services expense category, whereas such costs were included in Rate Base for recovery years prior to 2010.

[10] Depreciation: capital facilities of Claremont Water System. Amounts as reported in the CPUC Report on Schedule A-3 (charged to accounts 503, 504, and 505).

[11] Non-Income Taxes: payroll taxes, property taxes and other state and local taxes. Amounts as reported in the CPUC Report on Schedule B-4 (excluding state corporation franchise tax, federal income taxes and pump taxes).

[12] Income Taxes: Federal and California. Derived using Golden State Water's effective tax rate reported in the Annual Report on Form 10-K filed with the Securities and Exchange Commission and applied to pretax income including interest expense derived using the cost of debt and capital structure approved by the CPUC in the cost of capital proceedings.

[13] Allowed Return: Claremont Water System Rate Base multiplied by the authorized CPUC return. Amounts for Rate Base taken from CPUC Report Schedule A-1d.

Table 4
Golden State Water Allowed Return

	2007	2008	2009	2010	2011	Annual Increase
Allowed Return	$2,663,514	$2,855,206	$3,042,152	$2,950,851	$2,907,646	2.2%
Rate Base	$30,509,894	$32,705,681	$34,181,480	$33,155,624	$32,670,185	1.7%
CPUC Return	8.73%	8.73%	8.90%	8.90%	8.90%	0.5%

Taken together, Tables 3 and 4 reveal the following about the Claremont Water System:

- The annual Revenue Requirement increased from $13.4 million in 2007 to $16.0 million by 2011 (cumulative annual growth rate of 4.6%).

- The CPUC Allowed Return (which covers both payment of debt and equity return) grew at only 2.2%. This modest growth in the Allowed Return was dominated by the growth in the Rate Base (1.7%)—reflecting the company's capital improvement program over the period.

- The two fastest-growing components that comprise the Revenue Requirement have been Shared Services (11.8%) and Depreciation (8.4%). Shared Services involve the use of companywide expertise to assist local Golden State Water employees (water rights management, water quality management, infrastructure planning, accounting and financial services, risk management, human resources, information technology). The growth in recent years reflects a change in CPUC ratemaking and accounting directives (see fn. 9), as well as increased resources to address more stringent water quality and environmental regulations, and associated infrastructure planning. Rapid growth in Depreciation reflects the capital investment in the system over the past five years.

- Total Water Supply Cost grew at a rate of 2.6%. However, that number is somewhat misleading. Given the decline in water sales over this time period, the focus on total costs masks the rapid increase in the per-acre-foot (AF) cost of imported water (see Table 5). The cost per AF depends on the supply mix and rates charged for imported water. The water rate charged by Three Valley MWD has increased from $506/AF in 2007 to $754/AF by 2011.

Table 5
Total Water Supply Cost Rising While Volumes Are Falling

	2007	2008	2009	2010	2011
$ per Acre-Foot (AF)	$278.97	$343.97	$392.03	$481.03	$402.14
Total Water Supply Cost	$3,874,857	$4,536,260	$4,661,264	$5,108,514	$4,296,822
Total Supply (AF)	13,890	13,188	11,890	10,620	10,685
Three Valley MWD Water Rate ($/AF)	$506	$543	$600	$692	$754

Table 6 below is based upon Golden State Water's financial statements. The table reveals that in the past five years Golden State Water has reinvested about 97% of its equity return back into the Claremont Water System.

Table 6
Reinvestment of Equity Return into Claremont Water System

	2007	2008	2009	2010	2011	Cumulative
Equity Return[14]	$1,494,985	$1,602,578	$1,779,351	$1,725,949	$1,700,679	$8,303,542
Capital Spending—Equity Financed[15]	$1,305,965	$2,105,728	$1,871,826	$1,344,269	$1,442,280	$8,070,069
Contribution to Dividend[16]	$189,020	-$503,150	-$92,475	$381,680	$258,399	$233,473
Payout Ratio						
Claremont[17]	12.6%	-31.4%	-5.2%	22.1%	15.2%	2.8%
Companywide[18]	63.9%	47.4%	76.5%	78.1%	57.4%	63.8%

The above table shows that over the five-year period ending 2011, Golden State Water reinvested $8.1 million of its $8.3 million equity return into the Claremont Water System. Only 3% of returns were a contribution to shareholder dividends. Companywide, Golden State Water paid out 63.8% of net income as dividends to shareholders. In other words, Golden State Water reinvested over twenty times more of its equity return into the Claremont Water System than was invested in other companywide systems.

