



**BEFORE THE PUBLIC UTILITIES COMMISSION OF
STATE OF CALIFORNIA**

FILED

09-29-11
04:59 PM

In the Matter of the Application of Apple Valley Ranchos Water Company (U 346 W) for Authority to Increase Rates Charged for Water Service by \$3,896,586 or 20% in 2012; \$547,241 or 2.35% in 2013; and \$786,254 or 3.32% in 2014.

A. 11-01-001
(Filed January 3, 2011)

**OPENING BRIEF
OF THE DIVISION OF RATEPAYER ADVOCATES**

ALLISON BROWN

Attorney for the
Division of Ratepayer Advocates
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102
Phone: (415) 703-5462
Fax: (415) 703-2262

September 29, 2011

TABLE OF CONTENTS

I.	INTRODUCTION.....	1
II.	BACKGROUND	1
III.	DISPUTED ITEMS.....	2
	A. PAYROLL – NEW EMPLOYEES	2
	B. PAYROLL – MERIT INCREASE.....	5
	C. PAYROLL – BONUS.....	6
	D. EMPLOYEE BENEFITS – MEDICAL AND DENTAL INSURANCE	6
	E. EMPLOYEE BENEFITS – 401(K)	8
	F. EMPLOYEE BENEFITS – GROUP PENSION	9
	G. EMPLOYEE BENEFITS – EAP/WELLNESS	11
	H. REGULATORY ACCOUNTS – GROUP PENSION BALANCING ACCOUNT	11
	I. REGULATORY ACCOUNTS – PRESSURE REDUCING VALVE MEMORANDUM ACCOUNT.....	14
	J. ESCALATION YEAR METHODOLOGY – EMPLOYEE AND RETIREE HEALTHCARE.....	18
	K. OFFICE EXPANSION.....	18
	L. CARLYLE TRANSACTION CONTINGENCY	21
IV.	CONCLUSION	22

TABLE OF AUTHORITIES

Commission Decisions

D.10-12-017.....	12
D.10-11-035.....	12
D.10-06-038.....	12
D.07-05-062.....	18

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

In the Matter of the Application of Apple Valley Ranchos Water Company (U 346 W) for Authority to Increase Rates Charged for Water Service by \$3,896,586 or 20% in 2012; \$547,241 or 2.35% in 2013; and \$786,254 or 3.32% in 2014.

A. 11-01-001
(Filed January 3, 2011)

**OPENING BRIEF OF THE DIVISION OF RATEPAYER
ADVOCATES**

I. INTRODUCTION

Pursuant to Rule 13.11 of the California Public Utilities Commission’s (“Commission”) Rules of Practice and Procedure (“Rules”) and the schedule established by Administrative Law Judge (“ALJ”) Douglas Long, the Division of Ratepayer Advocates (“DRA”) hereby files its Opening Brief in Application (“A”) 11-01-001, Apple Valley Ranchos Water Company’s (“AVR”) request for authority to increase rates charged for water service.

II. BACKGROUND

On January 3, 2011, AVR filed a general rate case application to increase its rates by \$3,896,586 or 20% in 2012, \$547,241 or 2.35% in 2013; and \$786,254 or 3.32% in 2014. DRA filed a timely protest, as did the Town of Apple Valley. The Apple Valley School District was also granted party status. A Prehearing Conference was held on March 1, 2011, and a scoping memo was issued on March 21, 2011. On May 10, 2011, DRA served its testimony and Report on the Results of Operations (“DRA Report”) and the Town served its testimony of May 17. The school district did not serve testimony. On

May 27, 2011, AVR served its reply. This application was reassigned to ALJ Long on June 10, 2011.

The Parties engaged in Alternative Dispute Resolution beginning on June 8, 2011. As a result of those discussions, DRA and AVR reached a settlement on the majority of the issues raised in DRA's report. While the Town and the School District participated in the settlement discussions, neither party signed on to the settlement. On September 15, 2011, AVR and DRA filed the partial settlement and accompanying motion.

Evidentiary hearings on the unresolved issues were held on June 20 through June 22. Neither the Town nor the School District attended the evidentiary hearings.

This brief will only address the unresolved issues in this proceeding. All of the unresolved requests contained in AVR's application, listed and discussed below, should be denied. AVR has the burden of justifying any request for a rate increase as reasonable and prudent, and, for each of the issues discussed below AVR has not met that burden.

III. DISPUTED ITEMS

A. Payroll – New Employees

AVR has failed to justify all requested additions to payroll except for the Customer Service Representative and the Assistant General Manager.

In this general rate case ("GRC"), AVR is seeking to augment its payroll with four new positions. The four new positions are: (1) Customer Service Representative; (2) Water Audit Conservation Specialist; (3) Asset Management Project Coordinator; and (4) Water Quality Control Specialist.¹ In addition, AVR seeks approval of a new Assistant General Manager ("AGM"), but AVR does not consider this to be a new position because it is the result of reorganization or promotion and does not result in an addition to its employee count. However, AVR's request for an AGM-- even if it results from promotion or reorganization-- would increase its revenue requirement by over \$100,000

¹ Exhibit AVR-1, p. 29.

