

CALIFORNIA WATER SERVICE GROUP

Form 10-Q

October 29, 2015

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2015

or

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-13883

CALIFORNIA WATER SERVICE GROUP

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction

of incorporation or organization)

1720 North First Street, San Jose, CA.

(Address of principal executive offices)

408-367-8200

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated Filer ☒

Accelerated filer ☐

Non-accelerated filer ☐

Smaller reporting company ☐

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in rule 12b-2 of the Exchange Act) Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. Common shares outstanding as of October 27, 2015 — 47,876,087

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## PART I FINANCIAL INFORMATION

## Item 1.

## FINANCIAL STATEMENTS

The condensed consolidated financial statements presented in this filing on Form 10-Q have been prepared by management and are unaudited.

CALIFORNIA WATER SERVICE GROUP  
CONDENSED CONSOLIDATED BALANCE SHEETS

Unaudited

(In thousands, except per share data)

	September 30, 2015	December 31, 2014
<b>ASSETS</b>		
Utility plant:		
Utility plant	\$2,460,829	\$2,342,471
Less accumulated depreciation and amortization	(797,264)	(752,040)
Net utility plant	1,663,565	1,590,431
Current assets:		
Cash and cash equivalents	50,825	19,587
Receivables:		
Customers	41,574	25,803
Regulatory balancing accounts	38,112	53,199
Other	14,369	14,136
Unbilled revenue	31,276	23,740
Materials and supplies at average cost	6,087	6,041
Taxes, prepaid expense, and other assets	8,823	11,618
Total current assets	191,066	154,124
Other assets:		
Regulatory assets	398,535	390,331
Goodwill	2,615	2,615
Other assets	50,739	49,850
Total other assets	451,889	442,796
	\$2,306,520	\$2,187,351
<b>CAPITALIZATION AND LIABILITIES</b>		
Capitalization:		
Common stock, \$.01 par value; 68,000 shares authorized, 47,877 and 47,806 outstanding in 2015 and 2014, respectively	\$479	\$478
Additional paid-in capital	332,290	330,558
Retained earnings	308,083	295,590
Total common stockholders' equity	640,852	626,626
Long-term debt, less current maturities	416,447	419,233
Total capitalization	1,057,299	1,045,859
Current liabilities:		
Current maturities of long-term debt	6,565	6,607
Short-term borrowings	136,615	79,115
Accounts payable	77,261	59,395

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Regulatory balancing accounts	1,870	6,126
Accrued interest	9,678	4,194
Accrued expenses and other liabilities	68,781	62,269
Total current liabilities	300,770	217,706
Unamortized investment tax credits	1,947	2,032
Deferred income taxes, net	236,443	214,842
Pension and postretirement benefits other than pensions	276,525	270,865
Regulatory liabilities and other	76,799	83,279
Advances for construction	180,805	182,284
Contributions in aid of construction	175,932	170,484
Commitments and contingencies (Note 10)	—	—
	\$2,306,520	\$2,187,351

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

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CONDENSED CONSOLIDATED STATEMENTS OF INCOME

Unaudited

(In thousands, except per share data)

For the three months ended	September 30, 2015	September 30, 2014
Operating revenue	\$183,543	\$191,184
Operating expenses:		
Operations:		
Water production costs	60,437	66,980
Administrative and general	30,737	23,765
Other operations	17,872	15,692
Maintenance	5,952	4,800
Depreciation and amortization	15,342	14,648
Income taxes	15,293	19,233
Property and other taxes	5,709	5,232
Total operating expenses	151,342	150,350
Net operating income	32,201	40,834
Other income and expenses:		
Non-regulated revenue	3,814	4,409
Non-regulated expenses, net	(4,454)	(4,812)
Income tax benefit on other income and expenses	262	169
Net other loss	(378)	(234)
Interest expense:		
Interest expense	7,201	7,221
Less: capitalized interest	(498)	(271)
Net interest expense	6,703	6,950
Net Income	\$25,120	\$33,650
Earnings per share:		
Basic	\$0.52	\$0.70
Diluted	0.52	0.70
Weighted average shares outstanding:		
Basic	47,878	47,803
Diluted	47,887	47,840
Dividends declared per share of common stock	\$0.1675	\$0.1625
See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements		

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CONDENSED CONSOLIDATED STATEMENTS OF INCOME

Unaudited

(In thousands, except per share data)

