

**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 20.00% 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  
APPLE VALLEY RANCHOS WATER COMPANY**

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**OPENING BRIEF OF  
APPLE VALLEY RANCHOS WATER COMPANY**

**I. INTRODUCTION**

Pursuant to Rule 13.11 of the Rules of Practice and Procedure of the California Public Utilities Commission (“Commission”), and the briefing schedule set by Administrative Law Judge (“ALJ”) Douglas M. Long, Apple Valley Ranchos Water Company (“AVR” or “Company”) hereby respectfully submits this opening brief (“Opening Brief”) in support of its Application 11-01-001 (“Application”) in the above captioned general rate case (“GRC”) proceeding.<sup>1</sup>

As discussed in the Joint Motion of Apple Valley Ranchos Water Company and the Division of Ratepayer Advocates to Approve Settlement Agreement filed on September 15, 2011 (“Motion to Approve Settlement”), AVR and the Division of Ratepayer Advocates (“DRA”) have settled most of the issues raised by DRA in connection with the Application. In this Opening Brief, AVR will demonstrate why the Commission should approve AVR’s position on the contested issues not resolved by the settlement.

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<sup>1</sup> All subsequent references to “Rule” shall be to the Commission’s Rules of Practice and Procedure.

## II. SUMMARY OF AVR'S RECOMMENDATIONS

Pursuant to Rule 13.11, AVR provides the below summary of AVR's positions on the following unresolved issues:

### PAYROLL

- **New Employees**: AVR seeks approval for three (3) new positions – Water Audit Conservation Specialist, Water Quality Specialist, and Asset Management Project Coordinator – that are needed so that AVR can handle the increasing number of water audits requested by customers, effectively address increasing water quality tasks and issues, and efficiently manage assets and coordinate projects.
- **Merit Increase (General Office and AVR)**: AVR seeks approval of a continuation of its merit increase budget (2%), a critical component of its market and merit based compensation system for many years, which is necessary for AVR to provide competitive compensation to attract and retain qualified employees.
- **Bonus**: AVR seeks approval of a continuation of its modest, but important, bonus budget, based on a five year recorded basis, to reward exceptional performance by its employees.

### EMPLOYEE BENEFITS

- **Medical and Dental Insurance**: AVR proposes using escalation factors for its medical and dental insurance expenses based on AVR's outside actuary's 2012 medical trend projections instead of general CPI-U escalation factors.
- **401(k)**: AVR proposes an increase in its 401(k) expenses due to anticipated increases in employee participation in AVR's 401(k) plan, a trend confirmed by media reports and financial industry publications.
- **Group Pension**: AVR proposes an increase in its group pension expenses based on its outside actuary's projections, which are based on the pension plan's historical rate of return and declining interest rates.

- **Wellness Program**: AVR proposes an increased budget for its Wellness Program, which can help reduce health care costs.

**REGULATORY ACCOUNTS:**

- **Group Pension Balancing Account**: AVR seeks authorization for a Group Pension Balancing Account.
- **Pressure Reducing Valve Memorandum Account**: AVR seeks authorization for a Pressure Reducing Valve Memorandum Account.

**ESCALATION YEAR METHODOLOGY - EMPLOYEE AND RETIREE HEALTHCARE:**

AVR seeks approval of specific employee and retiree health care expense estimates for escalation years 2013 and 2014 based on medical cost trend projections in lieu of the default CPI-U based escalation year methodology.

**OFFICE EXPANSION**: AVR seeks approval of its office expansion project, to expand its nearly 50-year old office building. AVR requires additional space for its efficient future operations and growth and to comply with applicable California Building Code egress occupancy space requirements.

**CARLYLE TRANSACTION CONTINGENCY**: AVR recommends adoption of a Stock Transfer Expense Impact Memorandum Account to address the contingency that the transaction that is the subject of A.11-01-019 – the transfer of ownership of Park Water Company’s stock to Western Water Holdings – does not close by January 1, 2012. This memorandum account would track the differences between the General Office expenses agreed to in the Settlement Agreement and those proposed by AVR in the Application in the categories impacted by the transaction.

### **III. PROCEDURAL HISTORY**

In accordance with the Rate Case Plan adopted by the Commission in D.07-05-062 (“RCP”), on January 3, 2011, AVR filed its Application, along with prepared testimony and exhibits, its Revenue Requirements Report for Test Year 2012 (“AVR Report”, Ex. AVR-1), its General Office Report for Test Year 2012, AVR’s Urban Water Management Report, and Minimum Data Requirements. ALJ Bruce DeBerry was assigned to this GRC proceeding.

On February 2, 2011, DRA and the Town of Apple Valley (the “Town”) filed protests to the Application and, pursuant to Rule 1.4, thereby became parties to this proceeding. On March 9, 2011, ALJ DeBerry granted Apple Valley Unified School District’s (the “School District”) motion for party status. On May 26, 2011, ALJ DeBerry denied the motion of James and Christine Smith for party status. Accordingly, the parties to this proceeding are AVR, DRA, the Town, and the School District.

ALJ DeBerry held a prehearing conference on March 1, 2011, at which time the parties agreed to consider resolving disputed issues through an Alternative Dispute Resolution process. On March 21, 2011, Commissioner Peevey issued a Scoping Memo, setting forth a proposed schedule for the proceeding. On April 13, 2011, the parties were informed that ALJ Gary Weatherford had been assigned to mediate the parties’ contested issues.

On May 10, 2011, DRA served its testimony and Report on the Results of Operations (“DRA Report”, Ex. DRA-1). The Town filed its testimony on May 17, 2001. On May 27, 2011, AVR served the Rebuttal Testimony of Leigh K. Jordan, John D. Armstrong, Douglas K. Martinet, Mary A. Young, Donald R. Howard, Edward Jackson, Scott Weldy, and Rick Dalton. The School District did not file testimony.

On June 1, 2011, ALJ DeBerry held a Public Participation Hearing in the Town of Apple Valley. The parties were scheduled for a mediation with ALJ Weatherford on June 9 and 10, 2011. As ALJ Weatherford became unavailable on those dates, the parties used the time to hold settlement discussions on June 8-10, 2011. AVR and DRA attended in person while the Town and the School District participated telephonically. Although the parties were unable to reach a

resolution of the contested issues at that time, AVR and DRA continued their settlement discussions, including discussions during and after the evidentiary hearings, and ultimately entered into the Settlement Agreement submitted with the Motion to Approve Settlement.

On June 10, 2011, this GRC proceeding was reassigned from ALJ DeBerry to ALJ Long. Evidentiary hearings were held before ALJ Long on June 20-22, 2011. At the hearings, AVR's and DRA's testimony and reports were marked as exhibits and entered into the record along with additional exhibits introduced at the hearings. Neither the Town nor the School District attended or participated in the hearings.

On June 17, 2011, the Friday before evidentiary hearings were to begin, DRA moved to strike portions of AVR's rebuttal testimony on the grounds that the subject portions were "new evidence". At the start of the evidentiary hearings on Monday, June 20, 2011, ALJ Long denied DRA's motion and reaffirmed his ruling during the course of, and at the conclusion of, the evidentiary hearings.<sup>2</sup>

ALJ Long ordered opening briefs to be filed within two weeks of the filing of the parties' Motion for Approval of Settlement, with reply briefs to be filed within two weeks thereafter.<sup>3</sup> As the Motion for Approval of Settlement was filed on September 15, 2011, the parties' opening and reply briefs are due on September 29, 2011 and October 13, 2011, respectively.<sup>4</sup>

#### **IV. DISCUSSION**

##### **A. Payroll**

##### **1. New Employee Positions**

AVR seeks authorization for three positions: Water Audit Conservation Specialist, Water Quality Control Specialist, and Asset Management Project Coordinator. As the evidence establishes AVR's need for these positions to continue to meet the needs of all stakeholders –

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<sup>2</sup> Hearing Transcript ("Tr."), at 104, 115, 265, 267, 345-346, 427.

<sup>3</sup> Tr., at 425.

<sup>4</sup> Attached to the filed Motion to Approve Settlement were the Settlement Agreement and the Joint Comparison Exhibit of AVR and DRA ("Joint Comparison Exhibit Re Settlement").

including regulators, customers, and employees – AVR respectfully requests that the Commission approve these new positions.

a. The Water Audit Conservation Specialist Position Is Necessary

Under the Commission’s conservation objectives in the Water Action Plan and Conservation OII decisions, regulated water utilities are expected to have and maintain water conservation plans, programs, and conservation opportunities for its customers. Additionally, the Urban Water Management Planning Act Demand Management Measure #1 requires AVR to provide water survey programs for single-family and multi-family residential customers.<sup>5</sup>

To comply with these objectives and requirements, one of the conservation services AVR offers and provides to its customers is a water audit. In a water audit, an AVR representative reviews the customer’s water usage and educates the customer on indoor and outdoor water consumption as well as possible ways to reduce water usage, including adjustments to sprinkler timers and water runoff.<sup>6</sup> As AVR’s customers have become more aware of AVR’s water conservation programs over the last several years, the number of customers requesting water audits has increased. Additionally, AVR has experienced a significant increase in high water bill special reads, which have added to the number of water audits.<sup>7</sup> The result has been a dramatic increase in the number of customer water audits conducted by AVR. Between 2008 and 2010, the number of water audits nearly doubled – from 132 to 247, an increase of 87%.<sup>8</sup> Thus, on average, in 2010, AVR conducted nearly 5 water audits every week.

AVR does not have personnel specifically dedicated to conducting water audits. Accordingly, to date, water audits have been handled by AVR’s meter reading department.<sup>9</sup> The increase in the number of water audits, however, has required AVR to divert more and more meter reading resources to conduct water audits. This has resulted in an increasing backlog of

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<sup>5</sup> Ex. AVR-12 (Weldy Rebuttal), at 9.

<sup>6</sup> Ex. AVR-1 (AVR Report), at 32.

<sup>7</sup> Between 2008 and 2010, special reads increased by 72% – from 303 in 2008 to 521 in 2010. (Ex. AVR-12 (Weldy Rebuttal), at 9.)

<sup>8</sup> Ex. AVR-12 (Weldy Rebuttal), at 8-9.

<sup>9</sup> Ex. AVR-12 (Weldy Rebuttal), at 9.

meter-related tasks.<sup>10</sup> Moreover, the workload associated with basic meter reading functions also increased over the last few years. Beginning in 2010, AVR began manually tracking data for numerous customer service and meter reading activities in compliance with the Commission's General Order 103A, Appendix E, reporting requirements and, from 2008 to 2010, service orders for meter re-reads related to customer calls on high water bills increased from 303 to 521, an increase of 72%.<sup>11</sup> As AVR's General Manager testified, having a dedicated Water Audit Conservation Specialist handling customer water audits will allow the meter reading department to turn its attention back to its primary functions:

[Meter reading personnel] will be doing all the things that are on their job requirements, the meter reading, the maintenance of the system, the change-outs, up-sizing, downsizing of meters, hanging of the notices, door tags, lock-offs, reconnects, all the things they are required to do.<sup>12</sup>

Given the Commission's and AVR's continued focus and emphasis on conservation efforts, customer requests for water audits will only continue to increase during the current rate case cycle. AVR used its meter reading department to conduct water audits when their numbers were low and manageable, but AVR cannot continue diverting meter reading department resources to customer water audits. The Water Audit Conservation Specialist position is necessary for AVR to continue to meet its meter-related function while also providing water audits for its customers.

b. The Water Quality Specialist Position Is Necessary

Water quality is of paramount importance to AVR. AVR must comply with strict federal and state water quality regulations and provide its customers with a safe, wholesome, and reliable supply of potable water. Currently, in addition to ensuring the smooth and efficient operation and maintenance of all of AVR's wells and associated equipment, AVR's Production Supervisor is responsible for the Water Quality function.<sup>13</sup> His responsibilities as Production Supervisor have expanded tremendously, however, such that AVR now needs a single employee

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<sup>10</sup> Ex. AVR-12 (Weldy Rebuttal), at 9; Ex. AVR-1 (AVR Report), at 32.