Shareholder equity and return are critical elements for developing and maintaining a sustainable water system. Shareholder equity provides the risk capital to underwrite the system risks to make debt financing viable. Equity return rewards shareholders for bearing risk. For systems that have additional investment requirements, such as the Claremont Water System, the equity return is reinvested back into the enterprise as the equity contribution to the financing requirements of new capital investment. This capability and willingness of Golden State Water to invest in the Claremont Water System has been amply demonstrated over the past five years.

[14] Equity Return: Allowed Return (Table 3) less interest expense for the Claremont Water System derived using the cost of debt and capital structure by the CPUC in the cost of capital proceedings.
[15] Capital Spending—Equity Financed (Table 1).
[16] Contribution to Dividend: Equity Return less Capital Spending—Equity Financed.
[17] Payout Ratio–Claremont: Contribution to Dividend/Equity Return.
[18] Companywide = Dividends paid to American States Water (Golden State Water's holding company) divided by Golden State Water's net income.

Proposed City Acquisition of Claremont Water System

There are two basic questions about the City's acquisition of the Claremont Water System:

1. What would be the financial structure of the City-owned water utility? As discussed below, there is more to municipal finance than simply borrowing the money needed to pay Golden State Water.

2. How will the City-owned water utility replicate the services and the investment Golden State Water has provided to Claremont's water users? The City's "stand-alone" utility will face challenges related to funding and operations that are not faced by a larger water provider.

Financial Structure of City-Owned Utility

While a government-owned water system does not have shareholders, it does not follow that the acquisition and operation of the system can be financed by simply borrowing the amount needed to purchase and operate the system. Rather, extra borrowing is needed to create an equity cushion. Consider the example of traditional financing of a home purchase. The homeowner must make a down payment on the house to borrow the balance of the purchase price from a bank. A 20% down payment, for example, has traditionally been regarded as the minimum "equity" portion of the home financing. In addition, the homeowner must also qualify for the loan by having sufficient income relative to the mortgage obligation—not just enough income to pay the mortgage, but also some "cushion" of income to provide necessary comfort to the lender that the payments will be made regardless of fluctuation in other expenses or income the homeowner may incur.[19]

The municipal capital market in which the City of Claremont would seek funding to acquire the Claremont Water System also demands prudent financial structure. Consider, for example, the Metropolitan Water District of Southern California (MWD), which is the provider of supplemental surface water throughout Southern California. In part to satisfy the capital markets, MWD's finance plan has three components:[20]

- Equity Financing: Pay-as-you-go financing where 25% of capital investments are funded from reserves accumulated in prior years from rates charged to customers.

- Debt Service Coverage Ratio: Set rates so that net revenues of the system (revenues less operating costs) are two times debt service obligations.

- Operating Reserves: Unrestricted funds and cash investments equal to 173 days of operations.

[19] While some banks deviated from this model in the years leading up to the housing crash in 2008, the resulting financial catastrophe from the defaults on nontraditional loans is testimony to the consequences of deviating from sound financial principles.

[20] Metropolitan Water District of Southern California, *2004/05 Long Range Finance Plan,* October 11, 2004. Available on Metropolitan's website.

MWD's track record of aggressively raising rates to meet its debt service coverage and accumulate reserves is the foundation of its ability to raise funds in the municipal bond market at advantageous rates.[21] MWD's finance plan calls for debt coverage ratios far in excess of the minimum amount specified in its rate covenants (generally 1.25x).