For the nine months ended	September 30, 2015	September 30, 2014
Operating revenue	\$449,942	\$460,115
Operating expenses:		
Operations:		
Water production costs	158,661	174,297
Administrative and general	85,069	72,702
Other operations	51,227	48,072
Maintenance	15,735	14,793
Depreciation and amortization	46,015	46,788
Income taxes	21,008	22,584
Property and other taxes	16,036	15,601
Total operating expenses	393,751	394,837
Net operating income	56,191	65,278
Other income and expenses:		
Non-regulated revenue	10,540	12,163
Non-regulated expenses, net	(10,201)	(11,184)
Income tax expense on other income and expenses	(131)	(391)
Net other income	208	588
Interest expense:		
Interest expense	21,331	21,373
Less: capitalized interest	(1,472)	(851)
Net interest expense	19,859	20,522
Net Income	\$36,540	\$45,344
Earnings per share:		
Basic	\$0.76	\$0.95
Diluted	0.76	0.95
Weighted average shares outstanding:		
Basic	47,861	47,787
Diluted	47,877	47,825
Dividends declared per share of common stock	\$0.5025	\$0.4875
See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements		

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWSUnaudited  
(In thousands)

For the nine months ended:	September 30, 2015	September 30, 2014
Operating activities:		
Net income	\$36,540	\$45,344
Adjustments to reconcile net income to net cash:		
Depreciation and amortization	47,406	48,481
Change in value of life insurance contracts	758	(501 )
Changes in operating assets and liabilities:		
Receivables	(18,412 )	(13,781 )
Accounts payable	7,245	7,239
Other current assets	(2,428 )	(6,859 )
Other current liabilities	11,939	6,904
Other changes in noncurrent assets and liabilities	33,476	13,340
Net cash provided by operating activities	116,524	100,167
Investing activities:		
Utility plant expenditures	(118,309 )	(86,258 )
Purchase of life insurance contracts	(1,855 )	(3,207 )
Change in restricted cash	(241 )	354
Net cash used in investing activities	(120,405 )	(89,111 )
Financing activities:		
Short-term borrowings	82,500	99,900
Repayment of short-term borrowings	(25,000 )	(85,000 )
Debt issuance costs	(1,197 )	—
Proceeds from long-term debt	50	—
Repayment of long-term debt	(2,878 )	(4,604 )
Advances and contributions in aid of construction	10,741	8,780
Refunds of advances for construction	(5,050 )	(4,858 )
Dividends paid	(24,047 )	(23,295 )
Net cash provided by (used in) financing activities	35,119	(9,077 )
Change in cash and cash equivalents	31,238	1,979
Cash and cash equivalents at beginning of period	19,587	27,506
Cash and cash equivalents at end of period	\$50,825	\$29,485
Supplemental information:		
Cash paid for interest (net of amounts capitalized)	\$13,618	\$14,102
Income tax refunds	—	(6,000 )
Supplemental disclosure of non-cash activities:		
Accrued payables for investments in utility plant	\$24,856	\$16,308
Utility plant contribution by developers	5,573	8,148
See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements		



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CALIFORNIA WATER SERVICE GROUP

Notes to Unaudited Condensed Consolidated Financial Statements

September 30, 2015

(Amounts in thousands, except per share amounts)

Note 1. Organization and Operations and Basis of Presentation

California Water Service Group (the Company) is a holding company that provides water utility and other related services in California, Washington, New Mexico and Hawaii through its wholly-owned subsidiaries. California Water Service Company (Cal Water), Washington Water Service Company (Washington Water), New Mexico Water Service Company (New Mexico Water), and Hawaii Water Service Company, Inc. (Hawaii Water) provide regulated utility services under the rules and regulations of their respective state's regulatory commissions (jointly referred to herein as the commissions). CWS Utility Services and HWS Utility Services LLC provide non-regulated water utility and utility-related services.

The Company operates in one reportable segment, providing water and related utility services.

Basis of Presentation

The unaudited interim financial information has been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission (SEC) and therefore do not contain all of the information and footnotes required by GAAP and the SEC for annual financial statements. The condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements for the year ended December 31, 2014, included in its annual report on Form 10-K as filed with the SEC on February 26, 2015.

The preparation of the Company's condensed consolidated unaudited interim financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the balance sheet dates and the reported amounts of revenues and expenses for the periods presented. These include, but are not limited to, estimates and assumptions used in determining the Company's regulatory asset and liability balances based upon probability assessments of regulatory recovery, revenues earned but not yet billed, asset retirement obligations, allowance for doubtful accounts, pension and other employee benefit plan liabilities, and income tax-related assets and liabilities. Actual results could differ from these estimates.

In the opinion of management, the accompanying condensed consolidated unaudited interim financial statements reflect all adjustments, consisting of normal recurring transactions that are necessary to provide a fair presentation of the results for the periods covered. The results for interim periods are not necessarily indicative of the results for any future period.