<sup>11</sup> Ex. DRA-1 (DRA Report), at 10-3.

<sup>12</sup> Tr., at 284.

<sup>13</sup> Ex. AVR-12 (Weldy Rebuttal), at 7.

dedicated to Water Quality to permit its Production Supervisor to deal with his many other expanded responsibilities, which includes his involvement in or responsibility for a number of key areas, including Conservation (Water Use Efficiency Plan), the Urban Water Management Plan, Annual Water Quality Report, Annual Consumer Confidence Report, and NFPA 70(e) arc flash hazard. These significant areas have been added to his primary responsibility of ensuring AVR's production capacity and water quality.<sup>14</sup>

The current situation is an example of an employee being stretched to the limit, with no room to absorb any additional duties, much less adequately handle his current workload. Many of the Production Supervisor's responsibilities require active coordination with other agencies and consultants – for example, the preparation of AVR's Water Use Efficiency Plan required coordination with outside consultants, the Mojave Water Agency, and the Bureau of Reclamation.<sup>15</sup> The Production Supervisor also has continuing responsibilities on various new construction projects. He simply does not have sufficient time to perform the important duties to be assigned to the Water Quality Specialist described below.<sup>16</sup>

Although the Water Quality Vice President of AVR's parent company, Park Water Company ("PWC"), has provided, and will continue to provide, support to AVR on water quality matters, AVR needs a dedicated on-the-ground Water Quality Specialist to actively manage AVR's day-to-day water quality efforts, including reporting on water quality issues and responding to and addressing water quality issues that may arise.<sup>17</sup> The Water Quality Specialist will be responsible for routine sampling (which takes two days per week) as well as many other time-consuming duties.<sup>18</sup> The Specialist needs to develop a strong understanding of existing,

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<sup>14</sup> Ex. AVR-12 (Weldy Rebuttal), at 7.

<sup>15</sup> Ex. AVR-12 (Weldy Rebuttal), at 7.

<sup>16</sup> Ex. AVR-12 (Weldy Rebuttal), at 7.

<sup>17</sup> Ex. AVR-12 (Weldy Rebuttal), at 7.

<sup>18</sup> Ex. AVR-12 (Weldy Rebuttal), at 8.

pending, and anticipated federal and state water quality regulations and use this foundation to perform the requirements of the Water Quality Specialist function, which include the following:

- Water quality sample scheduling
- Water quality sample budgeting
- Sample collection
- Interpret water quality results and respond to results
- Archive results and perform trend analysis
- Maintain computerized records
- Develop and submit monthly / quarterly / annual reports
- Liaison to AVR contract laboratory
- Primary contact for California Department of Public Health, including responding to inquiries and planning inspections
- Analyze water quality for best operation of water system
- Investigate consumer complaints
- Collect special samples related to complaints
- Preparations for emergencies<sup>19</sup>

The Specialist will also be tasked with overseeing AVR's compliance with new EPA water quality testing requirements currently under discussion, which will require additional testing of currently non-regulated contaminants.<sup>20</sup>

Water quality is a very detailed and necessary part of the safe operation of AVR's water system and will only become more complex over time. New regulations and emerging regulated contaminants create challenges that AVR seeks to meet and address pro-actively, in part, by assigning the water quality function to a dedicated specialist, as recommended by PWC's Water Quality Vice President.<sup>21</sup> Water quality is too important a function to assign to a Production Supervisor tasked with fulfilling numerous other important, but time-consuming, obligations. AVR requests authorization for the Water Quality Specialist position to ensure AVR's

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<sup>19</sup> Ex. AVR-1 (AVR Report), at 32-33; Ex. AVR-12 (Weldy Rebuttal), at 7-8.

<sup>20</sup> Ex. AVR-12 (Weldy Rebuttal), at 8.

<sup>21</sup> Tr., at 285.

continuing compliance with federal and state water quality regulations and to ensure AVR's continuing ability to provide its customers with a safe, wholesome, and reliable source of potable water.

c. The Asset Management/Project Coordinator Position Is Necessary.

The Asset Management/Project Coordinator is an important position for AVR's efficient management of AVR's construction projects and fixed assets. This person will act as the liaison between AVR's engineering/construction and asset management departments and assist with all documentation relating to developers' needs in moving projects forward, including the following: create capital jobs; start/organize job folder; distribute bid packages for construction; manage construction projects, including creating construction contracts, reviewing billing, coordinating inspection, verifying time entries, tracking the progress of Construction Work in Progress ("CWIP") as projects are constructed, ensuring proper asset entry in jobs, and job review prior to closing out the job from CWIP into the Utility Plant accounts.<sup>22</sup> This position will also assist with coordinating the leasing of water rights. Knowledge of construction, contract management, job cost/fixed assets, and asset management is necessary to meet the demands of this position.<sup>23</sup>

Despite the overall state of the economy, AVR is very busy with AVR-funded projects and processing requests for potential construction of commercial projects such as the North Apple Valley Industrial Park project.<sup>24</sup> Past efforts to divide up the duties for this position among fixed asset personnel have been unsuccessful, as this division of duties has resulted in inefficiencies in performing the work associated with Fixed Assets while meeting the demands of the construction/jobs coordination function.<sup>25</sup> Given the importance of this position to the efficient management and coordination of fixed assets and projects, AVR filled this position with a temporary employee in October, 2010 and anticipates that the employee will be converted to a

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<sup>22</sup> Ex. AVR-12 (Weldy Rebuttal), at 6-7.

<sup>23</sup> Ex. AVR-12 (Weldy Rebuttal), at 7; Ex. AVR-1 (AVR Report), at 33.

<sup>24</sup> Ex. AVR-12 (Weldy Rebuttal), at 7.

<sup>25</sup> Ex. AVR-12 (Weldy Rebuttal), at 7.

Commission authorized regular employee.<sup>26</sup>

d. The Evidence Does Not Support DRA's Opposition To The Requested New Positions.

In opposing authorization for the new positions, DRA makes two generalized arguments: 1) “the functions of these new positions are specializations of ongoing activities that AVR’s employees are already doing”; and 2) “[i]n the current, economic environment, which is characterized by slow growth and a virtual jobs market recession, AVR should be *reducing* its workforce to increase productivity to a level similar to that of the overall economy.”<sup>27</sup> Neither of these arguments has merit.

With respect to DRA’s first argument – that the duties of the new positions are already being performed – DRA is wrong for the reasons discussed above in Sections IV.A.1.a.-c. The Water Audit Conservation Specialist position is needed so that the meter reading department can get back to focusing on its meter-related duties, including clearing up the backlog of meter-related tasks caused by the increase in water audits. The Water Quality Specialist position is necessary because, due to the significant increase in the Production Supervisor responsibilities, he is unable to perform his water quality duties while also satisfying his other duties. The immediate need for the Asset Management Project Coordinator position is demonstrated by the fact that AVR has already filled this position as a temporary position in October 2010; past efforts to divide the duties for this position have not worked.

DRA’s second argument – that the new positions should be rejected due to the current state of the economy – lacks merit because the state of the economy has no bearing on AVR’s demonstrated need for these positions. First, to the extent there is any correlation between the number of water audits and the economy, there is a negative correlation: downturns in the

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<sup>26</sup> Tr., at 286-287.

<sup>27</sup> Ex. DRA-1 (DRA Report), at 4-1, 4-3, 4-8, 49.

economy are likely to result in an *increase* in customers' interest in ways to reduce water usage and the attendant water bills, the very purpose of water audits. This negative correlation is supported by the fact that, between 2008 and 2010, AVR experienced an *87% increase in customer water audits*.<sup>28</sup>

Second, the need to maintain water quality exists in good times and bad times. Downturns in the economy or the general job market do not reduce the need to perform time consuming water quality duties. The current economy also has not reduced the workload of the Production Supervisor, whose duties have increased, not decreased.<sup>29</sup> The Production Supervisor's workload and the continuing need to ensure water quality are the driving forces behind AVR's request for authorization for the Water Quality Specialist position, neither of which are affected by the state of the economy.

Third, regular maintenance is necessary to maintain the fixed assets that comprise AVR's water system and AVR requires coordination of the existing construction-related projects as well as additional capital projects included in the Application. These jobs – to maintain and improve AVR's water system – need to be done regardless of the state of the economy.

## **2. Payroll – Merit Increase**

DRA agrees that it is important for employers – including regulated utilities – to attract and keep talented and qualified employees and to provide salaries that are competitive within the relevant industry.<sup>30</sup> DRA also agrees that it is important for employers to recognize employees' positive contributions to the company.<sup>31</sup> Likewise, DRA does not dispute that, as employees add to or improve their skills and abilities, it is reasonable to provide them with pay raises to reflect

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<sup>28</sup> Ex. AVR-12 (Weldy Rebuttal), at 9.

<sup>29</sup> Ex. AVR-12 (Weldy Rebuttal), at 7.

<sup>30</sup> Tr., at 363, 364.

<sup>31</sup> Tr., at 363.

this added value to their employer.<sup>32</sup> It is also uncontested that the Commission has never denied merit increases for AVR, despite consistent DRA opposition.<sup>33</sup>

Nevertheless, DRA proposes to limit AVR's ability to provide its employees with competitive market based compensation. DRA proposes to only allow COLA increases with no merit increases, and fails to account for merit increases AVR has already awarded in 2011.<sup>34</sup> As PWC's Director of Human Resources testified, the possibility of no merit increase budget is of great concern because it is AVR's "lifblood."<sup>35</sup> The merit increase budget should be authorized so that AVR may continue to be able to offer salary increases to employees based on individual employees' merit and competitive conditions in the water industry.

a. AVR's Compensation System Is A Merit-Based System.

Prior to 2001, AVR had a step compensation system, similar to that of the California Civil Service. Under a step system, employees receive automatic base pay increases at specific time intervals (typically six months to a year) through the first few years of their employment until they reach the top step for their job classification. These increases can be sizable (5% or more), typically increasing the employee's base pay by as much as 20% to 30% over a two to five year period. When an employee reaches the top step, no further step increases are available, but he or she continues to receive annual COLA increases.<sup>36</sup> If the employee is successful in bidding into a higher level job, the series of step increases is repeated until the top step of the new job is achieved. Thus, for example, a person starting as an Accounting Clerk with the State of California who eventually progresses to the top step of the Accounting Analyst classification (still a non-supervisory position) would realize a series of step increases totaling 98%. Such step

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<sup>32</sup> Tr., at 364.