The City of Claremont, of course, starts with a blank slate with respect to the Claremont Water System. It has no accumulated reserves from pay-as-you-go financing of the water utility. It has no unrestricted funds and cash investments equal to 173 days of a water utility's operations. In addition to financing the acquisition, it must fund the further capital improvements going forward and reimburse the City's costs incurred during the condemnation process (legal, appraisal, consulting, environmental and other expenses).[22] The assumptions regarding the initial funding of the City Water System necessary to meet the package of requirements demanded by the municipal bond market are the following:

- Term of Financing: 30 years
- Interest Rate: 4.5%
- Annual Debt Service Reserve: one-year debt service obligation
- Operating Reserve: 173 days' operating costs (exclusive of depreciation)
- Issuance Costs: 3% for $54 million Value of Water System, 2.75% for $104 million Value of Water System, and 2.25% for $205 million Value of Water System
- Debt Service Coverage Ratio: 2x

It is impossible at this point to calculate actual financial implications of the above requirements, because of uncertainty in the level of funding required. The most obvious uncertainty involves the purchase price the City will be required to pay for the Claremont Water System, which apparently would be determined by a jury through the valuation process as part of an eminent domain lawsuit.

Table 7 shows how the size of the acquisition financing varies with the total acquisition cost (purchase price, plus ancillary expenses and reserves) the City ultimately incurs to obtain ownership of the Claremont Water System. The table's calculations use three different purchase price assumptions for illustration purposes: $54 million (the amount of the City's initial offer to Golden State Water), $104 million, and $204 million.

[21] Standard & Poor's RatingsDirect, *Metropolitan Water District of Southern California; Water/Sewer, September 7, 2012*. Available on Metropolitan's website.

[22] A reasonable assumption based on experiences elsewhere is that these costs will total 3% of the purchase price.

Table 7
Size of Acquisition Financing by Size of Acquisition Cost

Value of Water System	$54 mil	$104 mil	$204 mil
Source of Funds	$72,266,841	$128,593,102	$240,323,360
Par Value of Bonds			
Use of Funds			
Purchase Price	$54,000,000	$104,000,000	$204,000,000
Capital Improv. Fund	$5,000,000	$5,000,000	$5,000,000
Cost Reimbursement	$1,620,000	$3,120,000	$6,120,000
Annual Debt Reserve	$4,436,573	$7,894,529	$14,753,822
Operating Reserve	$5,042,263	$5,042,263	$5,042,263
Issuing Costs	$2,168,005	$3,536,310	$5,407,276
Total	$72,266,841	$128,593,102	$240,323,360

Table 7 shows that the City must borrow nearly $72.3 million to fund the acquisition at the City's offer of $54 million. The larger the purchase price, of course, the larger the debt offerings. If the value of the Claremont Water System is determined to be $104 million ($50 million more than the City's offer) or $204 million ($150 million more than the City's offer), then the City must borrow $128.5 million or $240.3 million, respectively, to acquire the water system, meet Annual Debt Reserve and Operating Reserve requirements, reimburse costs incurred in the condemnation process and pay issuing costs.

How will the costs (and hence the water rates) for the City-owned system compare with Golden State Water's ownership? The answer is provided by comparing the Revenue Requirement of Golden State Water (Table 8) with the Revenue Requirement of the City-owned system (Table 9).[23]

Table 8
Annual Revenue Requirement of Golden State Water (2012)

Revenue Requirement	**$16,805,730**
Total Water Supply Cost	$4,409,306
Operations & Maintenance	$1,543,418
Admin. & General	$637,347
Shared Services	$3,066,229
Depreciation	$2,468,463
Non-Income Taxes	$401,144
Income Taxes	$1,307,725
Allowed Return	$2,972,099

[23] The Golden State Revenue Requirement ($16.8 million) is estimated by applying the annual growth rate in each component (Total Water Supply Cost through Allowed Return) to the 2011 values found in Table 3.

Table 9
Annual Revenue Requirement of City-Owned System
by Acquisition Cost

Value of Water System	*$54 mil*	*$104 mil*	*$204 mil*
Revenue Requirement	**$21,929,486**	**$28,845,398**	**$42,563,984**
Total Water Supply Cost	$4,409,306	$4,409,306	$4,409,306
Operations & Maintenance	$1,852,101	$1,852,101	$1,852,101
Admin. & General	$637,347	$637,347	$637,347
Shared Services	$3,679,475	$3,679,475	$3,679,475
Depreciation	$2,468,463	$2,468,463	$2,468,463
Non-Income Taxes	$60,071	$60,071	$60,071
Earned Interest	($50,423)	($50,423)	($50,423)
Subtotal	$13,056,340	$13,056,340	$13,056,340
Capital Charge	$8,873,146	$15,789,058	$29,507,644
Debt Service	$4,436,573	$7,894,529	$14,753,822
Coverage Ratio	2	2	2