Due to the seasonal nature of the water business, the results for interim periods are not indicative of the results for a 12-month period. Revenue and income are generally higher in the warm, dry summer months when water usage and sales are greater. Revenue and income are generally lower in the winter months when cooler temperatures and rainfall curtail water usage and sales.

Note 2. Summary of Significant Accounting Policies

Revenue

Revenue generally includes monthly cycle customer billings for regulated water and wastewater services at rates authorized by the commissions plus estimated unbilled revenue for water used between the customer's last meter reading and the end of the accounting period and billings to certain non-regulated customers at rates authorized by contract with government agencies.

The Company's regulated water and waste water revenue requirements are authorized by the commissions in the states in which they operate. The revenue requirements are intended to provide the Company an opportunity to recover its operating costs and earn a reasonable return on investments.

For metered customers, Cal Water recognizes revenue from rates which are designed and authorized by the California Public Utilities Commission (CPUC). Under the Water Revenue Adjustment Mechanism (WRAM), Cal Water records the adopted level of volumetric revenues, which would include recovery of cost of service and a return on investment, as

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established by the CPUC for metered accounts (adopted volumetric revenues). In addition to volumetric-based revenues, the revenue requirements approved by the CPUC include service charges, flat rate charges, and other items not subject to the WRAM. The adopted volumetric revenue considers the seasonality of consumption of water based upon historical averages. The variance between adopted volumetric revenues and actual billed volumetric revenues for metered accounts is recorded as a component of revenue with an offsetting entry to a regulatory asset or liability balancing account (tracked individually for each Cal Water district) subject to certain criteria under the accounting for regulated operations being met. The variance amount may be positive or negative and represents amounts that will be billed or refunded to customers in the future.

Cost-recovery rates are designed to permit full recovery of certain costs. Cost-recovery rates such as the Modified Cost Balancing Account (MCBA) provide for recovery of adopted expense levels for purchased water, purchased power and pump taxes, as established by the CPUC. In addition, cost-recovery rates include recovery of costs related to water conservation programs and certain other operation expenses adopted by the CPUC. There is no markup for return or profit for cost-recovery expenses and such costs are generally recognized when expenses are incurred. Variances (which include the effects of changes in both rate and volume for the MCBA) between adopted and actual costs are recorded as a component of revenue, as the amount of such variances will be recovered from or refunded to our customers at a later date. The off-setting entries are recorded to a regulatory asset or liability balancing account (transferred individually for each Cal Water district) subject to certain criteria under the accounting for regulated operations being met.

The balances in the WRAM and MCBA asset and liability accounts will fluctuate on a monthly basis depending upon the variance between adopted and actual results. The over- or under-recovery of WRAM is netted against the over- or under-recovery of MCBA in the corresponding district. The district's net WRAM/MCBA refund or recovery is interest bearing at the current 90 day commercial paper rate. At the end of any calendar year, Cal Water files with the CPUC to refund or collect the balance in the accounts. Most undercollected net WRAM and MCBA receivable balances are collected over 12 or 18 months. Cal Water defers net WRAM and MCBA operating revenues and associated costs whenever the net receivable balances are estimated to be collected more than 24 months after the respective reporting periods in which they were recognized. The deferred net WRAM and MCBA revenues and associated costs were determined using forecasts of rate payer consumption trends in future reporting periods and the timing of when the CPUC will authorize Cal Water's filings to recover the undercollected balances. Deferred net WRAM and MCBA revenues and associated costs will be recognized as revenues and costs in future periods when collection is within twenty-four months of the respective reporting period.

Flat rate customers are billed in advance at the beginning of the service period. The revenue is prorated so that the portion of revenue applicable to the current period is included in that period's revenue, with the balance recorded as unearned revenue on the balance sheet and recognized as revenue when earned in the subsequent accounting period. The unearned revenue liability was \$1.4 million and \$1.5 million as of September 30, 2015 and December 31, 2014, respectively. This liability is included in "accrued expenses and other liabilities" on the condensed consolidated balance sheets.

## Cash and Cash Equivalents

Cash equivalents include highly liquid investments with maturities of three months or less. Cash and cash equivalents was \$50.8 million and \$19.6 million as of September 30, 2015 and December 31, 2014, respectively. Restricted cash was presented on the condensed consolidated balance sheet in "taxes, prepaid expenses and other assets" and was \$1.0 million and \$0.8 million as of September 30, 2015 and December 31, 2014.