<sup>33</sup> Tr., at 371, 372. The issue of merit increase budgets has been litigated in prior AVR and PWC rate cases, with the Commission consistently ruling in favor of the methodology used by AVR and PWC, which does take merit increases into account (D.03-12-040, D.03-08-069, D.92-04-031 and D.91-05-024). This issue was also addressed by the joint settlement agreements reached in prior AVR (D.05-12-020 and D.99-03-032) and PWC (D.06-08-015, D.01-03-078 and D.97-11-061) rate cases.

<sup>34</sup> Ex. DRA-1 (DRA Report), at 4-10, 4-11.

<sup>35</sup> Tr., at 420.

<sup>36</sup> Ex. AVR-11 (Armstrong Rebuttal), at 3.

increases are built into the compensation system and are not necessarily tied to job market conditions. Funds must be budgeted to support such a step system.<sup>37</sup>

Since 2001, AVR has used a market and merit driven compensation system, whereby pay increase determinations are based on individual performance and what other employers are granting to union and non-union employees.<sup>38</sup> In a step system, pay increases depend on satisfactory performance and the passage of time, providing employees with little incentive to perform at a level higher than satisfactory.<sup>39</sup> In contrast, in a market driven merit-based system, which is the most common system in private industry, increases are never automatic, but are tied to annual individual performance appraisals, the employee's position in grade, and what is happening in the relevant industry and the job market in general. When a merit increase budget is established, individual base pay increases may range from 0% to some increment above the organization's merit increase budget (*e.g.*, 2%), depending on that individual's performance and position in grade.<sup>40</sup>

In setting its annual merit increase budget, AVR reviews objective survey data from human resources consulting firm Mercer, Economic Research Institute ("ERI"), and the U.S. Bureau of Labor Statistics' Consumer Price Indexes Pacific Cities and U.S. City Average All Urban Consumers. AVR considers what private and municipal water providers are doing for union and non-union employees.<sup>41</sup> In researching and evaluating what other employers are granting in base pay increases in the water industry and in the general job market, AVR takes into consideration variations in employer practices because, while many employers only provide merit increases, AVR's compensation system includes merit and COLA components. AVR accounts for its COLA pay adjustment by adopting a lower merit budget than market projections for employers that only grant merit increases. The goal and result of AVR's detailed annual

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<sup>37</sup> Ex. AVR-11 (Armstrong Rebuttal), at 3.

<sup>38</sup> Ex. AVR-11 (Armstrong Rebuttal), at 3; Tr., at 423.

<sup>39</sup> Ex. AVR-11 (Armstrong Rebuttal), at 3.

<sup>40</sup> Ex. AVR-11 (Armstrong Rebuttal), at 3-4.

<sup>41</sup> Ex. AVR-11 (Armstrong Rebuttal), at 2; Tr., at 423.

compensation review is that its combined merit and COLA increase is in line with developments in the water industry and the general job market.<sup>42</sup>

Merit increases are a critically important component of AVR's merit-based compensation system that allows AVR to provide competitive compensation to attract and retain a high performing workforce. AVR's merit system incentivizes employees to perform above minimum expectations, which results in increased productivity and efficiency.<sup>43</sup> AVR's detailed merit increase budget setting process satisfies the need to maintain market-competitive compensation for its employees while also respecting the needs of all its stakeholders, including customers.

Based on its annual review and evaluation of objective market salary survey data, AVR determined that a 2% merit budget is appropriate for 2011 and 2012. So that it may provide its employees with a competitive salary based on market conditions and individual merit, AVR recommends approval of a 2% annual merit increase budget.

b. DRA's Opposition To AVR's Requested 2% Merit Increase Budget Is Unreasonable and Unsupportable.

DRA opposes AVR's request on several grounds, none of which have merit. Arguing that AVR "automatically gives [merit increases] to all, or almost to all" employees and that merit increases are "generally unrelated to employees' performance," DRA proposes to disallow any merit increase budget.<sup>44</sup> DRA's basis for this argument is simply wrong. Consistent with the basic premise of AVR's merit-based compensation system, merit increases are never automatic and merit increase decisions are made on a case-by-case, employee-by-employee basis. Thus, while most employees do receive annual merit increases, some employees do not and the amounts awarded to specific employees vary widely.<sup>45</sup> AVR's merit increase awards for 2010, reflected in the below table, illustrates this fact.

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<sup>42</sup> Ex. AVR-11 (Armstrong Rebuttal), at 2, 4.

<sup>43</sup> Ex. AVR-11 (Armstrong Rebuttal), at 5, 7.

<sup>44</sup> Ex. DRA-1 (DRA Report), at 4-2.

<sup>45</sup> Ex. AVR-11 (Armstrong Rebuttal), at 4.

<b>2010 MERIT INCREASE DISTRIBUTION<sup>46</sup></b>	
<u>% Merit Increase</u>	<u># of Employees</u>
0.0%	3
0.35%	1
0.7%	2
0.9%	2
1.0%	2
1.3%	1
1.4%	7
1.9%	14
2.4%	8
2.9%	2

The distribution shown above is representative of every merit budget cycle (except 2009, for the reasons explained below) and demonstrates that, contrary to DRA's assertion, merit increases are neither automatic nor unrelated to employees' performance.<sup>47</sup>

DRA next criticizes AVR for not granting merit increases in 2009, as authorized by the last GRC decision.<sup>48</sup> This position ignores the fundamental market-driven nature of AVR's compensation philosophy. In the prior GRC proceeding, AVR had anticipated granting merit increases in 2009 and therefore sought authorization for a merit increase budget. AVR did not award any merit increases in 2009, however, because market merit projections at that time did not warrant such increases, given that few employers were granting base pay increases higher than AVR's COLA due to the economic downturn.<sup>49</sup> DRA implies that AVR somehow received a windfall by not granting merit increases in 2009.<sup>50</sup> Any such inference is unwarranted. Although AVR had a provision in the prior rate case for merit increases for 2009 and did not grant any, there was no provision in the rate case for merit increases in 2010 and 2011, when

<sup>46</sup> Ex. AVR-11 (Armstrong Rebuttal), at 4.

<sup>47</sup> Ex. AVR-11 (Armstrong Rebuttal), at 4.

<sup>48</sup> Ex. DRA-1 (DRA Report), at 4-9.

<sup>49</sup> Ex. AVR-11 (Armstrong Rebuttal), at 4-5.

<sup>50</sup> Ex. DRA-1 (DRA Report), at 4-9.

merit increases were granted.<sup>51</sup> AVR's decisions on merit increases in prior years – including the decision not to award any increases in 2009 – demonstrates AVR's adherence to its compensation philosophy and its ability to properly respond to changes in compensation in the water industry and the marketplace in general. AVR and its employees should not be penalized for AVR's reasonable and supportable decision not to award merit increases in 2009.

DRA further argues that AVR's payroll increases are “excessive, unrealistic, and unreasonable in light of the current economic woes of the State of California and the nation” and that AVR should be working to reduce its workforce.<sup>52</sup> This ignores the fact that AVR's compensation decisions do take into consideration what is happening in the general economy and job market and in the water industry. While some employers, such as those in the construction, financial, real estate related, and public sectors, are experiencing “economic woes”, other industries have not been hit as hard.<sup>53</sup> What is most important and relevant to AVR is what is happening in the water industry because AVR must remain competitive with water companies who compete with AVR for talent with the knowledge and skills applicable to AVR's business. AVR is not aware of – and there is no evidence of – any Class A water companies that have laid off employees or reduced wages. In fact, as a regulated water company, AVR cannot operate with excess staffing or overly high wages and, as shown above in Section IV.A., AVR requires additional staffing to fulfill its obligations to its customers and comply with ever-increasing regulatory demands on water companies.<sup>54</sup>

Notwithstanding DRA's arguments to the contrary, AVR's proposed 2% merit increase budget – the “lifblood” of its compensation system – is reasonable, supported by market and industry data, and drives higher performance, which ultimately benefits ratepayers. DRA's recommended disallowance of any merit increases is unwarranted and should be rejected.

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<sup>51</sup> Ex. AVR-11 (Armstrong Rebuttal), at 5.

<sup>52</sup> Ex. DRA-1 (DRA Report), at 4-5, 4-9.

<sup>53</sup> Ex. AVR-11 (Armstrong Rebuttal), at 6-7.

<sup>54</sup> Ex. AVR-11 (Armstrong Rebuttal), at 7.

### 3. Payroll – Bonus

#### a. A Bonus Budget Based On A 5-Year Average Is Reasonable And Appropriate.

To encourage and recognize exceptional performance, AVR's bonus policy permits the award of bonuses to employees whose performance is "exceptional, unusual, over and above what is expected" and who has "achieved a significant result and/or brought distinction to the Company."<sup>55</sup> These bonuses, for individual achievements, are not tied to AVR's financial performance. The vast majority of bonus recipients are non-exempt employees, not executives. For example, in 2010, 100% of the bonuses were given to non-executives, with amounts ranging from a low of \$35 to a high of \$2,000.<sup>56</sup> AVR seeks approval for a \$21,659 bonus budget, which is based on a 5-year average, escalated to Test Year 2012. This amount, representing about 0.6% of AVR's overall projected payroll expense, is neither extravagant nor unreasonable.<sup>57</sup>

DRA, however, proposes to allow only \$10,000, the amount of AVR's bonus payments in 2010.<sup>58</sup> This position is flawed and should be rejected. DRA's proposal ignores the fact that the amount of bonuses awarded for any given year will vary from year to year, based on particular employees' exceptional performance during a particular year that qualify for a bonus under AVR's bonus policy. That the 5-year bonus average (\$21,659) is more than double the 2010 bonus amount (\$10,000) amply demonstrates that 2010 is *not* representative of AVR's annual bonus payments.<sup>59</sup> Given the fluctuating nature of the bonus amounts paid, AVR's proposal, based on a 5-year average, provides a much better and more reasonable estimate of AVR's bonus budget for Test Year 2012.

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<sup>55</sup> Ex. AVR-11 (Armstrong Rebuttal), at 7-8.

<sup>56</sup> Ex. AVR-11 (Armstrong Rebuttal), at 8.

<sup>57</sup> Ex. AVR-11 (Armstrong Rebuttal), at 8.

<sup>58</sup> Ex. DRA-1 (DRA Report), at 4-8.

<sup>59</sup> Actual bonus payments were \$29,000 in 2006, \$7,325 in 2007, \$36,605 in 2008, \$16,785 in 2009, and \$10,485 in 2010.

**B. Employee Benefits**

**1. Employee Benefits – Medical and Dental Insurance**

Medical and dental insurance premiums are charged on a dollar per employee basis. AVR's 2011 estimated costs for medical and dental insurance are the actual rates that were in effect as of January 1, 2011, which reflects increases of 9.8% and 12% over 2010 rates for medical and dental insurance, respectively.<sup>60</sup> DRA has accepted the use of actual premium rates in effect for 2011. Based on AVR's outside actuary's medical cost trend projections, medical and dental insurance rates are expected to increase by 8.5% and 5.5% in 2012, respectively.<sup>61</sup>

a. DRA's Proposed CPI Escalation Factor Is Unreasonable and Unrealistic.

