



BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

FILED

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In the matter of the application of:
Alco Water Service, (U-206), (Alco) a
California Corporation, for an order
1) authorizing it to increase rates for
water service by \$3,709,633 or 62.6% in
test year 2010, 2) authorizing it to
increase rates on July 1, 2011 by
\$1,752,844 or 18.2% and July 1, 2012 by
\$1,016,639 or 8.9% in accordance with
Decision 08-11-035, and 3) adopting other
related rulings and relief necessary to
implement the Commission's ratemaking
policies.

A.10-02-006
(Filed February 1, 2010)

**REPLY COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES
TO THE COMMENTS OF ALCO WATER SERVICES
AND CALIFORNIA WATER ASSOCIATION
ON THE PROPOSED DECISION OF ADMINISTRATIVE LAW JUDGE LONG**

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I. INTRODUCTION

Pursuant to Rule 14.3 of the Commission's Rules of Practice and Procedure, the Division of Ratepayer Advocates ("DRA") respectfully submits its reply comments to Alco Water Service's ("Alco") and California Water Association's ("CWA") comments on the Proposed Decision of Administrative Law Judge Long. DRA will not reargue issues in its reply comments that it has previously addressed, but pursuant to Rule 14.3(d) it will respond to Alco's misrepresentations of fact, law, or condition on the record. Accordingly, these reply comments focus on the improper specific modifications to the Proposed Decision suggested by Alco and CWA. DRA urges the Commission to reject Alco's and CWA's modifications and recommends that the Commission adopt all of DRA's modification to the Proposed Decision ("PD").

II. FAMILY TRANSACTIONS

A. **Alco's and CWA's claim that no evidentiary record supports a ban on certain types of transactions between Alco and members of the Adcock family is false.**

It appears that CWA did not review the record in this proceeding prior to making its claim that "[n]o party to the Alco GRC appears to have raised any issue as to the propriety of [Adcock] family transactions."¹ As shown by the record, this statement is false. In its report, DRA not only stated that Alco's valuation of equipment and vehicles purchased from Mr. Tom Adcock (president of Alco) and from G&L Leasing, a company owned by Mrs. Adcock (mother of Tom Adcock and principal owner of Alco), was unjustified and unreasonable, but also unambiguously stated that these transactions are an example of self-dealing, as opposed to an arms-length negotiated transaction.² In addition, in its opening and reply briefs, DRA strongly questioned the propriety of these intra-family transactions because Alco purchased some of the equipment and vehicles as recently as December 2009, but nonetheless requested to replace several of these goods in this general rate case ("GRC").³

Moreover, Alco's claim that "there is no adequate basis in the record for the PD's imposition of a ban"⁴ of financial transactions between Alco and Alco's owners (the Adcock family) is a misrepresentation of the factual background and condition on the record. It is undisputed that the majority of the equipment and vehicles that the Adcock family sold to Alco have a net book value of zero (\$0) dollars.⁵ Furthermore, it is undisputed that historically the Adcock family had Alco's ratepayers paying rent charges on the same equipment and vehicles.⁶ Now, Alco requests that its ratepayers shoulder an inflated value on the residual use of equipment and vehicles which, in most cases, are very old and have outlived their usefulness.⁷ Based on the above facts, DRA opposed Alco's inflated valuation and its concurrent request to purchase new equipment and vehicles to replace several of the same types of equipment and vehicles that the Adcock family had recently sold to Alco. Given that DRA highlighted the impropriety of these family transactions in its report and throughout this proceeding, Alco cannot now claim that it did not have an opportunity to present evidence on its so-called safeguards for protecting the utility and its ratepayers.

¹ CWA's Comments, p. 4.

² Ex. D-1, p. 14-4.

³ DRA's Opening Brief, p. 32; DRA's Rely Brief, pp. 18-19, 21, 23.

⁴ Alco's Comments, p. 4.

⁵ Ex. D-1, pp. 14-4 – 14-8.

⁶ Ex. A-3, Schedule 10, p. 2.