## Adoption of New Accounting Standards

In May 2014, the FASB issued an Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers. This update creates a single, principles based framework for revenue recognition and is based on principles that govern the recognition of revenue at an amount an entity expects to be entitled when goods or services are transferred to customers. In August 2015, the FASB issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, deferring the effective date of this amendment for public companies by one year to January 1, 2018, with early adoption permitted as of the original effective date of January 1, 2017. The Company is currently evaluating the impact of adopting the new revenue standard on its consolidated financial statements and related disclosures.

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## Note 3. Stock-based Compensation

## Equity Incentive Plan

During the nine months ended September 30, 2015 and 2014, the Company granted annual Restricted Stock Awards (RSAs) of 61 and 60 shares, respectively, of common stock to officers and directors of the Company and 16 and 11 shares of RSAs were canceled during the nine months ended September 30, 2015 and September 30, 2014, respectively. The Company did not grant any shares of RSAs and 3 shares of RSAs were canceled during the three months ended September 30, 2015. The Company granted 2 shares of RSAs and no RSAs were canceled during the three months ended September 30, 2014. Employee RSAs granted in 2015 and 2014 vest over 36 months. Director RSAs generally vest at the end of 12 months. During the first nine months of 2015 and 2014, the RSAs granted were valued at \$24.29 and \$23.61 per share, respectively, based upon the fair market value of the Company's common stock on the date of grant.

During the nine months ended September 30, 2015 and 2014, the Company granted performance-based Restricted Stock Unit Awards (RSUs) of 39 shares and 37 shares of common stock, respectively, to officers. The Company did not grant any shares of RSUs during the three months ended September 30, 2015 and during the three months ended September 30, 2014. Each award reflects a target number of shares that may be issued to the award recipient. The 2015 and 2014 awards may be earned upon the completion of the three year performance period ending on March 3, 2018 and March 4, 2017, respectively. Whether RSUs are earned at the end of the performance period will be determined based on the achievement of certain performance objectives set by the Compensation & Organization Committee of the Board of Directors in connection with the issuance of the RSUs. The performance objectives are based on the Company's business plan covering the performance period. The performance objectives include achieving the budgeted return on equity, budgeted investment in utility plant, customer service standards, water quality standards, and safety standards. Depending on the results achieved during the three year performance period, the actual number of shares that a grant recipient receives at the end of the performance period may range from 0% to 200% of the target shares granted, provided that the grantee is continuously employed by the Company through the vesting date. If prior to the vesting date employment is terminated by reason of death, disability, or normal retirement, then a pro rata portion of this award will vest. RSUs are not included in diluted shares for financial reporting until authorized by the Compensation & Organization Committee of the Board of Directors. The 2015 and 2014 RSUs are recognized as expense ratably over the three year performance period using a fair market value of \$24.28 per share and \$23.61 per share, respectively, and an estimate of RSUs earned during the performance period.

The Company has recorded compensation costs for the RSAs and RSUs in administrative and general operating expenses in the amount of \$2.0 million and \$1.5 million for the nine months ended September 30, 2015 and September 30, 2014 respectively.

## Note 4. Equity

The Company's changes in total common stockholders' equity for the nine months ended September 30, 2015 were as follows:

	Total Common Stockholders' Equity
Balance at December 31, 2014	\$626,626
Common Stock Issued	1
Share-based compensation expense	1,732
Common stock dividends declared	(24,047)
Net income	36,540

Balance at September 30, 2015

\$640,852

Note 5. Net Income Per Share Calculations

The computations of basic and diluted net income per weighted average common share are noted below. Basic net income per share is computed by dividing the net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net income per share reflects the potential dilution that could occur if securities or other contracts were exercised or converted into common stock. RSAs are included in the weighted average

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common shares outstanding because the shares have all the same voting and dividend rights as issued and unrestricted common stock.

A total of 65 shares and 185 shares of Stock Appreciation Rights (SARs) were vested and outstanding and all were dilutive as of September 30, 2015 and September 30, 2014, respectively, as shown in the table below.

	Three Months Ended September 30	
	2015	2014
Net income available to common stockholders	\$25,120	\$33,650
Weighted average common shares outstanding, basic	47,878	47,803
Dilutive SARs (treasury method)	9	37
Weighted average common shares outstanding, dilutive	47,887	47,840
Net income per share - basic	\$0.52	\$0.70
Net income per share - diluted	\$0.52	\$0.70

  

	Nine Months Ended September 30	
	2015	2014
Net income available to common stockholders	\$36,540	\$45,344
Weighted average common shares outstanding, basic	47,861	47,787
Dilutive SARs (treasury method)	16	38
Weighted average common shares outstanding, dilutive	47,877	47,825
Net income per share - basic	\$0.76	\$0.95
Net income per share - diluted	\$0.76	\$0.95

Note 6. Pension Plan and Other Postretirement Benefits

The Company provides a qualified, defined-benefit, non-contributory pension plan for substantially all employees. The Company makes annual contributions to fund the amounts accrued for in the qualified pension plan. The Company also maintains an unfunded, non-qualified, supplemental executive retirement plan. The costs of the plans are charged to expense or are capitalized in utility plant as appropriate.