Tables 8 and 9 show that the Revenue Requirement of the City-owned system differs from Golden State Water's in four ways:

1. Where the Shared Services are in-house for Golden State Water, the Shared Services for the City must be outsourced because these professional services are not required full-time for the Claremont Water System. Golden State Water has full-time professionals on staff to address issues throughout Golden State Water service areas. Those professionals are essentially "on call" when needed to service Claremont, yet only a portion of their salaries is allocated to the Claremont system. A City-owned system must outsource these tasks to part-time consultants, or, alternatively, hire more full-time employees to operate the water system than does Golden State Water. Therefore, the estimate in Table 9 applies a 20% increase on Operations & Maintenance and Shared Services costs above those incurred by Golden State Water.

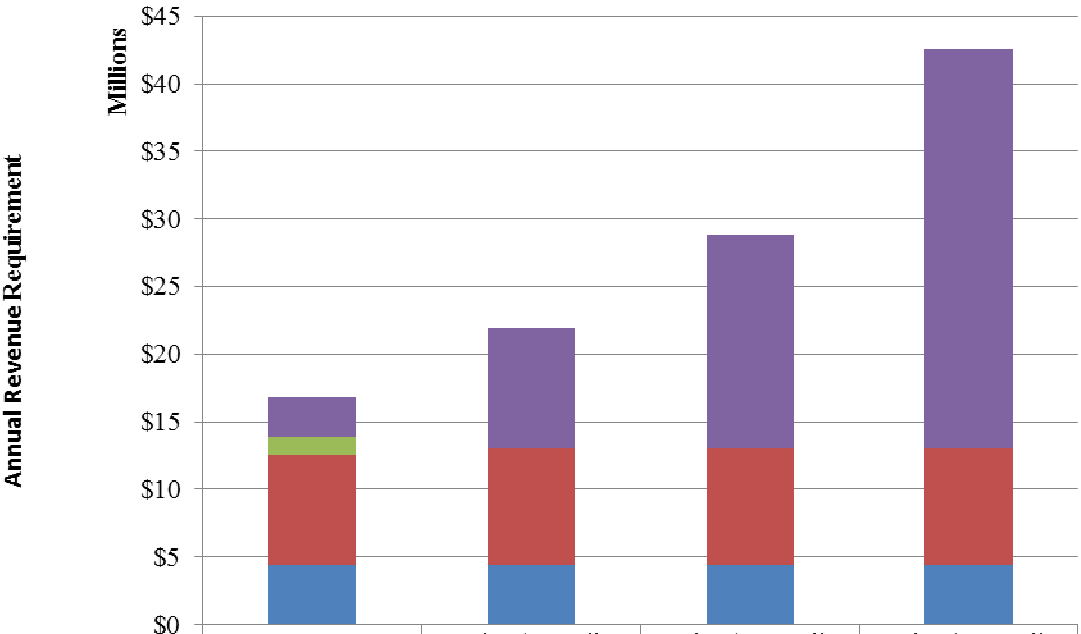
2. The City-owned system pays only payroll taxes, and not the property taxes and local fees paid by Golden State Water. The estimated annual cost savings of $341,073 are revenue losses for local governments.

3. The City can earn interest income on the debt service reserve and operational reserve (estimate assumes an interest rate of 1%).

4. Finally, rather than having the allowed return of CPUC regulation, the City-owned system levies a capital charge to generate debt service coverage. The magnitude of the charge, of course, will depend on the value of the Claremont Water System.

In the end, City ownership is more expensive than Golden State Water ownership under all scenarios (Figure 2). Figure 2 demonstrates that the major driver of added costs is the differences in the capital charge. The higher capital charge more than offsets the income taxes avoided by City ownership.