(over \$65,000 of salary plus benefits of 60%).² Therefore, it is more accurately described as a new position request than as simply one that results from promotion or reorganization.

As explained in Chapter 4 of DRA's Report on AVR's Payroll, DRA recommends the Commission approve two of AVR's requested positions in 2011: (1) the new Customer Service Representative ("CSR"), which results from a temporary employee becoming permanent; and (2) the new Assistant General Manager. The Commission should deny AVR's remaining requests for new positions as those requests are not justified.

AVR Failed to Justify its Other Requested Positions

AVR's request for a Water Quality Control Specialist is unsupported. During evidentiary hearings, AVR testified that many of the duties of the requested Water Quality Control Specialist, including water sampling and compliance with federal and state water regulations, are already being performed.³ Further, AVR testified that, to the best of their knowledge, the company has never failed to comply with water regulations.⁴ AVR argues that a new water quality control specialist position is needed to "free up the supervisor's time"⁵ but AVR offered no evidence that the supervisor's other duties are not currently being met, and AVR offered no other justification for this position. AVR's request for a Water Quality Control Specialist is not substantiated by the record and should be denied.

AVR failed to justify its request for an Asset Management Project Coordinator. The existing Asset Manager Supervisor, a new position resulting from reorganization or a promotion that occurred in March 2009, already possesses the skills to do this job.⁶

² Exhibit DRA-1, p. 4-1, footnote 61.

³ Transcript, V.3 at 243:12- 235:5; 237:15- 238:12.

⁴ *Id.* at 236:7-19.

⁵ *Id.* at 237:3-14,

⁶ *Id.* at 239.

Additionally, AVR testified that if the Commission were to deny the company's request to add this position, the company could fill that position with existing staff, its existing personnel practice.⁷ AVR has not demonstrated that its request to create an Asset Management Project Coordinator position is reasonable or prudent, and therefore this request should be denied.

AVR's justification for a Water Audit Conservation Specialist is inadequate. AVR water audits are presently being performed by meter readers. However, while AVR is requesting funding for an additional position for a function that is already being performed by existing employees, AVR admitted during hearings that the company did not reduce payroll for those meter readers currently performing water audits. AVR asserts that having meter readers perform water audits creates backlogs; however this claim is unsubstantiated by the record⁸. AVR's Meter Readers already possess the expertise specific to this position and currently perform the water audits. AVR's request for a Water Audit Conservation Specialist is unsupported and should be denied.

The Commission should deny AVR's three remaining requested positions because the functions of these new positions are specializations of ongoing activities that are already being performed by AVR's existing employees. AVR has not demonstrated that these positions are necessary or would confer any identifiable benefit. DRA already reflects these costs in Test Year 2012 Payroll expenditures because it uses AVR's historical 2010 payroll data to forecast AVR's Test Year 2012 payroll revenue requirement, and the duties to be performed by the new requested positions are already being performed by existing staff who are being paid to perform those duties. The historical data reflect the costs of these ongoing activities, including employees' training and development. Notably, DRA's recommended Test Year 2012 payroll includes \$32,439 for one of AVR's requested "new positions", the Asset Management Project Coordinator, whose position AVR filled with two temporary employees in Base Year

⁷ *Id.* at 240:15-19

⁸ Transcript V. 3, 233:4-18

2010.² DRA's Test Year 2012 payroll estimate also includes the cost of all other temporary employees that AVR itself does not include in its Test Year 2012 requests. AVR does not need to add the costs of three new positions to reach a reasonable level of test year revenue requirements.

The remaining differences between AVR and DRA's Test Year 2012 payroll expense estimates are due to the following: (1) differences in escalation factors; and (2) AVR's inclusion of forecasted merit pay raises, which DRA does not include in its forecasts due to AVR's payment of these to all, or almost all, of its employees.

B. Payroll – Merit Increase

The Commission should reject AVR's request for "merit raises" because the request has not been justified, and because the Commission authorized a similar merit raise in the last GRC that was never dispensed to employees. In its revenue requirement calculations, AVR included 2.0% annual "merit raises"¹⁰, for each year 2011 and 2012, which DRA does not include in its forecasts due to AVR's payment of these to all, or almost all of its employees. AVR portrays these requested merit pay increases in its workpapers as being granted to all operating service area employees on April 1st of each year. However, AVR requested (and the Commission approved) a similar merit increase in AVR's last GRC and AVR subsequently failed to grant its employees any merit raises in that year. Thus AVR overstated its revenue requirement in the last GRC for Test Year 2009 by the amount that the Commission included in AVR's authorized revenue requirement calculations for these unpaid "merit" pay increases. The Commission should reject AVR's same request for Test Year 2012 to avoid the clear risk of making the same

² Late-Filed Exhibit DRA- 12, 2010 Recorded Payroll, Temporary Employees, positions labeled "Fixed Assets."