DRA raises one issue – the appropriate escalation factor to determine medical and dental insurance expenses for Test Year 2012. Whereas AVR proposes using specific projections provided by its outside actuary (AON), DRA proposes applying the generic CPI-U escalation factor.<sup>62</sup>

The default CPI-U escalation factor, however, does not reflect reality. While DRA proposes the 3.0% labor escalation factor,<sup>63</sup> the reality is that health care costs increase at a much higher rate, particularly recently. According to the National Survey of Employer-Sponsored Health Plans conducted by Mercer: (a) in 2010, health care costs increased by 6.9%, the sharpest increase since 2004; (b) annual health care cost increases have averaged 7.25% since 1990; and (c) annual increases have not been less than 5.5% since 1998.<sup>64</sup> Health care reform laws passed in 2010 are expected to accelerate health care cost increases. Indeed, a recent survey by

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<sup>60</sup> Ex. AVR-11 (Armstrong Rebuttal), at 9.

<sup>61</sup> Ex. AVR-11 (Armstrong Rebuttal), at 9.

<sup>62</sup> Ex. DRA-1 (DRA Report), at 4-13.

<sup>63</sup> DRA originally proposed a 1.9% escalation factor for Test Year 2012, the labor inflation factor from DRA's Energy Cost of Service ("ECOS") memorandum dated February 28, 2011. (Ex. DRA-1 (DRA Report), at 3-3, 4-16.) Pursuant to the parties' settlement, DRA agreed to use the escalation factors from DRA's ECOS memorandum dated May 31, 2011, which provided a labor escalation factor of 3.0%. (Settlement Agreement, § 3.02.3, p. 10; Joint Comparison Exhibit Re Settlement, at 5.)

<sup>64</sup> Ex. AVR-11 (Armstrong Rebuttal), at 9, Attachment A.

PricewaterhouseCoopers' Health Research Institute noted that "U.S. employers can expect to see health care costs rise by 8.5% in 2012".<sup>65</sup> This 8.5% figure is consistent with, and further validates, AVR's actuary's projected 8.5% increase in medical costs in 2012.

Given this evidence of historical increases and even higher projected increases in 2012, it is unreasonable and unrealistic for DRA to argue for a 3.0% escalation factor. AVR's proposed 8.5% and 5.5% escalation factors for medical and dental insurance costs, respectively, which are realistic and supported by ample evidence, should be adopted.

b. AVR Has Taken, And Will Continue To Take, Reasonable And Appropriate Steps To Control Health Care Costs.

DRA further asserts its belief that "AVR can exercise a much greater level of control over the growth of its medical insurance costs than reflected in its estimated escalation factors".<sup>66</sup> DRA's belief, unsupported by the evidence, is wrong.

First, as PWC's Director of Human Resources testified, with the assistance of its benefits broker (Mercer), AVR shops all of its benefits every few years to ensure that it is getting the best value, to take advantage of lower premiums, and to minimize rate increases or achieve rate reductions.<sup>67</sup> Since 2000, AVR has changed its medical plan carrier twice. For plan year 2000, AVR changed carriers to reduce premiums and, for plan year 2011, AVR changed carriers to avoid a 19.97% rate increase.<sup>68</sup>

Second, a comparison of AVR's cumulative increase in health care costs with the national average shows that AVR has been able to achieve significantly lower increases than the national average reported in Mercer's National Survey of Employer-Sponsored Health Plans. Since 2000, when Mercer became AVR's benefits broker, AVR's cumulative increase in health care costs has been 83%. In contrast, the national average was a cumulative increase of 149%. Clearly, AVR is doing a much better job of containing costs than most employers in the National

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<sup>65</sup> Ex. AVR-11 (Armstrong Rebuttal), at 9.

<sup>66</sup> Ex. DRA-1 (DRA Report), at 4-14.

<sup>67</sup> Ex. AVR-11 (Armstrong Rebuttal), at 10.

<sup>68</sup> Ex. AVR-11 (Armstrong Rebuttal), at 9-10.

Survey. Given that health care costs in California have generally tended to rise faster than nationally, AVR would have done even better when compared against the average of other California employers.<sup>69</sup>

The evidence demonstrates that AVR actively monitors its health care costs and, where appropriate, takes steps to change benefits providers to avoid increases or to obtain lower rates. These steps have worked to keep AVR's health care costs low, as evidenced by its much lower than average increase in health care costs during the last decade.

c. DRA's "Cadillac Plan" Argument Has No Merit.

To support its conclusion that AVR provides "exceptionally high levels of health insurance" to its employees, DRA relies on the fact that, *in 2018*, AVR may be subject to a 40% excise tax under the Patient Protection and Affordable Care Act (PPACA), *i.e.*, a "Cadillac Plan."<sup>70</sup> By referring to AVR's health care plan as a "Cadillac Plan," DRA seeks to create the impression that AVR's health care plan is somehow extravagant and overly generous. Any such impression is false and should be rejected.

First, according to a recent article by Towers Watson, a global consulting firm, *more than 60%* of large employers' current health plans are projected to qualify as "Cadillac Plans" and therefore subject to the PPACA excise tax.<sup>71</sup> Moreover, "[a]ssuming even reasonable annual plan cost increases to project 2018 costs, *many of today's average plans will easily exceed the cost ceiling* primarily directed at today's 'gold-plated' plans."<sup>72</sup> Thus, that a health plan might qualify as a "Cadillac Plan" in 2018 does *not* support the conclusion that the plan provides extravagant benefits. Indeed, a review of medical plans offered to California Civil Service employees shows that the 2010 costs for *most* of the plans offered (5 out of 7) exceeded the average cost cited in the Towers Watson article and, therefore, are also potentially "Cadillac

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<sup>69</sup> Ex. AVR-11 (Armstrong Rebuttal), at 10.

<sup>70</sup> Ex. DRA-1 (DRA Report), at 4-14.

<sup>71</sup> Ex. AVR-11 (Armstrong Rebuttal), at 10.

<sup>72</sup> Ex. AVR-11 (Armstrong Rebuttal), at 10 (emphasis added).

plans” by 2018. The other two Civil Service plans exceed the threshold for single coverage, but not for family coverage, so the likelihood they will become “Cadillac plans” is somewhat less.<sup>73</sup>

Second, every year, with the assistance of Mercer, AVR benchmarks against other utilities all aspects of its benefit programs and considers changes to the design features of each benefit (deductibles, co-payments, etc.) to remain competitive, but not allow a drift to the high end of coverage.<sup>74</sup> Thus, irrespective of whether AVR’s current health plan might qualify as a “Cadillac Plan” in 2018, AVR’s plan provides benefits that are consistent with, and on par with, benefits offered by others utilities. There is nothing extravagant about AVR’s health care benefits. Accordingly, there is no merit to DRA’s suggestion that “AVR scale back its health insurance plans’ coverage to a more reasonable level resulting in significant savings over its current level.”<sup>75</sup> Indeed, DRA would have to apply that same conclusion to almost all plans its employees enjoy through the Civil Service.

At bottom, the potential that AVR’s health care plans might qualify as “Cadillac Plans” in 2018 – along with most large employers’ and the Civil Service’s plans – is a *non sequitur* that has no bearing on the reality AVR faces today and expects to face during the GRC cycle at issue here: ever increasing medical insurance costs that AVR actively manages to control.

## **2. Employee Benefits – 401(k) Expenses**

### **a. DRA and AVR Used Different Methodologies to Forecast Test Year 2012 401(k) Expenses.**

As an initial matter, DRA and AVR used different methodologies to forecast 401(k) expenses for Test Year 2012. AVR’s 401(k) estimate is based on its projected payroll, employee by employee, and applies the company-matching rate of 3% for only some of its employees to account for the fact that AVR anticipated some non-participating employees – seven for AVR and four for General Office. In contrast, DRA (erroneously) calculates a 2010 contribution rate

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<sup>73</sup> Ex. AVR-11 (Armstrong Rebuttal), at 11.

<sup>74</sup> Ex. AVR-11 (Armstrong Rebuttal), at 9-10.

<sup>75</sup> Ex. DRA-1 (DRA Report), at 4-14.

of 2.11% and 2.18% for AVR and General Office, respectively, and multiplies these rates by DRA's projected 2012 payroll.<sup>76</sup>

To reduce the potential confusion that could result from the parties using differing methodologies, in its rebuttal testimony (Martinet Rebuttal), AVR converts the results of its methodology to a contribution rate using the following formula:

$$\frac{401(k) \text{ expense}}{\text{Utility Payroll}} = \text{Contribution Rate}$$

The conversion of AVR's proposed 401(k) expense to a contribution rate, using this formula results in forecasted 401(k) expense estimate for 2012 of 2.50% and 2.70% for AVR and General Office, respectively.<sup>77</sup>

b. AVR's Proposed 401(k) Expenses Are Based On A Reasonable Expectation That Employee Participation Will Increase.

AVR's 401(k) expense estimate is based on a reasonable expectation that employees will increase their participation in the 401(k) plan (start or increase contributions). Recent information about trends in employees' activities relating to 401(k) plans supports AVR's assumption:

- A May 11, 2011 Reuters news article noted that "about 10 percent of plan participants increased their contribution to savings plans in the past quarter, while 3.2 percent cut their contributions. That marked a turnaround since the depths of the financial crisis in late 2008, when more people were cutting their contribution rate, a likely sign of households being under pressure from job losses."<sup>78</sup>
- A December 31, 2010 Bank of America/Merrill Lynch publication reported that for the 401(k) plans it manages: "Of all participants who took some type of savings action during Q4 2010, 543,340 (84%) took a positive action (started or increased contributions), versus 101,444 (16%) who took a negative action (stopped or decreased contributions)".<sup>79</sup>

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<sup>76</sup> Ex. AVR-8 (Martinet Rebuttal), at 22-23.

<sup>77</sup> Ex. AVR-8 (Martinet Rebuttal), at 23.

<sup>78</sup> Ex. AVR-8 (Martinet Rebuttal), at 23.

<sup>79</sup> Ex. AVR-8 (Martinet Rebuttal), at 23.

DRA contests the validity of AVR's forecasted 401(k) expense estimate and argues that the 2010 historic contribution rate it calculated (2.1%) be used to calculate AVR's 401(k) expense for Test Year 2012. DRA provides no justification for the adoption of its methodology – DRA simply notes that its methodology results in a lower expense estimate and concludes that its methodology is “preferred because it takes into account the 2010 historical contribution rate.”<sup>80</sup> DRA provides no explanation as to why it assumes – or why the Commission should assume – that the 2010 historical contribution is an accurate predictor of contribution rates for Test Year 2012. Given that the trend, as noted in the media and by financial institutions, is that employees are increasing their participation in 401(k) plans, AVR's estimate, which takes account of this trend, provides a more accurate and realistic projection of AVR's 401(k) expenses for Test Year 2012.

c. DRA's Computations Are Flawed.