Figure 2
City Ownership More Costly Than Golden State Ownership



	GSWC	City-$54 mil	City-$104 mil	City-$204 mil
Capital Charge	$2,972,099	$8,873,146	$15,789,058	$29,507,644
Income Tax	$1,307,725	$0	$0	$0
Operating	$8,116,600	$8,647,034	$8,647,034	$8,647,034
Water	$4,409,306	$4,409,306	$4,409,306	$4,409,306

Value of Claremont Water System

Table 10 charts the annual Revenue Requirement of the City-owned system and the percentage by which that Revenue Requirement would be increased above the Revenue Requirement of Golden State Water's ownership. Table 10 also shows the additional charge that would be borne by each water customer to cover the increase in the Revenue Requirement.[24]

[24] There are 10,908 connections in the Claremont Water System.

Table 10
Increased Annual Revenue Requirement Resulting from City Ownership

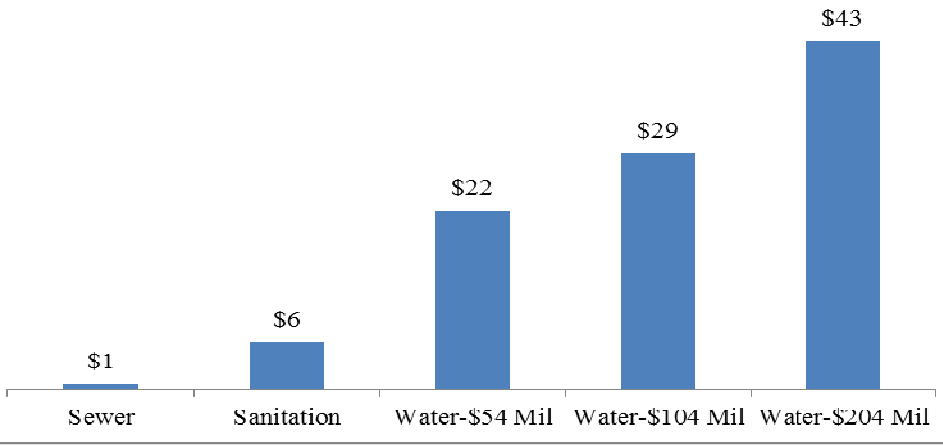
Acquisition Cost	$54 mil	$104 mil	$204 mil
Annual Increase Above Golden State	$5,123,755	$12,039,667	$25,758,253
Percent Increase	30.5%	71.6%	153.3%
Increase/Connection	$469.72	$1,103.75	$2,361.41

Table 10 shows that even if the purchase price of the system is $54 million, the annual Revenue Requirement of the City-owned water system increases from $16.8 million under Golden State Water ownership to $21.9 million under City ownership—an increase of 30.5%. This annual increase translates into $470 per customer. Higher awards will generate even larger increases—over $2,300 annually per customer if the purchase price is $204 million.

The Impact and Responsibilities of City Control of the Water System

The City acquisition of the Claremont Water System represents a major expansion of City government into business activity. Currently the City has sewer and sanitation enterprises with operating revenues of $1 million and $6 million, respectively (see Figure 3). Acquisition of the water system would be an explosion in operating revenues managed by the City, even if it were able to acquire the water system at the City's $54 million offer.

Figure 3
Operating Revenues of Claremont Enterprises Relative to Water System (millions)



Assets under City management would radically increase if the City acquires the water system. (See Figure 4.)