¹⁰ Although AVR characterizes its requested pay increase as a "merit raise, as explained further below, this pay increase does not appear to be strictly based upon merit. When AVR grants a merit raise, it automatically gives it annually to all, or almost all of its employees in April of each year. Accordingly, it is more in the nature of an additional cost of living, or non-specific pay increase that is generally unrelated to employees' performance. AVR's payment of such automatic Wages and Salaries increases might be unjustified in the current labor market if AVR is paying more in total compensation, including benefits, than is necessary for it to attract and maintain qualified workers. (DRA's Report, p. 4-3.

overstatement error. Even if AVR does grant these pay increases in 2012, approval of AVR's requested merit increases will increase AVR rates above what is necessary for AVR to recover its reasonable costs of service. Given the modest level of inflation in the overall economy and the high rate of unemployment AVR has not justified paying these raises. ¹¹ It should be noted that the purpose of an employer's compensation program is to retain and motivate employees to continue to work for a given employer. AVR has not presented any information in its application that indicates it is facing challenges in either finding new or retaining its existing employees given its existing salary structure.

C. Payroll – Bonus

The Commission should reject AVR's request for a 400% increase in bonuses over the bonuses paid in Base Year 2010. The Commission should reduce AVR's requested bonuses for Projected Year 2011, from approximately \$40,000 to \$10,000, the amount that AVR actually paid in Base Year 2010. AVR has failed to demonstrate that its proposed 400% increase in bonuses in Test Year 2012 is necessary, especially in light of the current poor economic outlook. The Commission should adopt DRA's recommended Test Year 2012 level of payroll expenditures because it is reasonable and supported by the record.¹² Again, AVR has not made the case that paying these bonuses is in any way required to retain the employees affected by this bonus program.

D. Employee Benefits – Medical and Dental Insurance

The Commission should adopt DRA's method of estimating medical and dental expenses because those estimates are based DRA's payroll estimates, which are reasonable and supported by the record. AVR calculates these expenses using AVR's January 2011 invoice premium levels, applied to AVR's requested payroll positions, which are the same as those that DRA recommends. AVR's testimony reports an increase of 9.8% in medical premiums in 2011 over those of 2010, while AVR's

¹¹ *Id.*, pp. 4-9 to 4-11.

¹² *Id.*, p. 4-8.

application reflects a 23% increase in the medical insurance costs in 2011.¹³ AVR explained these variances in response to DRA's Request JJS-9. The difference is attributable to employees' reclassification: 1) between Health Maintenance Organization (HMO) and Preferred Provider Organization (PPO) plans, and; 2) among the classes of single, single and spouse, and family coverage.

DRA agrees with these reclassifications and adjusts the 2011 medical premiums to include AVR's estimated medical insurance cost for the new Customer Service Representative in 2011. DRA then escalates this amount to Test Year 2012 using the updated labor inflation factor of 3%¹⁴ according to the Settlement, resulting in DRA's test year estimate. AVR – by contrast-- escalates its 2010 recorded amount by 23% in 2011, and then escalates the expense to Test Year by using an escalation factor of 8.5%, which AVR describes as “based on the projected increase in the medical cost trend used by AVR's outside actuaries for calculation of AVR's Postretirement Health and Life Benefits Actuarial Valuation.”¹⁵ AVR also adds medical insurance expenses for the three new requested positions for Test Year 2012.

AVR can exercise a much greater level of control over the growth of its medical insurance costs than is reflected in its estimated escalation factors. AVR's insurance broker Mercer estimates that AVR will be subject to an excise tax in 2018 for having high-cost medical insurance plans.¹⁶ The excise tax applies to what are commonly called “Cadillac” health insurance plans. Thus, AVR is providing its employees exceptionally high levels of health insurance benefits in dollar terms. DRA recommends that AVR scale back its health insurance plans' coverage to a more reasonable level resulting in significant savings over its current level. Following upon DRA's inclusion of AVR's projected Medical Insurance cost increases of 23% in 2011, DRA's use of the most recent

¹³ AVR's testimony refers to yet a third increase of 22%.

¹⁴ Three per cent is the most recently updated 2012 Labor escalation factor, which DRA agreed to use in the Settlement. DRA's original Report used a 1.9% labor escalation factor for Test Year 2012.

¹⁵ Exhibit AVR-1, p. 42.

¹⁶ Exhibit DRA-1, p. 4-14 and 13-6, citing the *Mercer Report*.

CPI-U Labor escalation factor of 3% is fair and more than adequate to provide AVR's rate recovery of its reasonable Medical Insurance costs. The Commission should adopt DRA's estimate for AVR's Medical Insurance costs for AVR's Test Year 2012.

For Dental Insurance Expenses, DRA adjusts to AVR's calculated increase for 2011, which uses AVR's January 2011 premiums, reflecting a \$5,180, or 17% increase over the 2011 level, and adds coverage for AVR's new Customer Service Representative. DRA then escalates this to Test Year 2012 using the CPI-U updated labor factor of 3% to arrive at DRA's test year estimate. AVR's estimate uses a 5.5% inflation factor for 2012 and provides coverage for AVR's requested three new employees, which DRA excluded from its payroll estimates.