As thoroughly detailed in the Rebuttal Testimony of Douglas Martinet, PWC's Chief Financial Officer, DRA's computations used to support its recommended 401(k) expense estimate suffer from a number of serious calculation errors and flaws.<sup>81</sup>

First, DRA's calculation of AVR's and General Office's 2010 contribution rates are wrong. In both cases, DRA uses the right numerator (recorded 401(k) expenses) but errs in calculating the correct denominator (utility payroll for AVR and General Office employees). For AVR, the correct denominator is \$2,895,656 but DRA overstates this by \$186,907. DRA includes \$110,347 of temporary labor payroll (not eligible for benefits) and \$188,194 of payroll charged to AVR from utility affiliates (who do not get benefits from AVR) while excluding \$111,634 of AVR payroll charged to capital jobs or the Irrigation system (which are used in calculating AVR benefits).<sup>82</sup> This results in the \$186,907 (\$110,347 + \$188,194 - \$111,634) overstatement. Correction of these errors results in a 2010 contribution rate for AVR of 2.25%,

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<sup>80</sup> Ex. DRA-1 (DRA Report), at 4-16.

<sup>81</sup> Ex. AVR-8 (Martinet Rebuttal), at 23-25.

<sup>82</sup> At the hearing, DRA's witness agreed that temporary labor payroll and payroll charged to AVR by its utility affiliates should not be included in payroll for the 401(k) expense calculation. (Tr., at 388-389, 393.)

which, coincidentally, is AVR's 5-year average.<sup>83</sup> For General Office, the correct denominator is \$4,430,517 but DRA overstates this by \$285,736 by including temporary labor of \$18,493 and \$267,243 in payroll for the President that is not charged to utility operations. Correction of these errors results in a 2010 contribution rate for General Office of 2.32%.<sup>84</sup>

Second, DRA errs in its treatment of the payroll of two existing General Office positions that DRA proposes to eliminate, neither of whom has ever been a plan participant. Thus, using the contribution rate times adopted payroll methodology provides an inaccurate result, as this incorrectly assumes an evenly weighted distribution of participants. This is best illustrated by an example. Assume that total 401(k) contributions historically have been \$10,000 based on participants' payroll of \$1,000,000. This would be a 1% contribution rate. Assume no changes to participants' payroll or staffing, except for the elimination of two non-participating positions with a payroll of \$200,000. DRA's method would result in matching contributions of 1% of \$800,000, or \$8,000. This would be wrong because AVR's 401(k) matching contribution would remain at \$10,000 as the pay of 401(k) participants is unchanged.<sup>85</sup> Thus, if DRA's methodology (rate x total adopted payroll) is used, the historic contribution rate for General Office has to be recalculated to exclude these two non-participating positions from the denominator. Correction for this error (and the error noted in the preceding paragraph) results in a 2010 contribution rate for General Office of 2.50%.<sup>86</sup>

d. AVR's Proposed Estimate Should Be Adopted.

For the reasons discussed, above, AVR's proposed estimate – based on and supported by trend data – should be adopted for 401(k) expenses for Test Year 2012. If the Commission were to disagree, however, AVR submits that a 5-year average is more likely to provide a reasonable

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<sup>83</sup> Ex. AVR-8 (Martinet Rebuttal), at 23, 24.

<sup>84</sup> Ex. AVR-8 (Martinet Rebuttal), at 24.

<sup>85</sup> Ex. AVR-8 (Martinet Rebuttal), at 24.

<sup>86</sup> Ex. AVR-8 (Martinet Rebuttal), at 25.

estimate than the 2010 1-year rate. The contribution rates for each of these possibilities (with DRA’s errors corrected) are summarized in the below table:<sup>87</sup>

<b><u>401(k) CONTRIBUTION RATES</u></b>			
	<u>AVR Proposal</u>	<u>5-Year Avg.</u>	<u>DRA Proposal</u>
AVR	2.50%	2.25%	2.25%
General Office	2.70%	2.60%	2.50%

Whichever set of rates the Commission adopts will need to be applied to total gross payroll for AVR and General Office employees to calculate the adopted 401(k) expense.

### **3. Employee Benefits – Group Pension**

AVR’s proposed group pension expense estimate for Test Year 2012 is based on projections prepared by AVR’s outside actuary, AON Consulting, which used a reasonable and supportable discount rate and expected rate of return. DRA’s objections regarding the discount rate and rate of return are unreasonable and unfounded and DRA’s proposed group pension expense estimate, based on flawed methodologies and calculation errors, should be rejected.

#### **a. DRA’s Use Of Escalation Factors Is Flawed.**

In proposing a significantly lower Test Year 2012 group pension expense estimate for AVR, DRA used an overly simplistic methodology that is flawed. DRA’s estimate is based on recorded 2010 pension expense, escalated to 2012 using labor escalation factors. The flaw here is that this methodology does not result in a useful or accurate estimate. Applying DRA’s methodology results in an estimate that is substantially lower than actual; if AVR’s 2006 recorded pension expense were escalated to 2010 using DRA’s escalation memo rates, the resulting estimate would be **21% less** than AVR’s actual 2010 pension expense.<sup>88</sup> There is simply no logical reason to use a methodology in this proceeding that – if used in prior proceedings – would have resulted in adopted expenses being under-estimated by more than 20%

<sup>87</sup> Ex. AVR-8 (Martinet Rebuttal), at 25.

<sup>88</sup> Ex. AVR-8 (Martinet Rebuttal), at 16.

when compared to recorded expenses. AVR's proposal, based on actuarial estimates, should be adopted, particularly since AVR inadvertently failed to adjust the actuarial estimates for changes associated with proposed new positions, which resulted in understated Test Year 2012 estimated pension expenses for AVR and General Office.<sup>89</sup>

A second flaw in DRA's methodology/calculation is that it used a slightly different methodology for General Office than for AVR. Although DRA starts with the same basic calculation for General Office that it did for AVR, DRA proceeded to multiply the result by 94.6% – apparently an adjustment for its lower payroll forecast for 2012 compared to 2011.<sup>90</sup> If DRA applied the same methodology for AVR, it should have made a corresponding adjustment to account for the increase in AVR payroll for 2012.<sup>91</sup> DRA's use of inconsistent methodologies for AVR and General Office is neither reasonable nor logical. The only result achieved by DRA's inconsistent methodologies is an unsupported lower pension expense estimate.

DRA's calculation of General Office pension expense suffers from the same flaw discussed above with respect to its methodology used for AVR – escalation of recorded 2010 expenses, using DRA's escalation memo rates, results in a significant under-estimation. DRA's payroll-related adjustment, however, is also flawed. First, the adjustment fails to consider the effect of ERISA caps. The current \$245,000 cap has been in place since 2009. Therefore, for employees with salaries that exceed this cap, any adjustment for pay in excess of \$245,000 is incorrect.<sup>92</sup> Second, DRA's payroll difference for General Office reflects DRA's exclusion of two employees (President and Assistant Secretary) who are not participants in the pension plan. Accordingly, DRA's estimating methodology for General Office is even more flawed than its estimate for AVR and should be rejected.<sup>93</sup>

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<sup>89</sup> Ex. AVR-8 (Martinet Rebuttal), at 17.

<sup>90</sup> Ex. DRA-1 (DRA Report), at 4-21.

<sup>91</sup> Ex. AVR-8 (Martinet Rebuttal), at 16-17.

<sup>92</sup> Ex. AVR-8 (Martinet Rebuttal), at 17.

<sup>93</sup> Ex. AVR-8 (Martinet Rebuttal), at 17.

b. AVR's Assumptions Reflected In Its Estimate Are Proper And Supported By Evidence.

DRA challenges two actuarial assumptions underlying AVR's pension expense estimate for Test Year 2012 – discount rate and rate of return – that differ from those used in AVR's actuarial consultant's report, prepared in 2010, for the pension fund's valuation as of January 1, 2010 (“2010 Pension Report”).

DRA first takes issue with AVR's use of a lower discount rate (5.25%) than the rate used in the 2010 Pension Report (5.75%). DRA provides no explanation, however, as to why AVR's use of a 5.25% discount rate in projecting Test Year 2012 expenses is improper.<sup>94</sup> AVR did not arbitrarily determine that the 5.25% rate was an appropriate assumption. To the contrary, AVR determined the appropriate discount rate based on prevailing market rates at the measurement date. On January 11, 2011, AVR's actuarial consultant advised that, based on then current rates, a rate of 5.50% or 5.25% would be a reasonable assumption and that a 5.75% rate was not supported by market data. In fact, in response to market data, AVR reduced the discount rate for its December 31, 2010 financial statements to 5.5%.<sup>95</sup>

DRA next questions the propriety of using the pension plan's average return over a 10-year period (2000-2009), approximately 3.65%, in calculating Test Year 2012 pension expenses. DRA's only basis for contesting AVR's use of this long-term average rate of return is that the 2010 Pension Report used a higher 5% rate of return.<sup>96</sup> The 5% expected rate of return assumption used in the 2010 Pension Report, however, was an assumption that had been used for some time without revision. Although the 5% figure was reasonably close to actual achieved returns in past years, the use of the 5% rate of return is no longer a reasonable assumption. The 5-year average rate of return on plan assets is 3.18%, which is lower than the approximate 3.65% 10-year average rate of return.<sup>97</sup> While AVR's use of the lower 5-year average would be

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<sup>94</sup> Ex. DRA-1 (DRA Report), at 4-17.

<sup>95</sup> Ex. AVR-8 (Martinet Rebuttal), at 18.

<sup>96</sup> Ex. DRA-1 (DRA Report), at 4-17.

<sup>97</sup> The pension plan's 10-year average rate of return for the 2000-2009 period was 3.67%. (Ex. AVR-8 (Martinet Rebuttal), at 18.)

justified, AVR opted to use the higher 10-year average because a longer period is likely to be more representative of future returns. Moreover, it is worth noting that the S&P 500 index for the same 10-year period had a *negative* return: **-0.95%**.<sup>98</sup> DRA does not and cannot dispute these objective, verifiable facts. Nevertheless, because the 10-year average rate of return results in a higher pension expense estimate, DRA argues against its use.

AVR's Test Year 2012 pension expense estimate is a reasonable projection based on market based discount rates and the pension plan's historical rate of return. In contrast, DRA's position is neither logical or reasonable nor supported by any evidence. Accordingly, AVR respectfully requests that the Commission reject DRA's contentions and adopt AVR's estimates. Further, while the parties disagree on which type of regulatory account (balancing or memorandum account) is appropriate to track pension plan costs (*see* Section IV.E.1., below), these costs can be tracked to ensure AVR does not get a windfall should the estimate be higher than actual expenses.