⁷ For example, Alco purchased a 1967 truck from Mr. Adcock. Also Alco purchased three 1965 trucks, one 1969 truck, and equipment dated back to 1951 from Mrs. Adcock. Ex. D-1, p. 14-6 and 14-8. In addition, Alco seeks to add \$65,130 in rate base for three Backhoe Loaders it acquired from Mr. Tom Adcock in December 2009 while it also requests to replace two of these Backhoe Loaders at a cost of \$200,800 in this GRC. Ex. D-1, p. 14-6; Ex. A-3, Schedule 26A, p.4.

B. Alco's and CWA's claim that the Commission cannot impose more restrictive rules on certain types of transactions between Alco and members of the Adcock family is wrong.

Alco claims that the Commission cannot prohibit transactions between Adcock family members and Alco because the prohibition adopted by the PD has no basis in Commission precedent and did not arise from a rulemaking process.⁸ However, Alco's and CWA's claim that there is no precedent for establishing more restrictive rules on Alco is incorrect. Pursuant to the § 701 of the Public Utilities Code, the Commission "may do all things"... "which are necessary and convenient in the exercise" of its power to supervise and regulate every public utility in the state of California. The PD found that the Affiliate Transaction Rules recently adopted in D.10-10-019 "primarily focus on inter-company transactions where those companies are financially related," but "do not sufficiently address transactions involving the utility and the owners and/or senior employees where there is little or no structural separation as occurs with Alco."⁹ Because Alco has no internal controls to preclude self-dealing in the transfer of goods and services from the Adcock family (or Alco's owners) to Alco, the PD properly concluded that a ban on family transactions would reduce the opportunity for abuse of the ratemaking process.¹⁰ As mentioned above, the Commission has the power to do all things necessary and convenient to regulate public utilities and, in this particular case, the PD exercises this power by imposing an additional rule on Alco to protect the utility and its ratepayers.

Moreover, and contrary to Alco's and CWA's contentions, the Commission need not re-open a rulemaking proceeding to impose more restrictive rules on certain types of transactions between Alco and members of the Adcock family.¹¹ CWA has overreacted and misread the intention of the PD by claiming that the Commission would be broadening the scope of the recently adopted Affiliate Transaction Rules by adopting the ban included in the PD.¹² However, despite this overreaction, Alco and CWA are well aware that the PD's Ordering Paragraph states that this ban only applies to Alco. Therefore, given that the PD's Ordering Paragraph 9 unambiguously states that Alco (and only Alco) is to cease such transactions, there is absolutely no need for a rulemaking process to impose this order on Alco.

C. Alco's claim that the Adcock family transaction ban could prove detrimental to Alco and its ratepayers has no basis in fact.

Alco claims that the PD "bar[s] an ownership family from purchasing equity in, or making market-rate loans to, the water utility that it owns" and claims that this rule could prove detrimental to Alco and its ratepayers.¹³ However, this claim has no basis in fact and misrepresents the PD's intention. Pursuant to §§ 816-830 of the Public Utilities Code, Alco cannot issue long-term debt or equity without specific authority from the Commission. Thus, under existing Code provisions, if Alco wants to issue equity to or receive a loan from members of the Adcock family, it would have to file an application for authority to do so. Moreover, contrary to Alco's contention, nothing in the PD undoes or restricts prior transactions approved by the Commission, such as the transaction allowed in D.08-11-035, which granted Alco authority to issue debt and equity. Accordingly, Alco has not shown how the PD's order will be costly to Alco and its ratepayers. Based on the above, the Commission should disregard Alco's and CWA's request to reject the PD's ban on transactions between Alco and the Adcock family and their requests to modify Finding of Fact 22, Conclusion of Law 12, and Ordering Paragraph 9. Instead, the Commission should adopt the modifications proposed by DRA and include more specific language that would clarify that such transactions are only intended to cease the purchase of goods and services owned by members of the Adcock family.

⁸ Alco's Comments, p. 5.

⁹ PD, p. 22

¹⁰ *Id.*, at 22-23.