The Commission should adopt DRA's estimation method of medical and dental insurance coverage because it is based upon DRA's recommended payroll levels for Test Year 2012, which are reasonable and supported by the record.

E. Employee Benefits – 401(k)

The Commission should adopt DRA's 401(k) recommendation because it is based on AVR's 2010 historical employee contribution rate and DRA's recommended payroll. The 401(k) benefits at issues here are matching contributions made by the company to employees' 401(k) plans and are, therefore, proportional to payroll expenses. AVR's estimated retirement savings reflect a 26% increase from \$69,383 to \$87,375 from 2010 to 2012. The increase is based on applying *estimated* employee contributions of 3% of payroll to AVR's estimated 2012 payroll. AVR assumed that employees will take greater advantage of AVR's matching of their 401(k) contributions than they did in Base Year 2010.

DRA calculated the 2010 historic contribution rate of 2.1% of retirement savings benefits paid to recorded payroll and multiplied this percentage by DRA's recommended Test Year 2012 total level of payroll. DRA also specifically added an additional amount to reflect AVR's conversion of a Customer Service Representative's ("CSR") position from temporary to permanent. DRA's recommended Test Year 2012 number is preferable to AVR's because it takes into account the 2010 historical contribution rate of

employee contributions to retirement savings and DRA's recommended payroll size. AVR's – by contrast—uses its augmented payroll numbers to calculate its required contributions and relies on an inappropriate assumption that its employees will take greater advantage of its 401(k) matching program.

F. Employee Benefits – Group Pension

The Commission should reject AVR's Group Pension plan estimates because they are based on questionable actuarial reports. AVR's Group Pension Plan is proportional to payroll. AVR estimated \$503,000 in retirement plan contributions for Test Year 2012, reflecting AVR's revised actuarial assumptions and its higher requested payroll, with which DRA disagrees.

DRA calculates its estimate of Test Year 2012 Pension Expenses beginning with the 2010 level of Pension Expense of \$402,000, which corresponds to the amount of Pension Expenses determined by AVR's June 30, 2010 actuarial report for calendar year ended 12/31/2010. DRA then applies the 2011 and updated 2012 labor escalation factors of 1.6% and 3%, respectively, to arrive at DRA's Test Year 2012 estimate of \$420,600. DRA's recommended number is preferable to AVR's because it uses DRA's inflation estimates for 2011-2012 and actuarial data that AVR's actuary AON Consulting provided prior to recent questionable changes to those assumptions, as explained in DRA's Report¹⁷.

For purposes of calculating its requests for this GRC, AVR reflects significantly different actuarial assumptions from those that its actuary AON Consulting used in preparing AVR's 2010 actuarial report. Table 4-C below compares the assumptions that AVR's 2010 actuarial report used with those it is now using to calculate Pension Expenses in this GRC.

¹⁷Exhibit DRA-1, pp. 4-16 to 4-18.

Table 4-C

		AVR Actuarial Assumptions	
		2010	2012
Assets	Expected Return on Plan	5.00%	3.65%
	Discount Rate	5.75%	5.25%

AVR states that the Expected Return on Plan Assets of 3.65% is the average return earned by its Pension Fund over the past ten years.¹⁸ This represents a significant decrease from the 2010 estimate of 5% that AVR's actuary AON Consulting used in the 2010 actuarial report. As projected earnings on the Pension Assets shrink, the amounts that AVR claims that it will have to contribute towards the Pension Benefit Obligation increase. Similarly, AVR significantly decreases its discount rate, which is used to discount Pension Benefits to their present value. The same interest rate is used to annually accrue interest on the Benefits Obligation in order that it will build up to the future amount AVR will ultimately have to pay. By using a lower discount rate, AVR increases the present value of its Pension Benefits Obligation, thereby increasing the amounts that AVR calculates that it must now contribute.

DRA asked AVR to recalculate its Pension Expenses using different assumptions for the Expected Return on Plan Assets and Discount Rate.¹⁹ AVR declined to provide these recalculations in the absence of DRA's assurance that it would recommend full recovery of the associated expense of the actuary's services employed to make these calculations. Because DRA does not believe AVR's 2012 actuarial assumptions are reasonable, DRA uses the 2010 estimate of Pension Expenses as a more reliable estimate available escalated to Test Year 2012. DRA notes that, even AVR's 2010 estimated return on plan assets of 5% is conservative relative to other pension plans that DRA has

¹⁸ Exhibit DRA-1, p. 4-17, footnote 80, referring to AVR's Response to Data Requests JJS-2 and JJS-3.