#### **4. Employee Benefits – EAP/Wellness**

DRA opposes proposed increases in AVR and General Office Wellness Program budgets based solely on the speculative assertion that the additional proposed amounts “may not be prudently spent.”<sup>99</sup> DRA's position is curious given its unfounded and unsupportable assertion that “DRA believes that AVR can exercise a much greater level of control over the growth of its medical insurance costs...”<sup>100</sup> A Wellness Program is an investment designed to do exactly what DRA advocates – controlling medical costs.<sup>101</sup> AVR's proposed Wellness Program budget, which is relatively nominal (\$4,800 for AVR and \$6,700 for General Office),<sup>102</sup> is an appropriate and prudent investment in AVR's on-going efforts to contain medical costs. DRA's unsupported

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<sup>98</sup> Ex. AVR-8 (Martinet Rebuttal), at 18.

<sup>99</sup> Ex. DRA-1 (DRA Report), at 4-19.

<sup>100</sup> Ex. DRA-1 (DRA Report), at 4-14.

<sup>101</sup> Ex. AVR-11 (Armstrong Rebuttal), at 12-13.

<sup>102</sup> Joint Comparison Exhibit Re Settlement, at 36.

objection notwithstanding, AVR requests that the Commission authorize AVR's proposed Wellness Program budget.

**C. Regulatory Accounts**

**1. Regulatory Accounts – Pension Balancing Account**

DRA and AVR agree that differences between recorded and adopted pension expenses be tracked via a regulatory account, but disagree as to the type of regulatory account to be established. AVR requests that the Commission authorize a new balancing account whereas DRA proposes a memorandum account.

AVR seeks a balancing account due to volatile market conditions that are outside of AVR's control. The recorded amounts are determined by AVR's outside actuary in accordance with applicable accounting standards.<sup>103</sup> AVR is seeking similar treatment previously afforded to other water and energy utilities regulated by the Commission, 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). In D.10-11-035, the Commission approved a pension balancing account for Golden State Water Company over the objections of DRA and, in doing so, noted its rationale:

Establishment of a two-way balancing account will provide a means for Golden State to control the volatility of its pension costs. Moreover, in recent years, we have approved and adopted pension and benefit balancing accounts for California-American Water Company and San Jose Water Company, as well as PG&E and SCE. We have also recently issued a proposed decision adopting a similar mechanism for California Water Services. Since these utilities all compete in the same market for capital, denying Golden State's request could place it at a disadvantage.<sup>104</sup>

The Commission's stated rationale applies equally to AVR, which is a Class A water utility like Golden State Water Company, California Water Service Company, San Jose Water Company, and California American Water. Given Commission precedent in authorizing the use of pension balancing accounts, including by AVR's water utility peers, AVR's request should be granted.

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<sup>103</sup> Ex. AVR-1 (AVR Report), at 101-102.

<sup>104</sup> D.10-11-035, at 36.

a. There Is No Merit To DRA’s “Prudency” Concerns.

As discussed above at Section IV.B.3.b., AVR’s discount rate and expected return on assets assumptions are reasonable, appropriate, and amply supported by evidence. Nevertheless, DRA opposes AVR’s proposed balancing account based on purported concerns “about the prudency of AVR’s management of its Pension Plan Assets” – implying that AVR has been somehow imprudent in managing plan assets or will, in the future, mismanage the investments.<sup>105</sup> There is simply no basis for DRA’s asserted concerns about the “prudency” of AVR’s management of its pension plan assets. DRA’s *preference* that AVR adopt a more aggressive investment strategy does not render AVR’s investment strategy imprudent.

AVR has made a conscious decision to protect its employees’ pension plan funds by applying a conservative investment strategy that seeks long-term, steady growth that minimizes volatility. In some years, AVR’s long-term strategy of investing plan assets in fixed return investments results in lower returns than other investment strategies. In other years, however, AVR’s investment strategy provides greater returns. AVR has opted to exercise its fiduciary obligations to its plan participants by foregoing potential higher returns and associated volatility in exchange for stable, long-term growth.<sup>106</sup> There is nothing imprudent about this investment strategy.

The prudence of AVR’s investment strategy is effectively demonstrated by a comparison of AVR’s pension plan’s 10-year average rate of return with that of the S&P 500 index during the 2000-2009 period. During this period, AVR’s conservative investment strategy resulted in a positive 3.67% rate of return while the S&P 500 index provided a **-0.95%** rate of return.<sup>107</sup>

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<sup>105</sup> Ex. DRA-1 (DRA Report), at 13-2.

<sup>106</sup> Ex. AVR-8 (Martinet Rebuttal), at 19-20.

<sup>107</sup> Ex. AVR-8 (Martinet Rebuttal), at 19-20.

Given that AVR's rate of return was **4.62% better** than the S&P 500, there is no reasonable basis for any concern that AVR has, or will in the future, mismanage the investment of the plan assets.

At the hearing in this proceeding, DRA sought to downplay this stark difference in performance by pointing to rates of return for various mutual funds offered by Vanguard, as of May 31, 2011.<sup>108</sup> DRA's exhibit, Exhibit DRA-6 (Vanguard Funds), illustrates the very volatility that AVR's investment strategy seeks to avoid. Whereas the S&P 500 index's average annual return for the 2000-2009 period (January 1, 2000 to December 31, 2009) was -0.95%, the S&P 500's 10-year average, as of May 31, 2011, had increased to 3.86% – a swing of nearly 5% in less than 18 months.<sup>109</sup> This volatility is also reflected graphically in Exhibit DRA-5, which shows the dramatic ups and downs of the S&P 500 index during recent years: from a high of 1,522.97 in mid-2007 to a low of 682.55 in early 2009 – a drop of more than 55% over an approximately 18 month period.<sup>110</sup> AVR does not have the appetite for risk to digest such wildly volatile markets and chooses not to expose its employees' pension funds to such volatility. As the Commission is no doubt aware, 2011 has been another volatile year for the financial markets – as PWC's Chief Financial Officer has testified, 2011 “has been wildly volatile, high ups and then crashing back down.”<sup>111</sup>

Moreover, DRA's prudence argument and recommended investment strategy is troubling on a number of fronts. First, notwithstanding AVR's 10-year performance track record, which out-performed the S&P 500 by 4.62%, DRA recommends that the Commission incentivize AVR to pursue unidentified “alternative investments” that, in DRA's opinion, would “earn significantly more” than the plan has earned historically.<sup>112</sup> This contention brings to mind the classic Aesop fable, “The Tortoise and the Hare.” DRA posits that AVR should behave less Tortoise-like and more Hare-like – that AVR should take more risks in investing its employees'

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<sup>108</sup> Ex. DRA-6 (Vanguard Funds); Tr., at 199-200, 205-207, 212-213, 215-217.

<sup>109</sup> Ex. DRA-6 (Vanguard Funds), at page 3.

<sup>110</sup> Ex. DRA-5 (S&P 500 Index Chart).

<sup>111</sup> Tr., at 219.

<sup>112</sup> Ex. DRA-1 (DRA Report), at 4-18.

pension funds in the hopes of potentially higher returns. AVR respectfully declines DRA's investment advice. AVR's investment strategy is an appropriate strategy that has resulted in the steady growth of plan assets and has protected exposing plan assets from the wild market volatility that has been the norm since 2008. Such volatility continues today and the Commission should not, as DRA proposes, incentivize AVR to deviate from its long-term investment strategy, which has protected plan assets over many years, by taking on more risk. In fact, AVR questions whether the Commission has any interest in providing "investment advice" to the utilities it regulates. DRA's attempt to thrust the Commission into that role seems misguided.

Second, DRA's recommendation for a memorandum account would require after-the-fact determinations as to the prudence of a particular investment strategy. As the Commission has no objective test for the prudence of pension plan investment decisions, AVR has serious concerns that DRA will engage in "Monday morning quarterbacking" as to AVR's investment decisions, creating more regulatory workload for the Commission, Division of Water & Audits ("DWA"), and AVR. Even more troubling is that DRA's recommendation would potentially place the Commission in the untenable position of setting investment strategies for utilities' pension plans by making after-the-fact determinations as to whether a particular investment strategy, based on the corresponding returns, had or had not been prudent.

AVR's proposed Pension Balancing Account, similar to those the Commission has already approved for other Class A water utilities, is the more appropriate tracking mechanism for pension expenses. A balancing account will allow for ministerial review by DWA instead of creating additional and unnecessary workload associated with a memorandum account and, importantly, would obviate the need for after-the-fact determinations as to the prudence of particular investment strategies. Accordingly, AVR respectfully requests that the Commission authorize AVR's proposed Pension Balancing Account.

## 2. Regulatory Accounts – Pressure Reducing Valve Memorandum Account.

AVR requests that the Commission authorize a new memorandum account that covers the unknown costs associated with the research, development and demonstration of Pressure Reducing Valve (“PRV”) modernization technology. AVR seeks to investigate the possibility of recovering wasted electrical energy while at the same time optimizing water system pressures and the flow of water in the distribution system through the use of modern electrical regenerative flow control valve technology.<sup>113</sup> In Resolution W-4854, the Commission authorized a similar memorandum account for San Jose Water Company, Golden State Water Company, California American Water Company and California Water Service Company.

DRA opposes the proposed memorandum account, arguing that AVR must demonstrate the cost-effectiveness of the PRV modernization project and that AVR “must be able to guarantee that all future costs that AVR requests for recovery are reasonably and prudently incurred before the Commission can authorize their recovery.”<sup>114</sup> DRA is wrong.

First, there is no requirement that AVR demonstrate the cost-effectiveness of the PRV modernization project. As the Commission noted in Resolution W-4854: “Although the Commission has described cost-effectiveness requirements for an entire portfolio of ratepayer-funded energy efficiency activities and programs, it has explained that *individual programs need not pass tests of cost-effectiveness in order to be eligible for funding.*”<sup>115</sup>

Second, there is no requirement that AVR demonstrate that the PRV modernization project will succeed. As the Commission has noted, “it would be unreasonable to require proponents of RD&D projects to provide a guarantee that proposed projects will succeed.”<sup>116</sup>

Third, the Commission’s authorization of a new memorandum account does not guarantee AVR’s recovery of the expenses or capital expenditures to be booked to the

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<sup>113</sup> Ex. AVR-7 (Jackson Rebuttal), at 29; Ex. AVR-1 (AVR Report), at 103.

<sup>114</sup> Ex. DRA-1 (DRA Report), at 13-10.

<sup>115</sup> R. W-4854, at 18 (¶ 26) (emphasis added).

<sup>116</sup> R. W-4854, at 18 (¶ 27).

memorandum account. Although AVR will need to establish the reasonableness of expenses charged to the memorandum account when it seeks reimbursement of such expenses, it need not do so now in seeking approval of the memorandum account.

AVR is not seeking current recovery or pre-approval of recovery for its proposed PRV modernization project expenditures. AVR merely seeks authorization to establish the memorandum account and record project expenses and the ability to seek reimbursement at a later time for expenditures established as reasonable. AVR seeks to be proactive in evaluating emerging technologies that could result in the recovery of energy through the use of modern electrical regenerative flow control valve technology; savings in energy costs will be tracked in the MCBA and would flow through to benefit ratepayers. Accordingly, AVR requests approval to establish the PRV Modernization Memorandum Account.