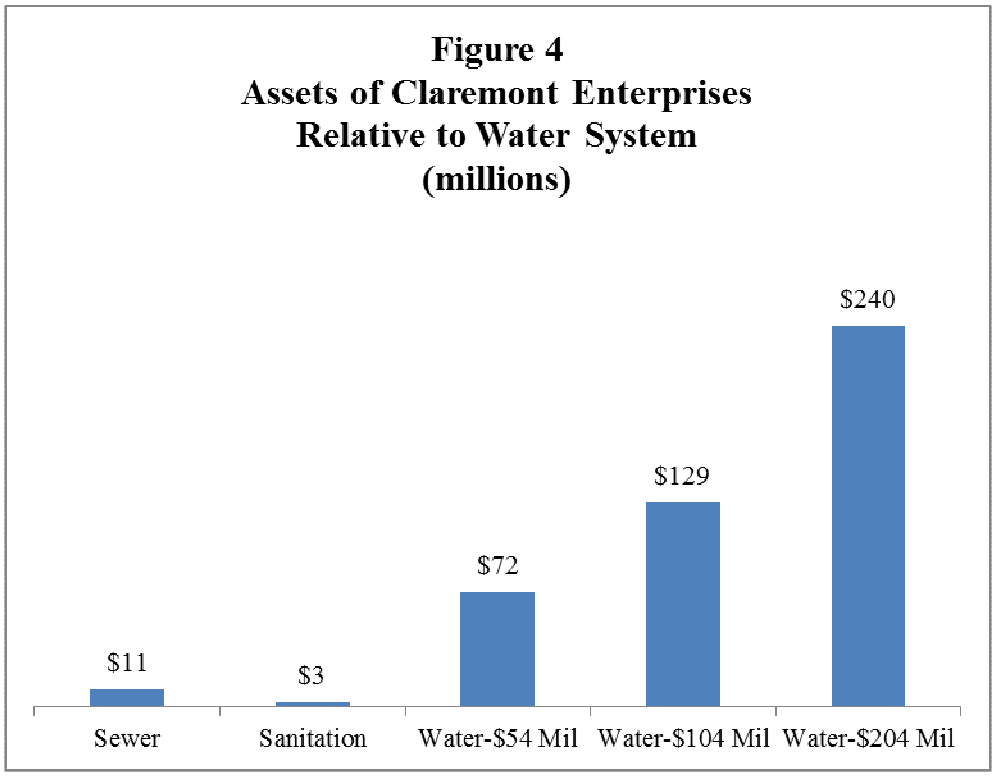


Figure 4 shows that the City's current enterprises have relatively minimal physical assets when compared to the water system. Neither of the City's current enterprises is managed for business purposes (they have negligible financial liabilities and generate less than $1 million in net income that is transferred to the City general fund). Getting into the water business will require a transformation of city employees into major asset managers.

City control of the water system would come with critical new operational responsibilities. Management and staff would be required to have the requisite skill, expertise and experience to operate the water system. City Council members would need to expand the skill set necessary for board decision making. Water resource management is not a venture for amateurs. Consider some of the activities:

- ► Water quality monitoring, compliance with federal and state regulations
- ► Water supply reliability and customer service operations
- ► Infrastructure maintenance
- ► Financial risk management and asset management
- ► Employee training and managing of specialized outside vendors

The scale of the Claremont Water System does not sustain the development of full-time in-house expertise for all skilled positions needed to operate the Claremont Water System. Instead, the City would have to develop a model based on significant outsourcing to part-time

consultants, and the City would need to have sufficient in-house management expertise to manage the consultants. The City has thus far offered no plan to meet these requirements. For example, there is no indication that the City has determined how many new employees it will hire, what the training and certifications of those employees will be, or what services will be outsourced to private or public entities. These are essential elements of any comprehensive plan to assume control of the Claremont Water System.

All water systems in California face many significant challenges. Imported water supplies serve 40% of Claremont's water needs. Water delivered by the Metropolitan Water District of Southern California (MWD), therefore, is a significant factor in Claremont's future. MWD's water rates have increased rapidly in the face of challenges it faces on the Colorado River and with the State Water Project. Should Claremont management decide to rely solely on MWD or should it develop its own alternative supplies, on its own or in partnership with other water agencies? As water quality regulations continue to evolve, which practices and investments should be made to satisfy regulatory obligations? Which are cost-effective? While groundwater has reliably served the majority of Claremont's water needs, what will be the best response if problems develop in the aquifer? Should the Claremont Water System rely solely on the Six Basins Watermaster or proactively solve problems? What about infrastructure planning, operations and risk management? Should the Claremont Water System be operated reactively or proactively? The experiences of government-owned systems, such as Los Angeles and San Diego, suggest that government ownership is a recipe for deferred maintenance that ultimately translates into deteriorating service and substantially high costs to address problems that had been kicked down the road due to poor asset management and planning.

Golden State Water has senior management and staff who are focused full-time on running municipal water systems. Therefore, the individuals responsible for the Claremont Water System have internal resources at their command. Senior management is accountable to the company's Board of Directors and shareholders. The Board is selected by shareholders for the sole purpose of monitoring the management of municipal water systems. Moreover, the CPUC approves all the company's activities, including rate-setting and capital improvement.