¹⁹ *Id.*, p. 4-17, footnote 81, quoting AVR's Response to DRA Data Request JJS-7, dated 3/18/11, Q.9.

reviewed. Nevertheless, DRA uses it because AVR's 2010 estimated return on plan assets reflects AVR's choice to invest its Pension Asset Funds in very conservative investments: cash, cash-equivalents, and U.S. Treasury fixed income assets. AVR declined to provide a description of the alternative investments that AVR had considered in its response to DRA's Data Request.²⁰ Nevertheless, DRA believes that AVR can earn significantly more on its plan assets if it pursues alternative investments, while still addressing its concerns about risk by keeping a conservative investment allocation.²¹

G. Employee Benefits – EAP/Wellness

The Commission should adopt DRA's recommended EAP/Wellness budget because it uses a standard five-year average as opposed to AVR's use of only the 2010 budget. DRA forecasts AVR's service awards, educational assistance, and its EAP/Wellness Program expenses using AVR's inflation-adjusted 5-year average, recalculated using DRA's approved historical labor inflation factors. AVR used a 5-year average as well, employing its own escalation factors, with one exception: for the EAP/Wellness Program, AVR used a "2011 budget" amount that reflects a \$1,500, or 46.4% increase from Base Year 2010 to Test Year 2012. DRA's estimate using a 5-year average is more reliable than AVR's "budgeted" amount for 2011. Given the substantial increase AVR requests for this expense, the inflation-adjusted historical amounts are preferable because they are known and certain while AVR's "budgeted" amounts are not justified.²²

H. Regulatory Accounts – Group Pension Balancing Account

AVR failed to justify its request for a group pension balancing account, and as such the Commission should deny this request. AVR requests that the Commission authorize a new Pension Balancing Account to track the difference between authorized pension contributions included in rates in this proceeding and the costs actually incurred.

²⁰ *Id.*, Q. 8.

²¹ *Id.*, p. 4-18.

²² *Id.*, p. 4-19.

AVR seeks such an account because of the projected increase in required pension funding resulting from “volatile market conditions.”²³ However, AVR failed to demonstrate that market conditions would impact the pension fund assets and failed to diversify those assets, resulting in a lower return. AVR’s pension fund assets are limited to two conservative and stable classes of assets, US Treasury Bonds and a Treasury Money Market Account²⁴, and as such are not subject to volatile market conditions, which is AVR’s rationale for requesting the Pension Balancing Account²⁵. AVR testified that if the company retains its investments until their maturity date, it is assumed that all of the investment will be returned, thus there is virtually no risk.²⁶ Additionally, these are both short term investments, which traditionally yield lower returns than long term investments.²⁷ AVR’s annual return on its pension fund assets is only 3.65 percent over a ten year average.

The amounts AVR requests to record in the proposed Pension Balancing Account are the difference between the SFAS 87 expense, as determined by AVR’s outside actuary and recorded as expense, and AVR’s recovery of costs for ratemaking purposes. AVR is seeking similar treatment to what the Commission previously afforded to other Class A water utilities including California American Water Company (D.10-06-038), California Water Service Company (D.10-12-017) and Golden State Water Company (D.10-11-035). However, DRA did not question the management of the pension fund assets in those prior proceedings. Here, AVR’s 2010 Actuarial Report (“2010 Report”), AVR’s workpapers and AVR’s Responses to DRA’s Data Requests reveal that AVR has inappropriately changed its actuarial assumptions since its 2010 Report and, consequently, overstates the Pension Expenses it requests in this GRC.²⁸ These

²³ Exhibit AVR-1, p. 101; Transcript V.2 168:4-13.

²⁴ Transcript V. 2, 142:13-16

²⁵ Exhibit AVR-1, p. 101

²⁶ *Id.* at 146:4-14; 171:21-26

²⁷ *Id.* at 143:3-12.

²⁸ Exhibit DRA-1, DRA’s Report, Chapter 4.

assumptions, as well as the lack of diversified investments and low yield raise serious concerns about the prudence of AVR's Pension Plan Assets' management.²⁹

AVR seeks to justify its actuarial assumptions based upon the performance of its Pension Asset Portfolio over the period 2000-2009, whose return exceeds that of the S&P 500 over the same period. However, there was a market crash beginning in 2008 from which the market has not yet recovered as of the end of the 10-year period in 2009. That period of time, and the negative return of 0.95%, is therefore, atypical.³⁰

Additionally, a balancing Account is not the appropriate vehicle for AVR to track its Pension Expenses. Balancing Accounts are used to track actual approved costs against a utility's recovery of such costs in rates, which the Commission has found to be prudent, just and reasonable. Given the issues that DRA raises regarding their reasonableness, the Commission should not conclude that AVR's Pension Expenses are reasonable until it resolves these issues in AVR's next GRC.³¹

DRA recommends that the amount of Pension Expenses be based upon AVR's 2010 recorded expenses, which reflect more reasonable assumptions than AVR uses to request its Pension Expenses for Test Year 2012.³²

DRA further recommends that AVR track its pension costs against the amount of pension expenses that the Commission adopts in this GRC in a Memorandum Account. A memorandum account will allow AVR to track any shortfall or over recovery of Pension Expenses subject to prudence review in AVR's next GRC. A memorandum account is the appropriate vehicle for AVR to track its Pension Expenses, pending the Commission's resolution of the issue of AVR's prudent management of its Pension Plan assets in AVR's next GRC. At that time, AVR can request a true up of the amount that

²⁹ *Id.*, at pp. 13-1 and 13-2.