**D. Escalation Year Methodology – Employee and Retiree Health care Expenses**

As discussed above in Section IV.B.1., annual health care cost increases have risen significantly. Based on projections prepared by AVR's actuarial consultant, AON Consulting, medical insurance costs are projected to rise 7.5% and 6.5% in 2013 and 2014, respectively, while dental insurance costs will rise 5.25% and 5.0% in 2013 and 2014, respectively.<sup>117</sup>

For escalation years 2013 and 2014, AVR proposes that the Commission adopt specific employee and retiree health care expense amounts based on actuarial medical cost trend projections instead of the default escalation year methodology that uses CPI-U escalation factors. AVR's proposal is based on the fact that projected annual increases in health care costs for the escalation years (as well as Test Year 2012) are significantly higher than the CPI-U escalation factors for 2013 and 2014.<sup>118</sup>

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<sup>117</sup> Ex. AVR-7 (Jackson Rebuttal), at 29.

<sup>118</sup> The CPI-U escalation rates are those from the memorandum published by DRA for May 31, 2011, which the Parties agreed to apply for all expense estimates that are subject to the use of escalation factors. *See* Joint Comparison Exhibit Re Settlement, at 5. If the Commission does not adopt AVR's proposal, the actual CPI-U rates that would be used for escalation years 2013 and 2014 would be determined in November of 2012 and 2013, respectively.

<b><u>ESCALATION RATE DIFFERENCE – MEDICAL</u></b>			
<b><u>Year</u></b>	<b><u>AON Projection</u></b>	<b><u>CPI-U</u></b>	<b><u>Difference</u></b>
2013	7.5%	1.8%	5.7%
2014	6.5%	2.0%	4.5%

<b><u>ESCALATION RATE DIFFERENCE – DENTAL</u></b>			
<b><u>Year</u></b>	<b><u>AON Projection</u></b>	<b><u>CPI-U</u></b>	<b><u>Difference</u></b>
2013	5.25%	1.8%	3.45%
2014	5%	2.0%	3.0%

The difference in AVR's and DRA's proposed escalation methodologies for the escalation years, in terms of real dollars, is significant – \$173,600 for 2013 and \$231,900 in 2014, a total of more than \$405,000 in projected health care cost increases that AVR will be unable to recover in rates:<sup>119</sup>

<b><u>ESCALATION RATE DIFFERENCE (\$) – 2013</u></b>				
<b><u>Type</u></b>		<b><u>AVR</u></b>	<b><u>DRA</u></b>	<b><u>Difference</u></b>
<b>AVR</b>				
	Medical (Employee)	\$600,400	\$487,200	\$113,200
	Dental (Employee)	\$43,300	\$37,400	\$5,900
	Retiree (PBOP)	\$184,700	\$176,100	\$8,600
<b>General Office</b>				
	Medical (Employee)	\$390,400	\$352,900	\$37,500
	Dental (Employee)	\$27,700	\$26,300	\$1,400
	Retiree (PBOP)	\$150,900	\$143,900	\$7,000
<b>Total – 2013</b>		<b>\$1,397,400</b>	<b>\$1,223,800</b>	<b>\$173,600</b>

<sup>119</sup> The amounts reflected in the below table are taken from Joint Comparison Exhibit Re Settlement (at 37-38). AVR's and DRA's proposed estimates for 2013 and 2014 are based on AVR's and DRA's respective estimates for Test Year 2012 which use different employee projections and escalation rates for Test Year 2012 and escalation years 2013, and 2014.

<b><u>ESCALATION RATE DIFFERENCE (\$) – 2014</u></b>				
<b><u>Type</u></b>		<b><u>AVR</u></b>	<b><u>DRA</u></b>	<b><u>Difference</u></b>
<b>AVR</b>				
	Medical (Employee)	\$639,400	\$499,500	\$139,900
	Dental (Employee)	\$45,400	\$38,400	\$7,000
	Retiree (PBOP)	\$196,500	\$180,500	\$16,000
<b>General Office</b>				
	Medical (Employee)	\$415,800	\$361,800	\$54,000
	Dental (Employee)	\$29,000	\$27,000	\$2,000
	Retiree (PBOP)	\$160,500	\$147,500	\$13,000
<b>Total – 2014</b>		<b>\$1,486,600</b>	<b>\$1,254,700</b>	<b>\$231,900</b>

AVR’s proposal is consistent with the treatment previously afforded to California Water Service Company in D.10-12-017. The settlement adopted in D.10-12-017 excluded employee health insurance and retiree health insurance from escalation and instead adopted a three-year budget for these costs.

DRA opposes AVR’s recommended methodology to adopt specific estimates for retiree and employee health care costs. DRA, however, has provided no evidence or any explanation for its objection, which is not surprising given that DRA misunderstood AVR’s proposal.<sup>120</sup> AVR respectfully submits that an actuarial medical cost trend projection provides better and more realistic escalation factors than the standard CPI-U escalation factors. So that expected but unavoidable increased health care costs for escalation years 2013 and 2014 can be recovered, AVR recommends that employee and retiree health care expense be removed from the escalation methodology for AVR’s 2013 and 2014 escalation year filings. In lieu of escalation, AVR recommends that its specific employee and retiree health care expense estimates reflected in the

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<sup>120</sup> Tr., at 358.

tables above (and in the Joint Comparison Exhibit Re Settlement) be used in AVR's 2013 and 2014 escalation year filings.<sup>121</sup>

**E. Office Expansion**

In this proceeding, AVR has requested Commission approval of \$702,000 in expenditures for its 2,300 square feet office expansion project. In its Application, AVR estimated that it will spend \$21,000 in 2011 on a master plan, \$320,000 in construction costs in each of 2012 and 2013, and an additional \$31,000 for new furniture and equipment in 2013.<sup>122</sup> DRA opposes AVR's request for two separate reasons: (1) the "inadequate delineation and support of need"; and (2) AVR's outdated cost estimates for the project.<sup>123</sup> AVR has acknowledged that its data supporting its office expansion request "was not well prepared", that the design was not finalized, and that the cost estimates for the project are based on 2006 data.<sup>124</sup> Richard Dalton, PWC's chief engineer, provided testimony in this proceeding, however, that (1) it is not unusual to not have a final design for a project at this stage of the process;<sup>125</sup> and (2) the cost estimates in AVR's Application for this project are probably low, if anything, as certain essential project items, such as the cost of architectural/engineering design for final construction plans and seismic and sewer connections, had not been considered by AVR when preparing the estimates for the project included in AVR's application.<sup>126</sup>

AVR does not believe, however, that questions regarding the sufficiency of data supporting its cost estimates should affect the question of its need for additional space. Therefore, AVR takes issue with DRA's unsubstantiated conclusion that AVR has failed to demonstrate the need for the proposed modest expansion of its office space. Additional space is not only needed, but required by AVR, for its efficient future operations and growth and to comply with applicable California Building Code (the "Code") egress occupancy space

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<sup>121</sup> Joint Comparison Exhibit Re Settlement, at 37-38.

<sup>122</sup> Ex. DRA-1 (DRA Report), at 7-10, Table 7G.

<sup>123</sup> Ex. DRA-1 (DRA Report), at 7-10 (emphasis supplied), 7-12.

<sup>124</sup> Ex. AVR-13 (Dalton Rebuttal), at 18.

<sup>125</sup> Tr., at 344-345.

<sup>126</sup> Tr., at 344; Ex. AVR-13 (Dalton Rebuttal), at 18.

requirements (24 C.C.R. § 1010, *et seq.*), which are currently violated by AVR according to the Apple Valley Fire Protection District (“AVFPD”).

**1. Evidence of Need for Office Expansion Project.**

AVR’s demonstrated need for its office expansion project is based on the following facts which have not been refuted or (except for the last bullet point) challenged by DRA:

- AVR’s main office building was built in 1964, when AVR had approximately 2,000 customers, and originally contained both office and warehouse space.<sup>127</sup>
- AVR currently has approximately 19,000 customers and the number of AVR’s employees has increased significantly since that time.<sup>128</sup>
- Over the years, the original office building was modified to convert warehouse space into additional offices and meeting space and an additional warehouse building was constructed.<sup>129</sup>
- Over more recent years, all meeting space in the original building has been converted to office space and portions of the warehouse building and its adjacent training center (office trailer), which is AVR’s sole remaining meeting space/conference room, have been converted to office space.<sup>130</sup>
- AVR has been forced to move: (1) its field maintenance department and the field dispatcher to its adjacent World War II Quonset hut, (2) its meter readers and safety coordinator into its warehouse building, and (3) its GIS and fixed asset departments into the training center, thereby reducing the space in AVR’s sole remaining conference room.<sup>131</sup>
- 26 employees require desk space in the main office building which contains 2054 square feet of usable space (excluding hallways, restrooms, server rooms, etc.)<sup>132</sup>

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<sup>127</sup> Ex. AVR-13 (Dalton Rebuttal), at 17; Ex. DRA-11 (May 10, 2011 Partial Response to PPM-5), at 1; Tr., at 302.

<sup>128</sup> Ex. DRA-11 (May 10, 2011 Partial Response to PPM-5), at 1-2; Tr., at 302.

<sup>129</sup> Ex. AVR-13 (Dalton Rebuttal), at 17; Ex. DRA-11, at 2.

<sup>130</sup> Ex. AVR-13 (Dalton Rebuttal), at 17-18; Ex. DRA-11, at 2.

<sup>131</sup> Ex. AVR-13 (Dalton Rebuttal), at 17-18.

<sup>132</sup> Ex. AVR-1 (AVR Report), at 67.

- AVR's main office building occupancy currently violates the Code according to the AVFPD.<sup>133</sup>

AVR's proposed office expansion would add 2300 square feet to the north portion of its existing main office building consisting of approximately 1000 square feet of office space and 1300 square feet of meeting area.<sup>134</sup> Mr. Dalton testified that the major reason for the proposed office expansion is AVR's need for additional space for employees (both office and meeting) in conducting its day to day operations, stating that AVR has "no room for another body to be added in our existing building and we are drastically in need of meeting space".<sup>135</sup> Mr. Dalton further testified that it is that issue, rather than the Code issue, which is the "primary" reason for the office expansion.<sup>136</sup> AVR is out of room now and the situation will only become worse as AVR continues to grow and add employees.<sup>137</sup> Constructing additional office and meeting space during the next rate cycle is a necessity for AVR, not an option. AVR submits that no other California Class A water company operates in such outdated and undersized facilities as those currently occupied by AVR. Photos of these facilities introduced into evidence at the hearing speak for themselves as to their inadequacy.<sup>138</sup>

## **2. Compliance with Code**

AVR's secondary reason for requesting Commission authorization to add 2300 square feet to its existing facilities is the applicable Code requirements which mandate 100 minimum square feet of space per employee.<sup>139</sup> AVR's main office building currently has offices for 26 employees and usable office space, as calculated by the AVFPD, of 2,054 square feet. After AVR had filed its Application, the AVFPD informed AVR's General Manager that AVR is currently not in compliance with Section 1004, "Occupant Load", of Chapter 10, "Means of

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<sup>133</sup> Ex. AVR-13 (Dalton Rebuttal), at 17.

<sup>134</sup> Tr., at 343.

<sup>135</sup> Tr., at 343-344.

<sup>136</sup> Tr., at 347.