The Company offers medical, dental, vision, and life insurance benefits for retirees and their spouses and dependents. Participants are required to pay a premium, which offsets a portion of the cost.

Cash contributions by the Company related to pension plans were \$22.7 million and \$14.0 million for the nine months ended September 30, 2015 and September 30, 2014, respectively. Cash contributions by the Company related to other postretirement benefit plans were \$7.5 million and \$2.4 million for the nine months ended September 30, 2015 and September 30, 2014, respectively. The 2015 estimated cash contribution to the pension plans is \$31.2 million and to the other postretirement benefit plans is \$15.0 million.

The following table lists components of net periodic benefit costs for the pension plans and other postretirement benefits. The data listed under "pension plan" includes the qualified pension plan and the non-qualified supplemental executive retirement plan. The data listed under "other benefits" is for all other postretirement benefits.

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	Three Months Ended September 30			
	Pension Plan		Other Benefits	
	2015	2014	2015	2014
Service cost	\$4,715	\$3,539	\$3,043	\$1,398
Interest cost	5,072	4,737	2,101	1,321
Expected return on plan assets	(4,770)	(4,091)	(908)	(832)
Amortization of prior service cost	1,502	1,527	12	11
Recognized net actuarial loss	2,308	1,002	2,182	656
Net periodic benefit cost	\$8,827	\$6,714	\$6,430	\$2,554

	Nine Months Ended September 30			
	Pension Plan		Other Benefits	
	2015	2014	2015	2014
Service cost	\$15,980	\$11,973	\$8,044	\$4,637
Interest cost	15,078	14,190	5,328	3,995
Expected return on plan assets	(14,354)	(12,449)	(2,660)	(2,339)
Amortization of prior service cost	4,506	4,547	34	33
Recognized net actuarial loss	7,108	3,008	5,099	2,206
Net periodic benefit cost	\$28,318	\$21,269	\$15,845	\$8,532

## Note 7. Short-term and Long-term Borrowings

On March 10, 2015, the Company and Cal Water entered into Syndicated Credit Agreements, which provide for unsecured revolving credit facilities of up to an initial aggregate amount of \$450 million for a term of five years. The Syndicated Credit Facilities amend, expand, and replace the Company's and its subsidiaries' existing credit facilities originally entered into on June 29, 2011. The new credit facilities extended the terms until March 10, 2020, and increased the Company's unsecured revolving line of credit. The Company and subsidiaries that it designates may borrow up to \$150 million under the Company's revolving credit facility. Cal Water may borrow up to \$300 million under its revolving credit facility; however, all borrowings need to be repaid within twelve months unless otherwise authorized by the CPUC. The credit facilities may each be expanded by up to \$50 million subject to certain conditions. The proceeds from the revolving credit facilities may be used for working capital purposes, including the short-term financing of capital projects. The base loan rate may vary from LIBOR plus 72.5 basis points to LIBOR plus 95 basis points, depending on the Company's total capitalization ratio. Likewise, the unused commitment fee may vary from 8 basis points to 12.5 basis points based on the same ratio.

Both short-term unsecured credit agreements contain affirmative and negative covenants and events of default customary for credit facilities of this type including, among other things, limitations and prohibitions relating to additional indebtedness, liens, mergers, and asset sales. Also, these unsecured credit agreements contain financial covenants governing the Company and its subsidiaries' consolidated total capitalization ratio and interest coverage ratio.

The outstanding borrowings on the Company lines of credit were \$64.2 million and \$61.7 million as of September 30, 2015 and December 31, 2014, respectively. The outstanding borrowings on the Cal Water lines of credit were \$72.4 million and \$17.4 million as of September 30, 2015 and December 31, 2014, respectively. The average borrowing rate for borrowings on the Company and Cal Water lines of credit during the nine months ended September 30, 2015 was 1.05% compared to 1.16% for the same period last year.

## Note 8. Income Taxes



The Company accounts for income taxes using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Measurement of the deferred tax assets and liabilities is at enacted tax rates expected to be applied to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

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We anticipate that future rate actions by the commissions will reflect revenue requirements for the tax effects of temporary differences recognized, which have previously flowed through to customers. The commissions have granted the Company rate increases to reflect the normalization of the tax benefits of the federal accelerated methods and available Investment Tax Credits (ITCs) for all assets placed in service after 1980. ITCs are deferred and amortized over the lives of the related properties for book purposes.