³⁰ Exhibit DRA-5

³¹ *Id.* at 13-2

³² *Id.*

the Commission authorizes for its Pension Expenses in this GRC with the prudently incurred excess or shortfall amounts that it actually records in a memorandum account.³³

DRA's cross-examination of AVR's witness Mr. Martinet, demonstrated that AVR's 3.65% assumed expected return on pension assets is very low and its historically earned return results is substandard because AVR did not diversify its investments (either short or long term) and because of poor plan management. AVR has relied on the return on the stock market over the 10 year period 2000-2009 to show that the return it earned on its Pension Fund Assets exceeded that of the S&P 500. However, that 10 year period is not representative of most 10 year periods' return on stocks because the stock market had not fully recovered in 2009 from the large decline in the market in 2008-2009.³⁴

Moreover, DRA showed through cross-examination that DRA's estimate of Pension Expenses, which uses AVR's recorded expenses for Base Year 2010 was, in fact generous because AVR's own calculations show that DRA's estimate significantly exceeds the level that would have resulted from escalation of 2006 recorded expenses instead of beginning with the 2010 recorded level.³⁵

I. Regulatory Accounts – Pressure Reducing Valve Memorandum Account

AVR Has Not Proposed PRV Project Details nor Has It Guaranteed the Cost-Effectiveness of its Project Costs

AVR requests that the Commission authorize a new memorandum account that “[C]overs the unknown costs associated with the research, development and demonstration of Pressure Reducing Valve [“PRV”] modernization technology. AVR plans to replace existing pressure reducing valves with electrical regenerative flow control valve technology.”³⁶ AVR's request is vague and general, asking the Commission to approve a memorandum account to track costs that are unknown and undefined (i.e. by project location,

³³ *Id.* at 13-2

³⁴ Transcript Vol. 3. pp. 190-202.

³⁵ *Id.*, p. 203.

³⁶ Exhibit AVR-1, AVR's Revenue Requirements Report, p. 107.

type of device and technology to be used, estimated range of costs, estimated schedule of completion, etc.) for the replacement of existing pressure reducing valves with regenerative flow control valve technology. In the absence of any specific proposed project plans, the amount that AVR may spend on these replacements is virtually unlimited. This is in contrast to the specifically described details and limited scope of the RD&D projects approved in R. W-4854.

Within the framework of this GRC, AVR must embark upon this project with a clear understanding that all future costs that AVR tracks in a memorandum account *and* later requests for approval are subject to a future review for reasonableness. This means that AVR must be able to show that the costs are reasonable and have been prudently incurred before the Commission can authorize their recovery. As a GRC request, AVR will ultimately need to show that the valve replacements have actually performed in a cost-effective manner before the Commission authorizes it to recover AVR's project costs.

Since AVR is proposing what amounts to RD&D trials, whose outcome is currently unknown, AVR cannot provide any assurance that the projects will be cost-effective. Nor does AVR offer any assurance that it will only request recovery of costs that it can demonstrate to be cost-effective.

Resolution W-4854 Was Not a Blanket Authorization of Approval of Any Water Utility's RD&D Projects, Including AVR's Undefined PRV Replacement Project

In Resolution W-4854, the Commission, authorized San Jose Water Company, Golden State Water Company, California American Water Company and California Water Service Company to establish new and separate memorandum accounts to track the costs associated with the research, development, & demonstration of specifically described pressure-reducing valve modernization projects. The Commission's approval was limited to these four utilities who sought approval of memorandum accounts to track six projects in order to be eligible for federal grant money for six projects begun prior to 12/31/2010 and completed before 12/31/2014. The purpose of the projects is to demonstrate the new technology and to evaluate the societal cost effectiveness of the PRV modernization program.

The Commission has only approved the specifically defined PRV-related RD&D projects in Resolution W-4854, under narrowly defined conditions. The Resolution states “Approval of these advice letters addresses an important issue, but it *is narrow, focused and confined to four utilities and RD&D.*”³⁷ Because approval of RD&D memorandum accounts is confined to the four utilities and the six projects named therein, Resolution W-4854 was not a blanket authorization of any other RD&D projects at this time. Rather, it approved trial projects and instituted a collaborative process between the electric and water utilities named therein and the Division of Water and Audits, who is directed to work on the selection of consultants and the development of appropriate measurement, verification, and evaluation protocols.

The Commission should not approve AVR’s Pressure Reducing Valve (“PRV”) Modernization Memorandum Account Request at this time. The projects AVR requests to track are Research, Development and Demonstration (“RD&D”) technology trial projects, whose outcomes are unknown, and whose cost-effectiveness no one can predict, including AVR. Moreover, AVR’s request is vague, undefined, and potentially unlimited in magnitude.