¹¹ See Alco's Comments, p. 5; see also CWA's Comments, p. 3.

¹² See *id.*

¹³ Alco's Comments, pp. 5-6.

III. COST OF CAPITAL

A. **Alco's comments regarding the PD's calculations of cost of long term debt misrepresents Commission practice and precedent.**

According to Alco, the PD incorrectly calculated the cost of long-term debt ("LTD") in a manner that is inconsistent with the Water Division's Standard Practice [SP] U-3-SM". However, Alco misrepresents the purpose of the standard practices.¹⁴ Alco fails to recognize that the Commission and its staff have discretion to deviate from standard practices when necessary. SP U-3-M unambiguously states that "the purpose of this standard practice is to provide guidance to engineers and [] analysts in the preparation of [] reports or resolutions."¹⁵ Although SP U-3-M suggests that the "actual cost of debt" be used in determining the rate of return, it is irresponsible to strictly apply this approach when Alco forecasts to issue new debt during its rate cycle. Therefore, PD correctly states that [the Commission's] "task is to determine "reasonable" debt rather than actual cost based on an arbitrary selection of a past figure."¹⁶ This principle is recognized in SP U-3-SM which states that "[t]he revenues are calculated for a future test year under the anticipated operating conditions;" consequently, "the components that make up the rates are estimates."¹⁷ The rate of return is a component for determining the total revenue requirement for a water utility which is based on forward looking estimates, including LTD.

Alco also argues that the proposed 8.0% cost of LTD for Alco ignores the Commission's adoption of 8.38% cost of LTD for two Class A water utilities and adoption of California American Water's ("Cal Am") \$35,000,000 loan at a cost of 10%.¹⁸ However, Alco fails to recognize two key facts. First, the 8.38% average cost of LTD was based on the interest rate forecasts these utilities submitted with the Class A cost of capital applications in May 2008 and 2009. The data used in determining the cost of debt in those cases is already outdated and should not be relied as a guide in setting the cost of LTD, as suggested by Alco. The PD appropriately relies on the current information available during this proceeding and uses the 10-Year U.S. Treasury Note and bond yields to set the appropriate cost of debt for Alco at 8.0%. Second, Alco also fails to note that the 10% cost of debt recognized for Cal Am was strictly for new debt issued at the peak of the financial crisis in November 2009.¹⁹ DRA submits that it is inappropriate to compare this rate to the rates available now that the financial markets have stabilized and recovered.

DRA recognizes that the Commission considers the embedded cost of existing debt plus the cost of any new debt issued to determine the weighted average cost of LTD on a prospective basis. If the Commission considers any readjustment to Alco's cost of LTD based on Appendix B of Alco's comments, the Commission should exclude the additional interest of the 4M Development loan and cost of issuance of the Allstate loan when recalculating the weighted average LTD.²⁰ The Commission should also order Alco to refinance the 4M Development loan at a more favorable interest rate and terms. With the current level of financial rates, the 4M Development loan is unreasonable particularly since it contains a built in escalating interest rate adder. Based on Alco's Appendix B, the rate paid on this loan increases every year from 12.03% in 2009 to 14.52% in 2012.²¹ DRA submits that ratepayers should not be required to pay for this high cost of debt when loan interest rates are at an all time low.

B. **Alco's critique of the PD's return on equity determination is flawed.**

Alco states that Commission should adopt an 11.3% return on equity ("ROE") for Alco because the Commission recently adopted an 11.3% ROE for another Class B water utility, Fruitridge Vista Water Company.²² However, as explained above and

¹⁴ Alco's Comment, pp. 6-7.

¹⁵ SP U-3-SM, Section A, p. 2.

¹⁶ PD, p. 34.

¹⁷ SP U-3-SM, Section C.12.(C), p. 4.

¹⁸ Alco's Comment, p. 8.

¹⁹ See DRA's Reply Brief, pp. 38-39.

²⁰ See DRA's Opening Brief, p. 40-41.

²¹ Alco's Comments, Appendix B, p. 6.