During 2012, the Company filed an application for a change in tax accounting method with the Internal Revenue Service (IRS) regarding the classification of expenditures related to tangible property as deductible repairs and capitalizable improvements deductible over time as tax depreciation. In September 2013, the U.S. Department of the Treasury (U.S. Treasury) and the IRS issued the final regulations for repairs and maintenance deductions with an effective date of January 1, 2014. In August 2014, the U.S. Treasury and IRS issued the final regulations regarding dispositions of tangible property with an effective date of January 1, 2014. These tax regulations allow the Company to deduct a significant amount of costs to maintain its depreciable plant that were previously capitalized for tax purposes and continue to be capitalizable for book purposes. The Company implemented the final regulations on its 2014 tax return.

As of September 30, 2015 and December 31, 2014, the Company had unrecognized tax benefits of approximately \$8.5 million and \$7.9 million, respectively. Included in the balance of unrecognized tax benefits as of September 30, 2015 and December 31, 2014 is approximately \$1.8 million and \$1.6 million respectively of tax benefits that, if recognized, would result in an adjustment to the Company's effective tax rate. The Company does not expect its unrecognized tax benefits to change significantly within the next twelve months.

The State of California Franchise Tax Board is presently auditing the Company's 2008 through 2011 enterprise zone filings. The State of Hawaii Department of Taxation is presently auditing the Company's 2013 capital goods excise tax filing. It is uncertain when the state audits will be completed. The Company believes that the final resolution of the state audits will not have a material impact on its financial condition or results of operations.

#### Note 9. Regulatory Assets and Liabilities

Regulatory assets and liabilities were comprised of the following as of September 30, 2015 and December 31, 2014:

	September 30, 2015	December 31, 2014
Regulatory Assets		
Pension and retiree group health	\$244,514	\$245,008
Property-related temporary differences (tax benefits flowed through to ratepayers)	73,797	72,350
Other accrued benefits	29,356	32,959
Net WRAM and MCBA long-term accounts receivable	16,972	14,449
Asset retirement obligations, net	14,792	13,863
Interim rates long-term accounts receivable	5,694	10,627
Tank coating	7,264	—
Health care balancing account	4,445	1,075
Other regulatory assets	1,701	—
Total Regulatory Assets	\$398,535	\$390,331
Regulatory Liabilities		
Future tax benefits due ratepayers	\$26,620	\$26,114
Conservation program	4,686	2,669

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Pension balancing account	2,181	4,291
Other regulatory liabilities	2,640	3,373
Total Regulatory Liabilities	\$36,127	\$36,447

Short-term regulatory assets and liabilities are excluded from the above table. The short-term regulatory assets were \$38.1 million as of September 30, 2015 and \$53.2 million as of December 31, 2014. The short-term regulatory assets were primarily interim rate memorandum account receivable and net WRAM and MCBA accounts receivable as of September

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30, 2015 and December 31, 2014. The short-term portions of regulatory liabilities were \$1.9 million as of September 30, 2015 and \$6.1 million as of December 31, 2014. The short-term regulatory liabilities were primarily short term net WRAM payables as of September 30, 2015 and were primarily short term net WRAM payables and net refund balances to rate payers for the water conservation program from the 2009 General Rate Case (GRC) as of December 31, 2014.

### Note 10. Commitment and Contingencies

#### Commitments

The Company has significant commitments to lease certain office spaces and water systems and to purchase water from water wholesalers. These commitments are described in Form 10-K for the year ended December 31, 2014. As of September 30, 2015, there were no significant changes from December 31, 2014.

#### Contingencies

##### Groundwater Contamination

The Company has undertaken litigation against third parties to recover past and anticipated costs related to groundwater contamination in our service areas. The cost of litigation is expensed as incurred and any settlement is first offset against such costs. The CPUC's general policy requires all proceeds from groundwater contamination litigation to be used first to pay transactional expenses, then to make ratepayers whole for water treatment costs to comply with the CPUC's water quality standards. The CPUC allows for a risk-based consideration of contamination proceeds which exceed the costs of the remediation described above and may result in some sharing of proceeds with the shareholder, determined on a case by case basis. The CPUC has authorized various memorandum accounts that allow the Company to track significant litigation costs to request recovery of these costs in future filings and uses of proceeds to comply with CPUC's general policy.