Approval of AVR’s PRV Memorandum Account Will Place Ratepayers at Unreasonable and Significant Economic Risk

The Commission in R. W-4854 said that it would authorize the utilities recovery of their RD&D costs if they were shown to be prudently incurred, but explicitly stated that the utilities did not need to guarantee a successful outcome (i.e. that the projects would actually work) for the Commission to authorize the utilities to recover their costs.³⁸

A basic idea underlying RD&D is that new technologies may be tested on a small scale in order to evaluate whether implementing them on a larger scale would be beneficial. Thus, as RD&D projects, it would be unreasonable to require Water Utilities to

³⁷ *Id.*, p. 11, *emphasis added.*

³⁸ R. W-4854, p. 14.:

provide a guarantee that the electrical regenerative FCV projects will be successful.³⁹

This places ratepayers at risk for the outcome of the trials approved in the Resolution. R. W-4854, therefore, approves tracking of the RD&D costs of six projects for four other utilities exclusively at ratepayers' risk even if the trials fail and/or do not prove to be economically cost-justified. The projects approved in Resolution W-4854 employ an as-yet unproven technology and will not be broadly introduced until the technology and societal cost-effectiveness has been proven.

AVR and other utilities should await the results of the Commission-approved trials before proceeding to install similar devices whose costs it intends to ultimately recover from ratepayers.⁴⁰ Failing to do so will place its ratepayers at additional risk by conducting trials that are extraneous to the projects approved in R. W-4854. However, informed by the results of those trials, AVR can better determine the feasibility of regenerative pressure reducing valve devices before proceeding to install them. This alternative approach will mitigate forcing ratepayers to bear additional, unnecessary risks of economic losses, beyond those which ratepayers already bear following the Commission's approval of RD&D projects in Resolution W-4854.

AVR's request seeks to expand the narrow, limited approval that the Commission granted four water utilities to conduct the six PRV project trials that those water utilities had specifically requested in their Advice Letter filings. Approval of additional RD&D trials to more than the four named utilities in R. W-4854 will also place unanticipated and unnecessary additional strain on Commission staff resources actively involved in the projects' planning, monitoring and oversight.

³⁹ *Id.*

⁴⁰ AVR, of course is free to proceed to explore and experiment with the new technologies at shareholders' expense, assuming such trials are within all health and safety laws and do not disrupt AVR's adequate provision of services. AVR should record the costs of such trials below-the-line for ratemaking purposes.

Conclusion

The Commission should reject AVR's request. AVR should await the results of the six trial projects that the Commission authorized four utilities to conduct in Resolution W-4854.

J. Escalation Year Methodology – Employee and Retiree Healthcare

AVR's request states: "AVR proposes to remove health care expense and retiree health care expense from any calculations of revenue requirement changes for AVR's 2013 and 2014 escalation year filings," arguing that health care is a "significant expense item subject to exclusion from escalation according to the rate case plan." AVR further alleges that the Commission's rate case plan "requires an adjustment for 'all non-recurring and significant expense items.' In lieu of escalation, AVR proposes that "specific employee and retiree health care expense" be used in the 2013 and 2014 escalation year filings."⁴¹ The Commission should deny AVR's request to remove health care expenses from its annual escalation filings because it would violate the Commission's adopted escalation methodology, which specifies that the CPI-U (Labor) escalation factor be applied to this category of expenses.⁴² AVR's request, therefore, violates the Commission's escalation methodology adopted in the Rate Case Processing Plan.

K. Office Expansion

AVR requests to expand its main office building by approximately 2,200 square feet; the expansion would be to the north portion of the existing building.⁴³ AVR's estimated total cost of this project is \$702,026 and includes costs associated with

⁴¹ Exhibit DRA-1, DRA's Report, p. 13-3, citing Exhibit AVR-1, AVR's *Revenue requirements Report.*, p. 100.

⁴² D.07-05-062, Appendix A, p. A-19.

⁴³ Exhibit AVR-1, AVR Revenue Requirement Report, page 67.

preparing a master plan, construction (spread over two years), and office furniture and equipment for the added space.

AVR has not adequately supported the need for the project and the cost estimates for the project. Specifically, AVR has not clearly delineated how it arrived at the additional office space it needs and its proposal is based on design and cost information that is outdated and possibly overstated. AVR has not provided the Commission with a well-defined plan and a valid cost estimate.

In its rebuttal AVR concedes that DRA's analysis contained valid concerns relative to the uncertainty of the design and the outdated cost estimates.⁴⁴ However, AVR asserts that additional office space is necessary. In response to DRA's Data Request PPM-5,⁴⁵ AVR provided in great detail a description on how it calculated the office space requirement to support its request for additional office space. It explained that "the total area of all office space and workstations of 2,054 square feet is divided by 26 people, which equals 79 square feet per person"⁴⁶ and went on to say that "we are very concerned about our existing main building being less than the 100 square foot requirement for a business as listed in Table 1004.1.1 [(of the California Building Code)]."⁴⁷

AVR's use of the 2,054 square feet net floor area in the above calculation is inconsistent with the requirements described in the California Building Code. AVR calculated the 2,054 square feet by "excluding hallways, restrooms, meeting space, and server rooms."⁴⁸ As presented in Exhibit DRA-10, Table 1004.1.1 of the California Building Code refers to 100 square foot requirement of "gross" floor area and defines "FLOOR AREA, GROSS" as "floor area within the inside perimeter of the exterior walls of the building under consideration, exclusive of vent shafts and courts, without

⁴⁴ Exhibit AVR-13, Rick Dalton's Rebuttal, page 18.

