

Defcon 1 in CA: Ratepayer Advocates Appointed to CPUC.

INVESTMENT CONCLUSION:

Underweight water utilities with concentrated exposure to CA regulation on concerns that newly appointed commissioners will drive shift toward more ratepayer-friendly posture. Recommend owning companies with more diversified regulatory exposure, including BUY-rated American Water (AWK) and Middlesex Water (MSEX).

KEY POINTS:

- **Two new commissioners appointed to CPUC.** Yesterday evening, California Governor Jerry Brown appointed Michael Florio and Catherine Sandoval as commissioners with the California Public Utility Commission, leaving one additional position on the five person commission to be filled. In addition, sources close to the situation indicate that current CPUC President Michael Peevey may opt to leave the commission in the event Brown appoints a new President to replace him - creating an additional opening that Brown would be responsible for filling.
- **New appointments suggest shift toward more ratepayer-driven CPUC.** Florio has spent more than 30 years as an attorney with The Utility Reform Network (T.U.R.N.), which represents consumers in direct opposition to regulated utilities in rate cases and other matters. Sandoval is a professor at Santa Clara University specializing in telecommunications policy. Although it remains to be seen how either will act in the commissioner role, there has been significant political pressure for the CPUC to more staunchly represent consumer interests, and we believe the commission is likely to shift in this direction. Indeed, consumer interests praised the appointments of two individuals with "stellar reputations as thoughtful and forceful advocates for consumers."
- **Cost of capital hearings loom; To begin in May 2011.** While water utilities will likely "fly below the radar" relative to prime consumer advocate targets such as PG&E, and are unlikely to come under direct frontal assault, a more ratepayer friendly PUC represents a systemic risk for all CA utilities. For water utilities, the first major test of the "new" CPUC's approach will come in May, when cost of capital hearings begin that will determine ROEs for 2012 and beyond. In the most recent hearings, ROEs were set at the top end of the 9.8%-10.2% range the PUC considered appropriate in light of then extraordinary financial market conditions. With financial markets stabilized and decoupling (in theory) creating a lower risk business model, we believe lower ROEs are likely.
- **Coup de grace? Brown considering new F.O.R. (friend of ratepayer) CPUC president.** Although the Governor's office is understandably mum on the issue, there is speculation that Brown will appoint a new CPUC president to replace current chief Michael Peevey. Sources close to the situation confirm that former T.U.R.N. president John Geesman is a contender for this spot and that he interviewed with Brown and staffers last week. This move could create the knock-on consequence of opening up a fourth opening, as Peevey may elect to step down in the event he is stripped of the president role. Overall, given the political backdrop of harsh and unrelenting criticism of the CPUC as being too cozy with utilities, we expect appointments to continue favoring ratepayer interests.
- **We recommend limiting CA exposure until the dust settles on ROE hearings.** While the new appointees are professionals that understand the need for fair, balanced regulation, and even longtime consumer advocates such as Florio are likely to adopt a more centrist mindset over time, in the near-term CA has moved to "Defcon 1" in terms of the regulatory risk. With this in mind, and with the water cost of capital hearings setting up as an early barometer of the CPUC's new direction, we advocate underweighting IOUs with concentrated CA exposure, instead favoring companies with more diversified regulatory exposure, such as American Water (AWK), Middlesex Water (MSEX). Aqua America (WTR) is also well diversified, but we rate WTR shares NEUTRAL on valuation.

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