²² Alco's Comments, p. 9.

contrary to Alco's contention, the Commission has discretion to deviate from standard practices to develop a return on equity for Alco. Neither Alco nor DRA know what facts the Division of Water and Audits considered in determining the 11.3% ROE for Fruitridge. DRA also notes that Fruitridge is much smaller than Alco and has a much lower long-term cost of debt and thus a lower overall cost of capital. DRA submits that the Commission should not adopt the high ROE that Alco requests given that Alco maintains a highly leveraged capital structure by choice -- a structure that it has complete control over. Therefore, the Commission should maintain the PD's ROE of 10.70%.

IV. INDEPENDENT AUDIT

While DRA agrees with Alco's assertions that it is annually audited by an independent certified public accounting firm, it believes that Alco must demonstrate how it engaged its current Certified Public Accountant and how it meets the PD's requirements, including providing the scope of the audit engagement, a copy of the engagement letter, and the cost of the audit engagement. Furthermore, since Alco provided its audited financial statements to DRA as a result of an informal data request, these statements were not formally filed with the Commission or its Division of Water and Audits.²³ Therefore, the Commission should require Alco to annually file its audited financial statements and the attested opinion of the Certified Public Accountant to DWA. DRA does not oppose allowing Alco to complete and submit the audit within 150 days of the fiscal year-end, as requested by Alco. Last, DRA notes that the PD should eliminate Ordering Paragraphs 14 and 15 which allow Alco to establish a Certified Public Audit Cost Memorandum account to recover reasonable costs recorded in this account. As recognized by Alco, the cost (\$28,000 per year) associated with its "Audited Financial Statement Preparation" is already included in rates in this GRC.²⁴

V. ALCO'S ALLEGED TECHNICAL ERRORS IN THE PD

A. The 2009 beginning balance for Plant in Service should be \$28,204,526 and not Alco's alleged amount.

Alco claims that the PD has a technical error because the "[P]arties agreed to a year-end 2008 (2009 beginning balance) Plant in Service of \$28,427,500," but the PD's work papers show a 2009 beginning balance for Plant in Service of \$28,204,526.²⁵ The \$222,974 difference is attributed to expenses associated with the construction of the Verona well, which Alco insists on including in rate base in this GRC, even though the well is still not used and useful. DRA submits that this is not a technical error and Alco's 2009 beginning balance for Plant in Service does not need to be corrected or changed for the following reasons. First, the number that Alco states the "Parties agreed to" refers to the audit DRA conducted on Alco's Plant in Service account at year-end 2008. DRA simply agreed to this number for purposes of the audit, but the beginning balance for Plant in Service in 2009 should be lower (\$28,204,526) because DRA did not and does not recommend the inclusion of construction costs for the Verona well (or any other proposed well) in rate base at this time. Second, the Plant in Service amount in the PD's work paper is not incorrect because the PD only authorizes Alco to recover the construction costs associated with the Verona well through an Advice Letter, only if and when the well is constructed and operational.²⁶ As explained below, since none of Alco's proposed new wells are completed and operational, the associated costs should not be recovered in rate base or as construction work in progress.

B. The PD should only allow \$300,000 for the new pump for energy efficiency upgrades and not the \$600,000 Alco requests.

While DRA does not oppose Alco's request that Ordering Paragraph 3 authorize it to file a Tier 2 rate base offset for the efficiency pump upgrade, it strongly opposes Alco's deceptive attempt to have the Commission authorize it to recover up to \$300,000 in 2010 and \$300,000 in 2012 for the energy efficiency pumps.²⁷ Alco is well aware that this PD only approved one of the two energy

²³ Alco's Comments, p. 11.

²⁴ *Id.*; see also Ex. A-3, Schedule 18, p. 2.

²⁵ Alco's Comments, p. 12.

²⁶ PD, p. 48 (Ordering Paragraph 1).