⁴⁵ Exhibit DRA-11. See page 2 of the data response.

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ Exhibit AVR-1, AVR Revenue Requirement Report, page 67.

deduction for corridors, stairways, closets, the thickness of interior walls, columns or other features.”⁴⁹ Therefore, for AVR’s main building, the “gross” floor area would be 4,320 square feet⁵⁰ and not 2,054 square feet. Using the same calculation performed by AVR (available area divided by number of employees), but with the correctly calculated available (i.e. gross) floor area, AVR’s main office building would provide 166 square feet of floor area per employee (4,320 square feet divided by 26 employees). This is 66% percent more than the 100 square feet per employee requirement specified the California Building Code.

AVR claims that its decision to use of net floor area is based on verbal instructions from the Fire Chief of the Apple Valley Ranchos Fire Department. However, AVR could not produce any written documentation that the Fire Chief’s interpretation should override the requirement clearly stated in the California Building Code. It is simply imprudent for AVR to embark on a \$700,000 construction project without adequately researching and confirming the California Building Code’s office space requirement. AVR’s witness Richard Dalton states that AVR and the Fire Department have “a good working relationship,”⁵¹ so DRA expects that the Fire Department would be willing to support AVR’s request by providing in writing its interpretation of the California Building Code and how the available floor area should be calculated in the application of the 100 square feet per employee requirement. Without such documentation, the Commission should reject AVR’s claim that the present main office building’s square footage does not meet the California Building Code requirement.

Interestingly, Mr. Dalton testified that: “the whole square footage thing that we’re talking about is not the primary reason why we want to add on to the office space. It is

⁴⁹ Exhibit DRA-14. 6-page excerpt from 2010 California Building Code printed on 6/17/2011 from <http://publicecodes.citation.com>, [Emphasis added.]

⁵⁰ Exhibit DRA-9, AVR’s Partial Response to DRA’s Data Request PPM-5, March 28, 2011, “Main Office” drawing.

⁵¹ Transcript Volume 4, page 347.

an added incentive, but it's not the primary reason."⁵² This statement serves to reduce the importance of AVR's previous claim that it was "very concerned"⁵³ about not meeting office space requirement and that it could be cited by the Fire Department.⁵⁴ If the primary reason for the office expansion is not to meet the California Building Code requirement, then it appears that the primary reason for the project is to gain additional meeting space, which AVR cited in its testimony and repeatedly raised in evidentiary hearings.⁵⁵ That need is equally unsupported and difficult to verify. Moreover, if the Commission accepts that AVR needs additional meeting space, it should question the size of the expansion and not allow AVR to add what would turn out to be a 2,200-2,300 square foot meeting space, or 50% of the existing main office area.

For the above reasons, the Commission should deny AVR's request for this office expansion project, except for AVR-requested \$21,000 for the site master plan, which would allow AVR to perform a comprehensive assessment of its existing buildings and office space requirements.⁵⁶ DRA also recommends that if AVR chooses to include a request for an office expansion project in its next GRC, the company should provide the Commission with more detailed design, verifiable justification, and up-to-date cost information. The Commission should also require AVR to demonstrate that the office expansion project would cost less than leasing office space or is the least cost alternative.

L. Carlyle Transaction Contingency

DRA recommends that the Commission take no action at this time to address the contingency that the Carlyle transaction will not be completed by January 1, 2012. There is no evidence or indication on the record that this transaction will not be completed. In

⁵² Transcript Volume 4, page 347.

⁵³ Exhibit DRA-11. See page 2 of AVR data response.

⁵⁴ Transcript Volume 4, page 347.

⁵⁵ Exhibit AVR-1, page 67.

⁵⁶ Exhibit DRA-1, DRA's May 10, 2011 Results of Operations Report, page 7-14.

fact, the record in this proceeding does not address this contingency, and it is premature for the Commission to take any action at this time.

IV. CONCLUSION

For all of the foregoing reasons, and for the reasons set-forth in its testimony, the Commission should adopt DRA's recommendations regarding 1) payroll; 2) employee benefits; 3) the pressure reducing valve memorandum account; 4) escalation year methodology; 5) the office expansion; and 6) the Carlyle transaction methodology.

Respectfully submitted,

/s/ ALLISON BROWN

ALLISON BROWN

Attorney for the
Division of Ratepayer Advocates
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102
Phone: (415) 703-5462
Fax: (415) 703-2262
aly@cpuc.ca.gov

September 29, 2011