City ownership places the water system under the control of the City Council. Council members have a broader plate of issues than simply water systems. Inevitably, individuals chosen on a broad range of issues will lack the depth of intellectual capital in water that those chosen solely for water issues have.

Conclusion

From a municipal finance perspective, Claremont's pursuit of Golden State Water's Claremont Water System is not prudent. The cost of acquiring the system is high, and the problem is that no one can say at this point *how high* that cost will be. Even accepting the City's estimate of a $54 million price tag for the system, the City will need to borrow over $72 million from the municipal capital market. However, it would be extremely unwise to assume that the City's estimate of the price will end up being the actual price. A price of roughly double the City's estimate will result in borrowing of about $130 million, and even that amount could be insufficient. In short, the takeover of the water system is an enormous financial risk for the City.

From an operational standpoint, there appears to be no justification for the takeover. Golden State Water has long experience operating the system, has resources from its companywide operations to draw upon when needed, and has regularly used its shareholder equity to fund capital improvements to the system. The City, by contrast, has no experience in the operation of the system and has put forth no plan for how it will do so. The City would need to acquire or outsource the necessary operational capability, including the expertise to comply with myriad State regulations concerning water quality and environmental standards, and the managerial competence to oversee all such operations. The City would no longer benefit from the economies and depth of experience Golden State Water provides as a result of its companywide assets.

From a consumer's perspective, the vision of lower water rates is a mirage. The City's need to finance the acquisition and then fund operations and capital improvements on a "pay as you go" basis will necessarily result in a Revenue Requirement for the system that is higher than Golden State Water's requirements, thus resulting in higher water rates for decades.

* * *

Rodney T. Smith, Ph.D.
December 17, 2012

The Economics of Claremont's Attempt to Buy the Water System

From a financial perspective, Claremont's pursuit of Golden State Water's Claremont Water System is very difficult to justify.

- The cost of acquiring the system is high, and the problem is that no one can say at this point *how high* that cost will be. Even accepting the city's estimate of a $54 million price tag for the system, the city will need to borrow over $72 million from the municipal capital market. However, it would be extremely unwise to assume that the city's estimate of the price will end up being the actual price.

- A price of roughly double the city's estimate will result in borrowing approximately $130 million, and even that amount could be insufficient. In short, the takeover of the water system is an enormous financial risk for the city.

- Accounting for 30-year payments of principal and interest for bonds needed to acquire the system, a $54 million purchase price results in total payments of $133 million; $104 million results in $236 million and a $204 million purchase price costs taxpayers $442 million. It is realistic to suggest that a takeover requires close to a quarter billion in new debt to taxpayers, which would directly impact city services and likely affect other public agencies in the region.

From an operational standpoint, there appears to be no justification for the takeover. There has been no public dissemination of an analysis that demonstrates how the city would provide water service from an operational and managerial standpoint, or of probable rates and other charges customers should expect.

- Golden State Water has long experience operating the system, has resources from its companywide operations to draw upon when needed, and has regularly used its shareholder equity to make capital improvements to the system.

- The city, by contrast, has no experience in the operation of the system and has put forth no plan for how it will do so. Even if it manages to acquire the operational capability needed, the city would not benefit from the economies and depth of experience Golden State Water provides as a result of its companywide assets.

- Operationally, the size of city government will have to expand rapidly in an effort to meet the significant technical and managerial demands of operating the system, none of which the city possesses. Ownership and operation of the Claremont Water System will dwarf all other services the city currently provides.

From a consumer's perspective, the vision of lower water rates is a mirage. If the goal of acquiring the system is to charge lower water rates, then the effort should be abandoned because that goal is not a feasible outcome through the condemnation process.

- The city's need to finance the acquisition and then fund operations and capital improvements on a "pay as you go" basis will inevitably result in a Revenue Requirement for the system that is higher than Golden State Water's requirements, thus resulting in higher water rates for decades.

    - At a $54 million purchase price customers will pay 30.5% more or $469 annually per connection.

    - At $104 million, customers will pay 71.6 % more or $1,103 annually per connection.

    - At $204 million, customers will pay 153.3 % more or over $2,361 annually per connection.