²⁷ See Alco's Comments, p. 13 (footnote 79) and Appendix A, p. 3.

efficiency pumps it requested in this GRC.²⁸ As shown in DRA's report (Exhibit D-1), Alco requested \$300,000 for energy efficiency pump upgrades to the Santana well station in 2010 and another \$300,000 for energy efficiency pump upgrades to the Kilbreth well station in 2012.²⁹ Therefore, the Commission should reject Alco's attempt to modify the PD to authorize the \$600,000 for two new pumps and instead authorize Alco to recover \$300,000 for only one energy efficiency pump.

C. The Commission should not make any of the adjustments to CWIP that Alco requests.

Alco claims that the Commission must reinstate the amount that Alco included in Construction Work in Progress ("CWIP") for consistency with the PD's authorization of the wells approved in this GRC.³⁰ However, Alco should not be allowed to book CWIP costs for these wells because the PD authorizes Alco to recover construction costs for these well after it files a Tier 2 Advice Letter, but only if and when a well has been constructed and has become operational.³¹ Alco misrepresents the Commission policy of allowing water utilities to be compensated for funds used during construction.³² Although the Commission has a policy allowing water utilities to be compensated for use of funds during construction by including CWIP in rate base, CWIP is intended for projects to be completed within a short cycle (1 to 2 years) and is not intended for projects with no definite completion date. For projects with uncertain completion dates, such as Alco's proposed wells, DRA recommends (and the PD requires) that Alco recover costs through the Advice Letter process. Otherwise, Alco would be allowed to include CWIP in rate base and earn a rate on return while the wells remain incomplete and inoperable.

If the Commission allows Alco to include CWIP for the proposed wells in rate base, it will be removing the incentive for Alco to have these wells in operation and be used and useful as soon as possible since it would already be earning a rate of return on the wells. DRA submits that this is a matter of enormous concern given that in its February 2010 GRC application Alco reported that the Verona well had been completed and in service.³³ However, later Alco disclosed that the Verona well would not be placed in service until May 1, 2010.³⁴ More troubling is the fact that as of January 2011, almost a year after Alco's initial claim that the Verona well was in service, this well still has not produced one drop of water for Alco's ratepayers. If Alco had been allowed CWIP treatment for this well, ratepayers would have been paying a return on over \$900,000 for more than a year before the well was used and useful.

Alco's Bardin well is another example of Alco's troubling pattern of underestimating the amount of time it will need to complete projects. In its February 2010 response to a DRA data request, Alco claimed that it planned to have the Bardin well drilled and placed in service by 2010.³⁵ However, that has not happened. Moreover, during its field inspection, DRA staff observed that, although drilled, the Bardin well was still an undeveloped, unfenced dirt lot with a hole in the ground. For this reason, DRA strongly recommends that the Commission reject Alco's request to reinstate the amount it included in CWIP for its proposed new wells.

VI. CONCLUSION

DRA urges the Commission to reject Alco's and CWA's modifications to the PD discussed herein, and adopt DRA's modifications to the PD.

²⁸ PD, p. 48 (Ordering Paragraph 3).

²⁹ Ex. D-1, pp. 17-36, 17-46 – 17-52.

³⁰ Alco's Comments, p. 14.

³¹ PD, at 48 (Ordering Paragraph 1).

³² See Alco's Comments, p. 14.

³³ See Ex. A-3, Schedule 26A, pp. 9-10 (Alco added Verona well CWIP to Plant in Service balance for 2009); see also Ex. A-1, p. 3.

³⁴ Ex. D-5 (Alco's response to DRA's Data Request PPM-02, question 2).

³⁵ Ex. D-5 (Alco's response to DRA's Data Request PPM-02, question 3).

Respectfully submitted,

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January 24, 2011

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of **REPLY COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES TO THE COMMENTS OF ALCO WATER SERVICES AND CALIFORNIA WATER ASSOCIATION ON THE PROPOSED DECISION OF ADMINISTRATIVE LAW JUDGE LONG** to the official service list in **A.10-02-006** by using the following service:

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Executed on **January 24, 2011** at San Francisco, California.

/s/ CHARLENE D. LUNDY

Charlene D. Lundy

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