## LEGAL PROCEEDINGS

From time to time, the Company has been named as a co-defendant in asbestos-related lawsuits. Several of these cases against the Company have been dismissed without prejudice. In other cases, Company's contractors and insurance policy carriers have settled the cases with no effect on the Company's financial statements. As such, the Company does not currently believe there is any potential loss that is probable to occur related to these matters and therefore no accrual has been recorded.

#### Other Legal Matters

From time to time, the Company is involved in various disputes and litigation matters that arise in the ordinary course of business. The status of each significant matter is reviewed and assessed for potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount of the range of loss can be estimated, a liability is accrued for the estimated loss in accordance with the accounting standards for contingencies. Legal proceedings are subject to uncertainties, and the outcomes are difficult to predict. Because of such uncertainties, accruals are based on the best information available at the time. While the outcome of these disputes and litigation matters cannot be predicted with any certainty, management does not believe when taking into account existing reserves the ultimate resolution of these matters will materially affect the Company's financial position, results of operations, or cash flows. The Company recognized a liability of \$4.1 million and \$3.2 million for known legal matters as of September 30, 2015 and December 31, 2014, respectively. The cost of litigation is expensed as incurred and any settlement is first offset against such costs. Any settlement in excess of the cost to litigate is accounted for on

a case by case basis, dependent on the nature of the settlement.

Note 11. Fair Value of Financial Assets and Liabilities

The accounting guidance for fair value measurements and disclosures provides a single definition of fair value and requires certain disclosures about assets and liabilities measured at fair value. A hierarchical framework for disclosing the observability of the inputs utilized in measuring assets and liabilities at fair value is established by this guidance. The three levels in the hierarchy are as follows:

Level 1 - Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. The types of assets and liabilities included in Level 1 are highly liquid and actively traded instruments with quoted prices.

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Level 2 - Pricing inputs are other than quoted prices inactive markets, but are either directly or indirectly observable as of the reporting date. The types of assets and liabilities included in Level 2 are typically either comparable to actively traded securities or contracts, or priced with discounted cash flow or option pricing models using highly observable inputs.

Level 3 - Significant inputs to pricing have little or no observability as of the reporting date. The types of assets and liabilities included in Level 3 are those valued with models requiring significant management judgment or estimation.

Specific valuation methods include the following:

Cash equivalents, restricted cash, accounts receivable and accounts payable carrying amounts approximated the fair value because of the short-term maturity of the instruments.

Long-term debt fair values were estimated using the published quoted market price, if available, or the discounted cash flow analysis, based on the current rates available using a risk-free rate (a U.S. Treasury securities yield curve) plus a risk premium of 1.19%.

Advances for construction fair values were estimated using broker quotes from companies that frequently purchase these investments.

September 30, 2015					
	Cost	Fair Value			
		Level 1	Level 2	Level 3	Total
Long-term debt, including current maturities	\$423,012	—	\$518,301	—	\$518,301
Advances for construction	180,805	—	73,305	—	73,305
Total	\$603,817	\$—	\$591,606	\$—	\$591,606

  

December 31, 2014					
	Cost	Fair Value			
		Level 1	Level 2	Level 3	Total
Long-term debt, including current maturities	\$425,840	\$—	\$534,068	\$—	\$534,068
Advances for construction	182,284	—	72,571	—	72,571
Total	\$608,124	—	\$606,639	\$—	\$606,639

#### Note 12. Subsequent Event

On October 13, 2015, Cal Water agreed to sell \$150.0 million in aggregate principal amount of first mortgage bonds in a private placement. Pursuant to the agreement, Cal Water sold \$100.0 million of the first mortgage bonds on October 13, 2015, consisting of \$50.0 million of 3.33% series QQQ maturing October 15, 2025 and \$50.0 million of 4.31% series RRR maturing October 16, 2045. Cash proceeds of approximately \$99.4 million, net of \$0.6 million debt issuance costs, were received. Cal Water used a portion of the net proceeds from the offering to repay outstanding borrowings on the Cal Water line of credit of \$72.4 million. The sale of the remaining \$50.0 million of the first mortgage bonds, consisting of \$40.0 million of 4.41% series SSS maturing April 15, 2046 and \$10.0 million of 4.61% series TTT maturing October 15, 2025, is scheduled to close on March 11, 2016, subject to customary closing conditions.

#### Note 13. Condensed Consolidating Financial Statements

On April 17, 2009, Cal Water issued \$100 million aggregate principal amount of 5.875% First Mortgage Bonds due 2019, and on November 17, 2010, Cal Water issued \$100 million aggregate principal amount of 5.500% First Mortgage Bonds due 2040, all of which are fully and unconditionally guaranteed by the Company. As a result of these guarantee arrangements, the Company is required to present the following condensed consolidating financial information. The investments in affiliates are accounted for and presented using the “equity method” of accounting.