<sup>137</sup> Ex. AVR-1 (AVR Report), at 67; Tr., at 278-279.

<sup>138</sup> Ex. AVR-15 (AVR Office Photos).

<sup>139</sup> Ex. AVR-13 (Dalton Rebuttal), at 17.

Egress” of the Code because it does not meet the required 100 square feet usable space per employee minimum in its main office building as that Section is interpreted by the AVFPD.<sup>140</sup>

At hearing, DRA’s counsel spent a substantial amount of time seeking to establish that the AVFPD is incorrectly interpreting the Code by excluding hallways and common areas, rather than including them when calculating the building’s total usable space per employee.<sup>141</sup> AVR testified, however, and had previously furnished DRA information in response to a Data Request, that AVR’s General Manager, Scott Weldy, had specifically asked the AVFPD fire chief whether common areas of AVR’s building were to be included or excluded in calculating the 100 square foot minimum space requirement per employee and that the fire chief had advised Mr. Weldy that the common space must be excluded from the calculations.<sup>142</sup> As the AVFPD has the authority to enforce the Code and cite AVR for Code violations, AVR views AVFPD’s interpretation as definitive for its office space planning purposes.<sup>143</sup>

AVR has provided DRA contact information for the Fire Protection District chief for DRA to verify the methodology used by AVFPD in determining compliance with the Code’s 100 square feet per person occupancy requirement. DRA elected, however, not to follow up with AVFPD.<sup>144</sup>

AVR’s current schedule calls for beginning the project in 2012 and completing it in 2013. Mr. Dalton testified as to the many steps that AVR will need to take in order to complete the project in that timeframe.<sup>145</sup> AVR cannot afford to delay expanding its office until 2014, the test year for its next rate case; its immediate needs for additional space are just too great.

### **3. Option of Leasing Office Space**

AVR submits that, based on the evidence, the Commission should conclude that it is appropriate for AVR to begin and complete the office expansion project as proposed by AVR

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<sup>140</sup> Tr., at 277-278.

<sup>141</sup> Tr., at 330-334, 346-352.

<sup>142</sup> Tr., at 277; Ex. DRA-11 (May 10, 2011 Partial Response to PPM-5), at 2.

<sup>143</sup> Tr., at 277, 342.

<sup>144</sup> Tr., at 302.

<sup>145</sup> Tr., at 335-338.

and further conclude that AVR's estimates of the cost of the office expansion are sufficiently reasonable to include in ratebase. If, however, the Commission finds that AVR's design of the project is insufficiently detailed or definite, or that its cost estimates are insufficiently current or accurate, to allow AVR's proposed plant additions for this project to be adopted, AVR submits that the evidence in this proceeding demonstrating the need for additional space is sufficiently compelling as to require that the issue be addressed in some fashion in this proceeding.

One option, as an alternative in this proceeding to authorizing the office expansion, would be to provide AVR with an expense allowance to lease office space. DRA proposed in its report "assuming additional office space is needed, AVR should at least consider leasing office space as an alternative to expanding its office building".<sup>146</sup> Neither AVR nor DRA proposed any estimate of the cost of leasing office space in this proceeding but it cannot reasonably be assumed that the cost to lease office space to address AVR's needs would not be less than \$1,500 to \$2,000 per month (\$18,000 - \$24,000 per year). Since neither party proposed that AVR lease office space, neither party made any allowance in its estimates for this expense, and the Commission would need to add it to the expenses otherwise adopted for AVR. AVR considers leasing office space to be, at best, a short-term solution to a long-term problem. However, it would allow AVR to address its immediate and pressing space problem in this rate case cycle and take the time before the next GRC to refine the design and cost estimates for its office building Project.

**F. Carlyle Transaction Contingency**

Currently pending before the Commission is the application of PWC (and AVR and Western Water Holdings) seeking approval for the transfer of ownership of PWC stock to Western Water Holdings, an entity ultimately owned by Carlyle Infrastructure Partners (the "Carlyle Transaction" or the "Transaction"), A.11-01-019 (the "Transfer Proceeding"). The application in this GRC proceeding did not presume the approval of the application in the Transfer Proceeding or attempt to incorporate any cost impacts resulting from the Carlyle

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<sup>146</sup> Ex. DRA-1 (DRA Report), at 7-13, 21-22.

Transaction. In response to data requests, AVR identified a number of expense changes that would result from that transfer – cost reductions in payroll expenses and benefits due to the retirement of the current President/CEO and Assistant Secretary (both current stockholders) and increases to Directors’ Fees and Consulting Fees, with the net cumulative impact of all the changes being a reduction in General Office expenses.<sup>147</sup>

DRA and AVR have reached agreement on the impacts of the Carlyle Transaction on the General Office expenses for 2012 – 2014 (*see* Settlement Agreement, § 16.02.16 (Carlyle Transaction)), and those impacts have been incorporated in Resolved Issues numbers 42-45 (*id.*, at 20-21) and the expense and Summary of Earnings tables of the Joint Comparison Exhibit Re Settlement. The parties to the Settlement Agreement (the “Parties”) do not agree, however, on the appropriate way to deal with the contingency that the Transaction will not close by January 1, 2012.

The transaction closing date is currently unknown, as the closing is contingent on several conditions being met, including, among others, that the Transaction receive required state and federal regulatory approvals, that no material adverse change shall have occurred in PWC’s business, assets or operations between December 21, 2010 (the date the Merger Agreement was executed) and the closing, as well as several other conditions. *See* §§ 8.1 and 8.2 of the Merger Agreement for a full listing of conditions to closing. AVR proposes that the Commission address this contingency. DRA proposes the Commission not take any action because the Parties have executed a Settlement Agreement in the Transfer Proceeding.

DRA’s position implies that, because PWC, AVR, Western Water, and DRA have filed a Settlement with the Commission in the Transfer Proceeding, the Transaction is essentially completed. AVR hopes that all conditions to the closing will be met so that the Transaction can be completed by the end of this year, but, as of now, there is no certainty this will occur. The Transfer Proceeding is not an all-party settlement – the Town of Apple Valley, the School District, and several others have opposed the Commission’s adoption of A.11-01-019 throughout

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<sup>147</sup> Ex. AVR-14 (Jordan Rebuttal), at 7.

that proceeding and, even though a number of them participated in the settlement discussions, they did not join in the Settlement. Even if the Settlement was an all-party settlement, the Commission is not bound by it and the Parties cannot simply presume that the Commission will adopt it. While that proceeding has been taken under submission, no Proposed Decision has yet been issued. Even when a Proposed Decision is issued, there is no way of knowing to what extent comments filed by parties, possible ex parte communications, and/or differences of opinions among Commissioners may delay the issuance of a final decision – assuming that the final decision adopts the Settlement, or at least approves the Transaction upon conditions that are acceptable to the applicants in the Transfer Proceeding. The Transaction will not close until all satisfactory regulatory approvals have been obtained and all other conditions to closing have been met.

The impacts of the Carlyle Transaction on the General Office Expenses for 2012 – 2014 are reductions and increases – a net reduction – to various General Office expenses due to changes in PWC’s executive and Board personnel that will result from the Transaction. Unless and until the Transaction closes, however, neither the personnel changes nor the net reduction in General Office expense will occur.

DRA argued in its report that the elimination of cost due to the President and Assistant secretary leaving the Company will occur regardless of the Transaction, but AVR’s response to DRA’s data requests clearly states that there is no plan, if the Carlyle Transaction does not close, for the President (Mr. Wheeler), or the Assistant Secretary, to step down within this rate cycle.<sup>148</sup> DRA also suggested it would propose a ratemaking adjustment, presumably to reduce or eliminate Mr. Wheeler’s salary, even absent the Transaction, stating “...and DRA will not support the dual CEO’s salaries.”<sup>149</sup> However, despite the fact that Mr. Schilling and Mr. Wheeler now share Co-CEO responsibilities, they do not share all functions and one is not simply redundant to the other; Mr. Wheeler is also President and Chairman of the Board, titles

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<sup>148</sup> Ex. AVR-14 (Jordan Rebuttal), at 8-9.

<sup>149</sup> Ex. DRA-1 (DRA Report), at 11-14.

and functions not shared with Mr. Schilling. Ignoring the nomenclature, it is not unusual to have two executives filling the functions of CEO, President, and Chairman of the Board. In addition, DRA's suggestion ignores Mr. Wheeler's vast reservoir of knowledge and expertise, both generally and specifically to PWC and AVR, that is unique and impossible to replace or duplicate.<sup>150</sup> As it is, almost half of Mr. Wheeler's salary is booked as non-utility expense and the remaining ratemaking salary is modest for his position.<sup>151</sup> There is no basis to presume that the costs eliminated as a result of the Carlyle Transaction would be eliminated absent the completion of the Carlyle Transaction, either in actuality or as a ratemaking adjustment.

The net reduction to PWC General Office expense resulting from impacts of the Carlyle Transaction is significant. Netting out the reductions and increases in the various expenses reduces annual expenses by over \$200,000.<sup>152</sup> If the Transaction does not close by January 1, 2012, there will be over \$200,000 of annual General Office expenses, which are reasonable and necessary, which would not be provided for in this proceeding and which will not be eliminated unless and until the Transaction closes. AVR submits that a post-2011 closing or the possibility that, for whatever reason, the Transaction is terminated are contingencies that the Commission should address and provide for in this proceeding.

AVR recommends that the most efficient way for the Commission to address this contingency is to authorize a memorandum account. Therefore, AVR proposes that the Commission adopt a "Stock Transfer Expense Impact Memorandum Account", to be effective January 1, 2012. This memorandum account would terminate at the closing of the Transaction; if the Transaction closes prior to January 1, 2012, this memorandum account would never become effective. The memorandum account will track the differences between the expenses agreed to in the Settlement for PWC's General Office Expense in this GRC proceeding and those proposed by AVR in A.11-01-001 in the expense categories impacted by the Transaction (these are the only estimates in the record for those expense categories without the impact of the

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<sup>150</sup> Ex. AVR-14 (Jordan Rebuttal), at 9-10.

<sup>151</sup> See PWC 2010 General Order 77-M Report.

<sup>152</sup> Joint Comparison Exhibit Re Settlement, at 20-21; Settlement Agreement, § 16.02.16, at 48-49.

Carlyle Transaction). Prior to recovery, AVR would adjust the balance to incorporate the effect on its Application estimates of the impacted expense categories of all applicable issues (escalation factors, medical insurance premium increases, etc.) where the adopted estimates differ from AVR's application estimates. Recovery of the balance in the memorandum account would be requested in the next GRC that reviews PWC's General Office expenses, which as currently scheduled, would be AVR's next GRC. In that proceeding, DRA would have the opportunity to review the balance tracked in the memorandum account and make any recommendations it may consider appropriate regarding recovery or partial recovery of any or all of the balance.

**V. CONCLUSION**

For the foregoing reasons, AVR's recommendations with respect to the unresolved issues discussed above are reasonable, realistic, and supported by the evidence. AVR respectfully requests that the Commission adopt AVR's recommendations, which will allow AVR to continue to provide its customers with reliable water service at a reasonable cost.

Respectfully submitted,

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