The following tables present the condensed consolidating balance sheets as of September 30, 2015 and December 31, 2014, the condensed consolidating statements of income for the three months ended September 30, 2015 and 2014, condensed consolidating statements of income for the nine months ended September 30, 2015 and 2014, and the

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condensed consolidating statements of cash flows for the nine months ended September 30, 2015 and 2014 of (i) California Water Service Group, the guarantor of the first mortgage bonds and the parent company; (ii) California Water Service Company, the issuer of the first mortgage bonds and a 100% owned consolidated subsidiary of California Water Service Group; and (iii) the other 100% owned non-guarantor consolidated subsidiaries of California Water Service Group.



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CONDENSED CONSOLIDATING BALANCE SHEET

As of September 30, 2015

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
<b>ASSETS</b>					
Utility plant:					
Utility plant	\$ 1,318	\$ 2,268,876	\$ 197,832	\$ (7,197 )	\$ 2,460,829
Less accumulated depreciation and amortization	(548 )	( 751,913 )	( 46,601 )	1,798	( 797,264 )
Net utility plant	770	1,516,963	151,231	( 5,399 )	1,663,565
Current assets:					
Cash and cash equivalents	5,523	43,359	1,943	—	50,825
Receivables and unbilled revenue, net	13	120,790	4,528	—	125,331
Receivables from affiliates	23,161	690	195	( 24,046 )	—
Other current assets	182	13,517	1,211	—	14,910
Total current assets	28,879	178,356	7,877	( 24,046 )	191,066
Other assets:					
Regulatory assets	—	395,079	3,456	—	398,535
Investments in affiliates	651,120	—	—	( 651,120 )	—
Long-term affiliate notes receivable	24,452	—	—	( 24,452 )	—
Other assets	806	48,803	4,628	( 883 )	53,354
Total other assets	676,378	443,882	8,084	( 676,455 )	451,889
	\$ 706,027	\$ 2,139,201	\$ 167,192	\$ ( 705,900 )	\$ 2,306,520
<b>CAPITALIZATION AND LIABILITIES</b>					
Capitalization:					
Common stockholders' equity	\$ 640,852	\$ 581,135	\$ 75,367	\$ ( 656,502 )	\$ 640,852
Affiliate long-term debt	—	—	24,452	( 24,452 )	—
Long-term debt, less current maturities	—	415,375	1,072	—	416,447
Total capitalization	640,852	996,510	100,891	( 680,954 )	1,057,299
Current liabilities:					
Current maturities of long-term debt	—	6,201	364	—	6,565
Short-term borrowings	64,215	72,400	—	—	136,615
Payables to affiliates	—	3,235	20,811	( 24,046 )	—
Accounts payable	—	74,277	2,984	—	77,261
Accrued expenses and other liabilities	64	75,231	5,034	—	80,329
Total current liabilities	64,279	231,344	29,193	( 24,046 )	300,770
Unamortized investment tax credits	—	1,947	—	—	1,947
Deferred income taxes, net	896	236,447	—	( 900 )	236,443
Pension and postretirement benefits other than pensions	—	276,525	—	—	276,525
Regulatory liabilities and other	—	73,911	2,888	—	76,799
Advances for construction	—	180,297	508	—	180,805
Contributions in aid of construction	—	142,220	33,712	—	175,932
	\$ 706,027	\$ 2,139,201	\$ 167,192	\$ ( 705,900 )	\$ 2,306,520



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CONDENSED CONSOLIDATING BALANCE SHEET

As of December 31, 2014

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
<b>ASSETS</b>					
Utility plant:					
Utility plant	\$1,318	\$2,154,146	\$194,204	\$ (7,197 )	\$2,342,471
Less accumulated depreciation and amortization	(377 )	(710,840 )	(42,545 )	1,722	(752,040 )
Net utility plant	941	1,443,306	151,659	(5,475 )	1,590,431
Current assets:					
Cash and cash equivalents	4,108	13,929	1,550	—	19,587
Receivables	—	108,815	9,114	(1,051 )	116,878
Receivables from affiliates	20,001	3,608	—	(23,609 )	—
Other current assets	—	16,443	1,216	—	17,659
Total current assets	24,109	142,795	11,880	(24,660 )	154,124
Other assets:					
Regulatory assets	—	387,387	2,944	—	390,331
Investments in affiliates	637,998	—	—	(637,998 )	—
Long-term affiliate notes receivable	25,263	—	—	(25,263 )	—
Other assets	891	47,617			